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DEDUCTIONS FROM GROSS INCOME: PAYMENTS AND ACCRUALS DEDUCTIBLE AS "TAXES"

Robert Hanes Gray*

It has been frequently observed that the proper solution of many tax problems requires the application of economic and accounting principles as well as rules of law.[1] The use of such "non-legal" materials is particularly important when dealing with income tax questions.[2] Any statute which attempts to tax virtually every form of gain necessarily includes within the scope of its operation dissimilar businesses, trades, professions, and transactions having widely different margins of profit. Unless the burden of the tax is to be distributed in a capricious and arbitrary fashion these differences must be taken into account; the varied types of private revenue must be analyzed and the income carefully estimated and apportioned to the proper assessment period.[3] If this is not done, members of the same income group will be compelled to pay greatly disproportionate amounts to the government exacting the tax. From the viewpoint of equitable taxation it is imperative that the statute contain an accurate concept of income and a feasible means of ascertaining it.[4]

In an effort to reach a tax base appropriate for these heterogeneous sources of revenue the federal act starts with the taxpayer's *gross* income.[5] Since persons with the same *gross* income may have entirely different *net* incomes the injustice of a steeply graduated tax on the

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[1]For example, see Magill and Maguire, Cases on Taxation (3rd ed. 1940) v; Griswold, Cases and Materials on Federal Taxation (1940) vi; Brown, Book Review (1941) 90 U. of Pa. L. Rev. 238, 241.

[2]See Magill, Taxable Income (1936) 19, 20; Haig, The Concept of Income in Haig, The Federal Income Tax (1921) 3.

[3]In general, see Simonds, Personal Income Taxation (1938) 42 et seq.

[4]"The problem of income taxation is in essence the problem of finding norms which will be useful as measures of the "respective abilities" of the "diverse" taxpayers who constitute contemporary economic society." Wueller, Concepts of Taxable Income II: The American Contribution (1938) 53 Pol. Sci. Q. 557, 580.

[5]Int. Rev. Code § 22.

former amount is apparent; consequently Congress has provided for a number of deductions which are allowed when computing the amount subject to the tax.[6] Although this remainder is designated as "net income,"[7] it is evident that the appropriateness of the designation is determined by the exactness with which these deductions permit the reflection of the taxpayer's actual gain for the year. Inasmuch as the practical importance of such items as "business expense," "interest," "taxes," and "depreciation" will vary tremendously among the several taxpayers, an inadequate allowance for a particular expense will impose an indiscriminate burden upon those adversely affected thereby while an excessive deduction, in addition to depriving the federal government of revenue, relieves others of their fair share of the tax.

Among the many problems which arise in attempting to discover an equitable tax base, one of the most troublesome is that relating to the proper treatment of payments made by the taxpayer which are used for the support of the federal, state, and local governments. These payments may be made for a number of reasons and they may take a variety of forms. For example, in addition to the customary exactions of the tax collector, kindly disposed and appreciative citizens occasionally make voluntary contributions to the public treasury. Goods and services are frequently purchased from publicly owned enterprises which may be operated either as a monopoly or in competition with private business. The value of benefits received from public improvements and the cost of administrative action may be collected from the person whose property, business, or activity is directly affected thereby. Delinquents may be compelled to pay sums of money by way of punishment. These and similar payments help finance the activities of government. With the many possibilities of combination and overlapping, such exactions are variously described and are frequently misdescribed by taxpayers, courts, and legislatures.

The problem is further complicated by the fact that the immediate payer of the exaction is not the person, in many cases, who actually bears the burden of the "contribution" to the government. Such payments are frequently shifted. This shifting may be either forward or backward and the amount may be highly conjectural or easily dis-

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[6]Int. Rev. Code § 23. The subsections are as follows: (a) Expenses; (b) Interest; (c-d) Taxes; (e-j) Losses; (k) Bad Debts; (l-n) Depreciation and Depletion; (o, q) Contributions; (p) Pension Trusts; (r) Dividends Paid by Certain Banking Corporations; (s) Net Operating Loss.

[7]Int. Rev. Code § 21 (a) Definition—"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

cernible. In addition, many payments, both direct and indirect, are in the nature of personal expenditures while others are closely related to the taxpayer's trade or business—and the payments in the latter category may be either current expenses or capital charges. In all of these situations, what should determine whether the transaction in question is to be considered when computing the income tax liability of the taxpayer? With more than one-fifth of the national income being absorbed by some 175,000 federal, state, and local taxing units,[8] the manner in which this problem is solved will appreciably affect not only the fiscal adequacy of the income tax, but also its effectiveness in equitably distributing a large part of the national tax burden.

