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Income Tax Department

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Income Tax Department

EDITED BY JOHN B. NIVEN

The only change made in the amended article 1506, issued under T. D. 2943, is the exclusion of Virginia partnership associations from those, like Michigan partnership associations, mentioned in the next to last sentence as being uniformly treated as corporations.

The court decision under T. D. 2944, regarding deductibility of bond discount, has no relation to present conditions. It relates to the 1909 act only, under which the court ruled that the pro-rated instalments of discount on bonds sold were not deductible because they were neither interest nor a loss. Now, under regulations 45, such discount is deductible—and as interest. The subject is fully discussed in article 544, wherein the treatment is carefully and properly worked out for all conditions, whether the bonds are sold at par, at a discount or at a premium. If the bonds are sold at par, discount on the purchase is to be credited as income and premiums paid are to be deducted as expense all at once—that is, in the year when the purchase occurs. If bonds are sold at a premium or discount, the premium or discount is to be pro-rated over the life of the bonds, as income or expense, as the case may be, and only the difference between the premium or discount on retirement and the corresponding amount remaining unaccounted for as income or expense on the bonds purchased must be reported in the year when the bonds are repurchased.

TREASURY RULINGS

(T. D. 2943, Nov. 6, 1919.)

Income tax—Limited partnerships as a corporation.

Article 1506 of regulations 45 is hereby amended to read as follows:

Art. 1506. Limited partnership as corporation.—On the other hand, limited partnerships of the type of partnerships with limited liability or partnership associations authorized by the statutes of Pennsylvania and of a few other states are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members, providing for the transferability of partnership shares, and capable of holding real estate and bringing suit in the common name are more truly corporations than partnerships and must make returns of income and pay the tax as corporations. The income received by the members out of the earnings of such limited partnerships will be treated in their personal returns in the same manner as distributions on the stock of corporations. In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized. A Michigan partnership association is a corporation. Such a corporation may or may not be a personal service corporation. See sections 200 and 218 of the statute and articles 1523-1532.

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(T. D. 2944, Nov. 8, 1919.)

Income tax—Decision of court.

DEDUCTION UNDER SECTION 38, ACT OF AUGUST 5, 1909, OF DISCOUNT ON BONDS SOLD.

Where a corporation sold bonds at a discount during 1906, 1907, and 1908 no deduction from gross income for the years 1909, 1910, and 1911 of sums set aside by the corporation to pay such discount at the maturity of the bonds is permitted under the provisions of section 38, act of August 5, 1909, authorizing corporations to deduct from gross income "(second) all losses actually sustained within the year * * *" and "(third) interest actually paid within the year on its bonded or other indebtedness * * *."—*Baldwin Locomotive Works v. McCouch* (221 Fed., 59) explained.

The appended decision of the United States circuit court of appeals for the ninth circuit in the case of *Southern Pacific Railroad Co. v. Muenter* is published not as a ruling of the treasury department but for the information of internal-revenue officers and others concerned.

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

No. 3286 AND 3287, ——— TERM, 1919.

Southern Pacific Railroad Co., a corporation, plaintiff in error, v. August E. Muenter, formerly collector of internal revenue, et al., defendants in error.

(In error to the United States District Court for the Northern District of California.)

Before GILBERT, ROSS, and HUNT, circuit judges.

GILBERT, circuit judge: The court below sustained a demurrer to the complaint brought by the plaintiff in error to recover certain items of corporation income tax paid under protest upon its net income for the years 1909, 1910, and 1911. The complaint alleged that during the years 1906, 1907, 1908, the plaintiff in error borrowed various sums of money, and as security therefor issued and sold interest-bearing bonds of the par value of $1,000, drawing interest at 4 per cent. per annum, and maturing on the first day of January, 1955, which bonds it was necessary to sell at a discount. The amount involved in the action is the sum of $1,392.22, income tax upon reserved sums of money which the plaintiff in error had set aside as the pro rata amount of the discount for the years in question distributed over the entire period until the maturity of the bonds, the plaintiff in error contending that the discount is to be regarded as a portion of the interest which it pays upon the loans. The question presented is whether or not money so reserved and set aside by book entries to meet the final payment of the discount could be deducted from the net income of the corporation under the income tax law of 1909 (36 Stat., 102, sec. 38). That act, so far as it pertains to this question, provides that the net income upon which the tax is to be assessed is ascertained by deducting from the gross income (second) all losses actually sustained within the year and not compensated by insurance or otherwise, (third) interest actually paid within the year on its bonded or other indebtedness. The plaintiff in error refers to *Baldwin Locomotive Works v. McCoach* (215 Fed., 967), and the same case on appeal (221 Fed., 59), as sustaining its contention. In that case the bonds were 31-year bonds, and the assessor thought it proper to deduct one-thirty-first of the total discount from the gross income of each taxable year. The controverted question in the case, however, was whether or not

the corporation could deduct for the year 1910 the total discount upon the bonds which they had sold at 5 per cent. discount. The court held that a book charge because of the sale of an issue of bonds at less than par is not a part of the "expenses actually paid within the year out of income" so as to be deducted from gross income. There was no discussion of the question whether one-thirty-first part of the total discount deducted for the year had been deducted lawfully, as that deduction was not involved in the controversy. We think the present case is determined adversely to the plaintiff in error by the plain language of the statute. The money set apart upon the books each year until the maturity of the bonds to meet the loss which came from selling the bonds below par was the application of a prudent and proper system of business, and was a wise provision for the future, but it was not the payment of interest, nor did it represent a loss actually sustained within the year. The money was not in fact paid out. Notwithstanding the books of the plaintiff in error the money is still in its possession, and subject to its control. A system of bookkeeping will not justify the Government in claiming taxes, nor will it justify the taxpayer in claiming exemption from taxation. The facts must control. *Baldwin Locomotive Works v. McCoach* (221 Fed., 59); *Mitchell Bros. v. Doyle* (225 Fed., 437).

The judgment is affirmed.