It may be argued that allowance should be made in the tax base for all payments which contribute to the support of government. Irrespective of whether the payment is made directly or indirectly, as long as the taxpayer is able to demonstrate the extent of his contribution to the public treasury his taxable income should be reduced by that amount. In addition to the advantage of avoiding the specious but prevalent objection to paying a "tax on a tax," this plan has the very real virtue of disregarding the purely formal distinctions resulting from the phrasing of a particular tax statute. Both the name given the exaction and the person upon whom it is technically imposed would be ignored; its incidence would determine its deductibility.

Another solution would be to treat payments to the various governments just as any other expenditure. If they represent expenses incident to the taxpayer's trade or business, those in the nature of a current expense would be deducted in the year paid or accrued while capital expenditures would be amortized over the appropriate years—assuming, of course, that the expenditure represents a recoverable capital charge. To thus limit the deduction to payments or accruals incurred in connection with the taxpayer's income producing activities offers a number of practical advantages. The difficulty of determining the incidence[9] of the tax is obviated; the productivity of the act as a revenue measure is greatly increased;[10] and the solution conforms with

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[8]16 Fortune Magazine (1937) 107; Moulton and Others, Capital, Expense, Employment, and Economic Stability (1940) 271; Shoup, Facing the Tax Problem (1937) 3.

[9]"This does not mean that it is impossible ever to be reasonably definite regarding the incidence of a particular tax, but it does imply that absolute assurance can seldom be attained. In this field modesty is a becoming virtue." Haig, Taxation, 14 Encyclopaedia of the Social Sciences (1934) 537.

[10]The deduction of taxes has been the largest of the several deductions permitted individual taxpayers and it has been steadily increasing in amount. Individuals

the general plan of the statute to ignore, for the purpose of ascertaining net income, the personal expenses of the taxpayer.[11]

The early federal income tax acts apparently accepted, in part, this second view. The first of such statutes, the Act of 1861, reflected a reluctance on the part of Congress to enumerate the various expenses which were to be considered in computing the tax. An unfamiliarity with the niceties of accurate income assessment and a justifiable fear that specific allowances would be abused by the taxpayers led to the policy of merely indicating the sources of income covered by the Act. The Secretary of the Treasury was expected to work out the method whereby the amount of such income would be ascertained. However, to this general plan there was one important exception. The statute expressly provided that "in estimating said income, all national, state, or local taxes assessed upon the property, *from which the income is derived,* shall be first deducted."[12] The Act of 1862,[13] which superseded the earlier law, and the Act of 1864[14] contained similar provisions. But in spite of the careful phrasing of the statute the Commissioner of Internal Revenue did not limit the deduction to taxes assessed upon property producing revenue subject to the federal income tax; instead, both the regulations and the forms failed to distinguish between taxes paid in connection with the income producing activities of the taxpayer and taxes which were of a personal nature.[15] Congress accepted this interpretation when the Act was amended in 1865 to permit the deduction of "*all* national, state, county, or municipal taxes paid within the year."[16] Broad statements of a similar nature were incorporated in the subsequent Civil War statutes[17] and the abortive Act of 1894.[18]

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deducted $541,191,000 for taxes in 1934 and $838,272,000 in 1937. U. S. Treasury Department: Statistics of Income for 1934 (1936) 9; U. S. Treasury Department: Statistics of Income for 1937 (1938) Part 1. Under the suggested solution the entire tax deduction would not, of coure, be eliminated. An important part of the above deduction represents business taxes. Presumably the much larger deduction of taxes by corporations ($2,161,892,000 for 1934; $3,665,565,000 for 1937, Statistics of Income, supra page 13, Part 2) would not be seriously affected.

[11]See Int. Rev. Code § 24.

[12]12 Stat. 292 § 49. Italics supplied.

[13]12 Stat. 432 § 91.

[14]13 Stat. 223 § 117.

[15]See Treasury Regulation, May 1, 1863, reprinted in Estee's Excise Tax Law (1863) 298, and the form of return reprinted at page 304.

[16]13 Stat. 469 § 117. Italics supplied.

[17]14 Stat. 471 (1867) § 117; 16 Stat. 256 (1870) § 9.

[18]28 Stat. 509 (1894) § 32. The Act was declared unconstitutional by Pollock v. Farmers' Loan & Trust Co., 157 U. S. 429, 15 S. Ct. 673 (1895); on rehearing 158 U. S. 601, 15 S. Ct. 912 (1895).

Since the earlier statutes had permitted the deduction of "all" taxes, Congress, when it enacted the crudely drawn Corporate Excise Tax Act of 1909,[19] continued this practice. Inasmuch as the expenditures of corporations falling within the purview of this legislation were normally those relating to their income, this provision, from the point of view of accurate income accounting, was far less objectionable than those which preceded it.[20] Unfortunately, with the enactment of the more inclusive income taxes under the Sixteenth Amendment the inaccuracies of the Civil War statutes were repeated when Congress provided for the deduction of "*all* national, State, county, school, and municipal taxes."[21]

As a result of this apparent liberality of all the allowance it was claimed in *United States v. Woodward*[22] that, when computing the taxable *income* of a decedent's estate, the full amount of the federal estate tax (in this case an amount in excess of the income for the year) should be deducted from gross income. Since the exaction had been designated as a "tax" and since it was imposed by the exertion of the federal taxing power, the Supreme Court saw no reason for denying the deduction. The words of the statute were "clear and comprehensive and include[d] every tax."[23] The statute provided for the deduction of "taxes" and "taxes" meant *all taxes other than those expressly excepted.* There was no basis for a construction which would limit the deduction to taxes incurred in earning taxable income; with the exception of those enumerated,[24] all taxes were deductible.

Yet in spite of this broad interpretation of the Act to permit the deduction of taxes irrespective of their relation to taxable income, there has been no discernible tendency to construe section 23 (c) in a manner which would permit those who contributed equally in the support of government[25] to benefit to the same extent by the allow-

[19] 36 Stat. 11 § 38 (2d).

[20] But even here, the statute failed to distinguish between taxes which represented current expenses and those representing capital expenditures.

[21] 38 Stat. 166 § II (B). Taxes assessed against local benefits were excluded. Italics supplied.

[22] 256 U. S. 632, 41 S. Ct. 615 (1921).

[23] 256 U. S. at 634, 41 S. Ct. at 616.

[24] The Act of 1918 excluded federal and foreign income, war-profits, and excess-profits taxes. 40 Stat. 1057, §214 (a) 3.

[25] "A precise statement of taxes paid is inadequate. A tax burden of an individual can be measured only after knowing what amount of the taxes that he pays is shifted to others, and what amount of the taxes of others is shifted to him. In other words, the test is taxes borne rather than taxes paid. But this involves many debatable assumptions about the shifting of taxes." Shoup, Facing the Tax Problem (1937) 221.

ance. All taxes other than those specifically excluded may be deducted from gross income, but the taxes deductible are those which have been technically imposed upon the taxpayer claiming the deduction; i.e., he may deduct only his "own" taxes.[26] Although the 1909 Act permitted corporations to deduct "all sums paid by it within the year for taxes,"[27] it had been previously said that deductible taxes must be the taxes of the corporation seeking the deduction and not the taxes of another.[28] Taxes imposed upon stockholders but collected by the state from the corporation could not be deducted by the latter;[29] such taxes were the stockholders' taxes and deductible only by the stockholders.[30] Subsequent legislation abrogated the effect of these decisions so far as they relate to corporations,[31] but the general rule established thereby has continued with increasing vigor.[32] Thus taxes paid gratuit-

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[26]"There can be no doubt but that the clause in the federal statute providing for the deduction from the gross income of a corporation of 'all sums paid by it within the year for taxes imposed under the authority of ... any state' means taxes imposed upon it and not upon some other person or corporation. No other reasonable conclusion could be drawn from the language used." Eliot National Bank v. Gill, 210 F. 933, 936 (D. Mass. 1913). See Grand Hotel Co., 21 B. T. A. 890, 893 (1930). See Paul, Selected Studies in Federal Taxation, second series (1938) 24.

[27]36 Stat. 11 § 38 (2d).

[28]E. g. see United States v. Central National Bank, 24 F. 577 (D. N. Y. 1885).

[29]National Bank of Commerce in St. Louis v. Allen, 211 F. 743 (E. D. Mo. 1914); Northern Trust Co. v. McCoach, 215 F. 991 (D. Pa. 1914); Eliot National Bank v. Gill, 218 F. 600 (C. C. A. 1st, 1914); First National Bank v. McNeal, 238 F. 559 (C. C. A. 5th, 1917); Porter v. U. S., 27 F. (2d) 882 (C. C. A. 9th, 1928) affirming 20 F. (2d) 935 (D. Ida. 1927); cert. den. 279 U. S. 875, 49 S. Ct. 340 (1929). Where the tax was construed as being "on" the corporation there was, of course, no objection to the corporation taking the deduction. Ferguson v. Fidelity Union Trust Co., 24 F. (2d) 520 (C. C. A. 3d, 1928); United States v. Guaranty Trust & Savings Bank, 253 F. 291 (D. Fla. 1918). A. R. R. 2377, II—1 C. B. 161.

[30]National Bank of Commerce in St. Louis v. Allen, 211 F. 743 (E. D. Mo. 1914); Title Insurance & Trust Co., 11 B. T. A. 288 (1928); A. W. Hurley, 6 B. T. A. 695 (1927). However, the stockholder was required to include the amount paid in his gross income. Title Insurance & Trust Co., supra and A. W. Hurley, supra.

[31]42 Stat. 261 (1921) §§ 214 (a) (3), 234 (a) (3). "The deduction for taxes allowed by sub-section [23] (c) shall be allowed to a corporation in the case of taxes imposed upon a shareholder of the corporation upon his interest as shareholder which are paid by the corporation without reimbursement from the shareholder, but in such cases no deduction shall be allowed the shareholder for the amount of such taxes." Int. Rev. Code § 23 (d). There is a similar provision for life insurance companies. Int. Rev. Code § 203 (5). For an unsuccessful attempt to use § 234 (a) (3) as means of securing a deduction for a dividend, see Bank of Mt. Hope, 25 B. T. A. 542 (1932).

[32]Settlor may not deduct transfer taxes. Ardengi v. Helvering, 100 F. (2d) 406 (C. C. A. 2d, 1938). Beneficiary may not deduct taxes of the trust. Busch v. Commissioner, 50 F. (2d) 800 (C. C. A. 5th, 1932). Cf. Estate of John Edgar Morrell, 43 B. T. A. No. 90 (1941). Cf. Archibald R. Watson, 42 B. T. A. 52 (1940) where sole owner of corporation holding title to country estate was permitted to deduct taxes on estate which he paid. See also Lone Pine Lawn Corporation, 41 B. T. A. 638

ously for another[33] and even those taxes paid pursuant to the terms of a contract[34] may not be deducted by the person actually making the payment to the taxing unit; they may be deducted only by the person who has had his taxes paid.[35] Furthermore, the incidence of the tax does not determine its deductibility[36]—and this is true even though the

(1940), aff'd 121 F. (2d) 935 (C. C. A. 2d, 1941), where personal holding company owning remainder after intervening life estates was not permitted to deduct taxes paid by it. But see Joell Company, 41 B. T. A. 825 (1940), where residence was conveyed to family corporation on condition that it pay taxes, etc., and lease to grantor and/or daughter for life for $1 per year. The corporation was permitted to deduct the taxes which it paid. Mary E. Evans, 42 B. T. A. 246 (1940). F. C. Nicodemus, Jr., 26 B. T. A. 125 (1932) (tenants by the entireties; husband paying tax permitted to deduct full amount. "Lessees" of cooperative apartments have met with varied success. The deduction of an aliquot part was denied in Wood v. Rasquin, 21 F. S. 211 (D. N. Y. 1937), aff'd 97 F. (2d) 1023 (C. C. A. 2d, 1938), and Charles R. Holden, 27 B. T. A. 530 (1933). However, in spite of Congressional refusal to provide for the deduction of property taxes on corporate cooperatives [Seidman's Legislative History of Federal Income Tax Laws (1938) 514] the tax was allowed in Boreland v. Commissioner, 123 F. (2d) 358 (C. C. A. 7th, 1941) where the apartment was in the name of an individual.

[33]Colston v. Burnet, 59 F. (2d) 867 (Ct. App. D. C. 1932) cert. denied 287 U. S. 640, 53 S. Ct. 89 (1932) (husband paid taxes on wife's property); Robinson v. Commissioner, 53 F. (2d) 810 (C. C. A. 8th, 1931) (stockholder paid the taxes of a corporation in which he had a large interest); National Piano Co. v. Burnet, 50 F. (2d) 310 (Ct. App. D. C. 1931) (one corporation paid the taxes of another); Burech v. Commissioner, 50 F. (2d) 800 (C. C. A. 5th, 1931) (trustee gave personal check to pay the taxes of the trust estate). Sigmund Spitzer, 23 B. T. A. 776 (1931) (former stockholder and official paid deficiency assessment against defunct corporation); Beula E. Croker, 27 B. T. A. 588 (1933) (stockholder paid taxes on corporate property); Eugene W. Small, 27 B. T. A. 1219 (1933) (husband paid taxes on wife's land); Mrs. Charles F. Dean, 1 B. T. A. 27 (1924) (husband paid taxes on wife's property.) See also Parrott Estate Co. v. McLaughlin, 89 F. (2d) 188 (C. C. A. 9th, 1937); Trust No. 5522 and Trust No. 5644, Bellehurst Syndicate, 27 B. T. A. 1250 (1933).

[34] Charles R. Holden, 27 B. T. A. 530 (1933); Caroline T. Kissel, 15 B. T. A. 1270 (1929). Although not deductible as a tax, the payment or accrual may be deductible under some other provision of the act. Where a tenant agrees to pay the taxes on leased property the payment may be allocated to and deductible as rent in those cases where rent is a business expense. Denholm & McCay Co., 39 B. T. A. 767 (1939); John D. Flackler, 39 B. T. A. 395 (1939); I. T. 2164, C. B. IV - 1, 34. But where rent is not deductible, taxes paid as rent are not deductible. Charles R. Holden, supra; Caroline T. Kissel, supra.

[35]Beula E. Croker, 27 B. T. A. 588 (1933); T. H. Symington & Son, Inc., 35 B. T. A. 711 (1937). But the amount so paid must ordinarily be included in the gross income of the person who had his taxes paid. A. W. Hurley, 6 B. T. A. 695 (1927); Title Insurance & Trust Co., 11 B. T. A. 288 (1928). If it is not, the tax is not deductible. United States v. Aetna Life Ins. Co., 260 F. 333 (D. Conn. 1919) (1909 Act). Cf. Commissioner v. Terre Haute Electric Co., Inc., 67 F. (2d) 697 (C. C. A. 2d, 1934) with Watervliet Paper Co., 16 B. T. A. 604 (1929).

[36]In Shearer v. Commissioner, 48 F. (2d) 552 (C. C. A. 2d, 1931), the taxpayer purchased an automobile and the dealer charged the excise tax as a separate item. In denying the deduction, Judge Learned Hand said: "In substance... we must agree that the only person who has suffered any diminution of what would otherwise have

evidence of the "shifting" is reasonably clear.[37] For example, a consumer may deduct a sales tax imposed on him and "collected by" the retailer,[38] but he may not deduct a sales tax imposed on the retailer and passed on to him.[39] Because of this implied limitation[40] many taxes are deductible or not according to the fortuitious use of language by legislative draftsmen.[41] If the tax is "on" the dealer, he must include the total amount received from the sale in his gross income, but he is permitted to deduct the tax on the sale;[42] if the tax is "on" the customer, the dealer is merely a collecting agent for the state and need not include the amount so collected in his gross income.[43] In both cases the result, so far as the dealer is concerned, is usually the same; it is the customer who is in a difficult position. In either case he may bear the burden of the tax—its economic effect will be little influenced by the wording of the statute.[44]

From the point of view of accurate *income* assessment the legislative and judicial approval of the earlier administrative extension of the deduction to include *all* taxes measurably distorted the tax base. Accountants, while not in agreement as to the theoretical basis for the

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been an income, is the customer, and that a nicer accommodation of the tax to economic burdens would have distinguished between cases in which the tax could be shown to have been added, and those where the dealer had to bear it. But the final incidence of taxation is not a measure of the person on whom the tax is levied, and it seems to us that the form of the statute must control." 48 F. (2d) at 555. See Biddle v. Commissioner, 86 F. (2d) 718 (C. C. A. 2d, 1936).

[37]See supra note 36. See also R. C. Musser, 3 B. T. A. 498 (1926); George E. Hamilton, 6 B. T. A. 240 (1927); Elmira Arms Co., 7 B. T. A. 703 (1927); A. Eisenberg, 11 B. T. A. 574 (1928); George M. Cohan, 11 B. T. A. 743 (1928).

[38]E. g., see I. T. 2942, XIV - 2 C. B. 94; I. T. 2953, XV - 1 C. B. 92. See also M. Rea Gano, 19 B. T. A. 518 (1930); Genevieve Tucker, 2 B. T. A. 796 (1925).

[39]Elsie S. Eckstein, 41 B. T. A. 746 (1940). Mim. 3988, XI - 2 C. B. 25 (1932); O. D. 287, 2 C. B. 112 (1909); I. T. 3382, 1940 - 1 C. B. 12; I. T. 3378, 1940 - 22 - 10270. See also, I. T. 35510, 1941-42-10867.

[40]Although the language of the statute does not expressly limit the deduction to the taxpayer's own taxes, it has been held that this is the necessary implication of the statute granting the deduction. See Commissioner v. Plestcheeff, 100 F. (2d) 62, 63 (C. C. A. 9th, 1938).

[41]Because of the importanace of the deduction the language of the state statutes is no longer always fortuitous. For example, in Michigan the motor fuel tax act was amended to permit consumers to deduct the tax. See I. T. 2945, XIV C. B. 296. Since the Michigan sales tax is not deductible, I. T. 2732, XII - 2 C. B. 45, there is a movement under way to amend this act. The Michigan use tax of 1937 is deductible by the consumer. I. T. 3158, 1938 - 1 C. B. 130, I. T. 3161, 1938 - 1 C. B. 116.

[42]E. g. I. T. 2783, XIII - 1 C. B. 54. See also K. Taylor Distilling Co., Inc., 42 B. T. A. 7 (1940).

[43]Since the amount collected is not included in gross income the dealer may not deduct it as a tax. I. T. 3441, 1941 - 3 - 10564.

[44]For a discussion of the shifting of the sales tax see Haig and Shoup, The Sales Tax in the American States (1934) 29 et seq.

deduction of business taxes,[45] are agreed that such taxes must be considered when determining annual income.[46] *But taxes which pertain to the personal expenses of the individual whose income is being computed represent an entirely different type of payment.*[47] The manner in which the taxpayer spends his income is his own affair—his taxable income should not depend, in part, on whether he buys a theatre ticket and pays an amusement tax thereon[48] or purchases a novel which may not be subject to an immediate tax. Consequently, for many years economists have objected to this deduction which fails to distinguish between business and personal taxes.[49] But even if it is assumed that it is desirable to permit the deduction of taxes having no relation to income in order to escape the objection to paying a tax "on" a tax, it is apparent that the present deduction falls far short of this goal.[50]

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[45]Compare Gilman, Accounting Concepts of Profit (1939) 314, 315, with Paton, Essentials of Accounting (1938) 101, 102. Compare also Canning, Economics of Accountancy (1929) 37, 38.

[46]Sanders, Cost Accounting for Control (1934) 165; Montgomery, Auditing Theory and Practice (6th ed. 1940) 251, 298; Lawrence, Cost Accounting (1939) 182; Sanders, Hatfield and Moore, a Statement of Accounting Principles (1938) 37. However, with respect to the proper treatment of income taxes there is some dispute. Compare the "division of profits" concept expressed in Sanders, supra at 165; Lawrence, supra at 182; Paton, op. cit. supra note 45 at 101; Hatfield, Accounting (1927) 373, 374; Cole, The Fundamentals of Accounting (1920) 291; Seeger, The Nature of Income Tax (1924) 37 Journal of Accountancy 101, 108, with the "expense" concept expressed in Arisman, Federal and State Income Taxes as an Element of Cost (1936) 18 Nat. Ass'n. of Cost Accountants Bulletin 385; Hadden v. Commissioner, 49 F. (2d) 709 (C. C. A. 2d, 1931); Commissioner v. James, 49 F. (2d) 707 (C. C. A. 2d, 1931; Guarantee Construction Co., 2 B. T. A. 1145, 1150 (1925). Cf. T. D. 2791, T. B. R. 17, 2 C. B. 294.

[47]Montgomery, Income Tax Procedure (1917) 352.

[48]Such taxes are deductible. M. Rea Gano, 19 B. T. A. 518 (1930).

[49]"The law permits the deduction for all taxes... Why this deduction should be allowed is not clear." Seligman, The Federal Income Tax (1914) 29 Pol. Sci. Q. 1, 9, 10, also in Seligman, The Income Tax (1914) 684.

"Personal taxes, taxes on one's home, and other non-business taxes should not be deducted any more than any other personal expense." Plehn, Introduction to Public Finance (1931) 343, 344. See also Hewett, The Definition of Income and its Application in Federal Taxation (1925) 22; Groves, Financing Government (1939) 160, 161; Shoup, Facing the Tax Problem (1937) 562, note 3. Cf. King, Public Finance (1935) 316; Model Income Tax Laws of the National Tax Association, Personal Income Tax, Article III, § 306 (c).

[50]A comparison of the amounts actually deducted from gross income with the estimated tax burden borne by the taxpayer emphasizes the inadequacy of § 23 (c). In 1937 the average deduction varied between 2.96 per cent and 4.21 per cent of income, U. S. Treasury Department: Statistics of Income for 1937 (1938) 14, whereas the tax burden of selected family income groups has been estimated to vary between 8 per cent and 109 per cent. See Shoup, Studies in Current Tax Problems (1937) 32. See also Leonard, the Direct Tax Burden on Low Income Groups (1939) 10.

Thus, instead of permitting the deduction of taxes on the basis of the relation of the tax to income or on the basis of the taxpayer's actual contribution to the support of government, an intermediate concept has been adopted. The problem is one of determining the meaning of "taxes" rather than that of proof of direct and indirect payment or that of differentiating between current expense on the one hand and personal expense or capital charges on the other. Consequently, in addition to the inequities resulting from a capricious allowance or disallowance of a payment merely because of its formal description, this substitution has given rise to a number of difficult problems which continue to cause unnecessary litigation; it has by no means simplified the operation of the federal income tax.

A tax has been defined as "a compulsory contribution from the person to the government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred."[51] Three characteristics of a tax may be found in this definition.[52] First, the "contribution" to the government must be compulsory. Second, the revenue must be used for a common purpose. And third, the exaction must be made without regard for individual benefit. Many interpretations of section 23 (c) have been in accord with this definition.

It appears to be well settled that a voluntary payment to the government may not be deducted as a *tax*.[53] Thus, gifts and loans clearly do not fall within this classification and they may not be deducted as "taxes paid or accrued."[54] Within the same category are payments made for goods and services purchased from a government unit engaged in business.[55] These types of payments and accruals cause little difficulty;

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[51]Seligman, Essays on Taxation (10th ed. 1925) 432.

[52]For judicial recognition of these characteristics, see, for example, (1) United States v. La Franca, 282 U. S. 568, 572, 51 S. Ct. 278 (1931); Tevander v. Ruysdall, 299 F. 746 (C. C. A. 7th, 1924), (2) United States v. Butler, 297 U. S. 1, 61 S. Ct. 312, 317 (1936); Loan Association v. Topeka, 20 Wall. 655 (U. S. 1874) (McAllister, Public Purpose in Taxation (1930) 18 Calif. L. Rev. 137, 241; cf. Buehler, Public Finance (2d ed. 1940) 654 et seq.), (3) Cornelius v. Kromminga, 179 Ia. 712, 161 N. W. 625 (1917); State v. Wetz, 40 N. D. 299, 168 N. W. 835 (1918). See also, I. T. 3511, 1941-43-10874.

[53]See supra notes 26, 28, 33 and 34, where the payment of the tax was "voluntary" and therefore non-deductible.

[54]In addition to the fact that the word "tax" has lost its earlier donative significance the Int. Rev. Code § 23 (o) (q) permits the deduction of contributions to federal, state and local governments in certain cases.

[55]Voluntary payments in accordance with a contractual agreement made with a foreign government not deductible as taxes. Amtorg Trading Corporation, 25 B. T. A. 327 (1932) reversed on another point 65 F. (2d) 583 (C. C. A. 2d, 1933). Postage not a tax. Reg. 86, 94, 101, Art. 23 (c)-1; Reg. 74, 77, Art. 151; Reg. 65, 69, Art.

more troublesome questions are presented in those cases where the taxpayer is under no technical obligation to pay, at the time demanded, the exact amount claimed as a deduction.

Since, theoretically speaking, it may be argued that a taxpayer is not compelled to pay an illegal "tax," the Board of Tax Appeals for a number of years adhered literally to the view expressed in an unrelated situation by the Supreme Court in *Norton v. Shelby County*: "An unconstitutional act is not law.. it is, in legal contemplation, as inoperative as though it had never been passed."[56] Inasmuch as an unconstitutional tax was void *ab initio,* it was, therefore, not deductible.[57] Similarly, since a retroactive tax, although valid, could have only prospective coercive effect, such taxes were not accruable deductions for the relevant years prior to their enactment.[58] Furthermore, the

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131; Reg. 45, 62, Art. 131. See Baltimore & Ohio Railroad Co. v. Maryland, 21 Wall. 456 (U. S. 1874). But see Bauer, Rates and Revenues of Public Enterprises (1936) 183 Annals Am. Academy of Pol. Sci. 70; 2 Lyon, Abramson and Associates, Government and Economic Life (1940) 1129 et seq. Note the treatment of municipal water rates in Leonard, the Direct Tax Burden on Low Income Groups (1939) 10; cf. Mahler v. Commissioner, 119 F. (2d) 869 (C. C. A. 2d, 1941).

[56]118 U. S. 425, 442, 6 S. Ct. 1121, 1125 (1886). Cf. Chicot County Drainage District v. Baxter State Bank, 308 U. S. 371, 374, 60 S. Ct. 317, 318 (1940).

[57]Payments made under a tax statute later declared unconstitutional not deductible as "taxes" when the amounts paid are subsequently refunded. Mary W. Leach, 16 B. T. A. 781 (1929), affirmed 50 F. (2d) 371 (C. C. A. 1st, 1931); Lehigh Valley Coal Sales Co., 15 B. T. A. 1401 (1929); Philip C. Brown, 10 B. T. A. 1122 (1928). In E. L. Bruce Co., 19 B. T. A. 777 (1930) where the payment was not refunded it was held that while the payment could not be deducted as a tax, it could be deducted as a loss. But where only a part of the statute was held unconstitutional and there was nothing to show that the amount paid would have been less if the unconstitutional provision had not been enacted, the amount paid as a tax could be deducted in full. Charles F. Fawsett, 30 B. T. A. 908 (1934). See First National Bank, Stoughton, Wisconsin, 22 B. T. A. 1050, 1053 (1931). A mere claim of unconstitutionality does not affect the question of deductibility. A taxpayer on an accrual basis must deduct the tax in the year in which it accrues—not in the year in which its constitutionality is finally established. See Bartles-Scott Oil Co., 2 B. T. A. 16, 18, 19 (1925). Cf. Commissioner v. Terre Haute Electric Co., Inc., 67 F. (2d) 697 (C. C. A. 2d, 1934) where the related problem of accrued income was considered. The lessor was required to include in its gross income accrued taxes which the lessee was required to pay as a part of the rent even though the amount due was not ascertained until final adjudication.

[58]Union Bleachery v. Commissioner, 97 F. (2d) 226 (C. C. A. 4th, 1938); Ed. Schuster & Co., Inc., v. Williams, 283 F. 115 (C. C. A. 7th, 1922); Norwich & Worcester R. Co. 16 F. (2d) 944 (D. Mass. 1926); Estate of William H. Block, 39 B. T. A. 338 (1939); James Bliss Combs, 17 B. T. A. 279 (1929); Purdy & Henderson Co. 4 B. T. A. 70 (1926); Jamestown Worsted Mills, 1 B. T. A. 659 (1925). O. D. 387, 2 C. B. 116; O. D. 505, 2 C. B. 116; O. D. 1118, 5 C. B. 133; McCarthy, When Does a Tax Accrue? (1924) 37 Journal of Accountancy, 268, 272, 273. The Problem does not arise where the taxpayer reported on the cash basis; such taxes are deductible in the year paid. I. T. 1498, I-2 C. B. 95. Cf. Fawcus Machine Co. v. United States, 282

courts and the Board adopted similar reasoning in other types of transactions. Section 23 (c) having been construed to presuppose a valid exaction, sums demanded and paid to a taxing unit under the mistaken belief that the taxpayer was subject to the statute in question have also been held not to be "taxes"—[59] and the same is true of excessive assessments; to the extent that the amount claimed exceeded the legally collectible exaction the payment or accrual could not be deducted as a tax.[60]

This conceptualistic attitude concerning the nature of a tax appeared to work equally well in reverse. A retroactive statute which reduced the taxpayer's liability for an earlier year,[61] a refund of a tax due to a condition subsequent,[62] and the underassessment of a tax—[63] these events in no way affected the "true" amount to be deducted during a specific year by a taxpayer on an accrual basis. Just as a taxpayer who paid less, as the result of a compromise, than the amount required by statute was permitted to deduct the *full* amount which he should have paid,[64] so those who ultimately paid less than the legal tax or who

U. S. 375, 51 S. Ct. 144 (1931) where a retroactive increase in rate, made in ample time for taxpayer to adjust its accounts, was held to require the deduction of the larger amount in the earlier year. But the rule is not applied if the increase is made after the return is due. See G. C. M. 22366, 1941-4-10575.

[59]Inland Products Co. v. Blair, 31 F. (2d) 867 (C. C. A. 4th, 1929) (amounts paid as a tax on sweet cider pursuant to Treasury Regulations 44 and 52, later declared void not deductible; return must be adjusted by excluding the amount refunded). Cf. Borg & Beck Co., 24 B. T. A. 995, 1009 (1931) (correctness of deduction not investigated since it was paid in good faith and recovery barred refund). See Leach v. Commissioner, 50 F. (2d) 371 (C. C. A. 1st, 1931); Bergen v. Commissioner, 80 F. (2d) 89 (C. C. A. 4th, 1935).

[60]Stimson Inv. Corp. v. United States, 35 F. S. 498 (D. C. Mass. 1940); Lattimore v. United States, 12 F. S. 895 (Ct. Cl. 1935); Mary W. Leach, 16 B. T. A. 78 (1929); Bettie Matthews, 21 B. T. A. 96 (1930); O. D. 741, 3 C. B. 115; I. T. 2081, III-2 C. B. 97.

[61]J. I. Case Co. v. United States, 32 F. S. 754 (Ct. Cl. 1940); I. T. 2827, XIII-2 C. B. 130. Cf. U. S. Industrial Alcohol Co., 42 B. T. A. 1323, 1390 (1940). See American Laundry Machinery Co., 32 B. T. A. 793 (1935), where the tax was not deductible since it was repealed in the year in which it accrued. See also G. C. M. 8218, IX-2 C. B. 106; G. C. M. 16491, XV-1 C. B. 109; James Bliss Combs, 17 B. T. A. 279 (1929); Purdy & Henderson Co., 4 B. T. A. 70 (1926).

[62]Mim. 3958, XI-2 C. B. 33 (1932). Cf. U. S. Industrial Alcohol Co., 42 B. T. A. 1323, 1388 et seq. (1940).

[63]Uncasville Mfg. Co. v. Commissioner, 55 F. (2d) 893 (C. C. A. 2nd, 1932); Montgomery v. United States, 23 F. S. 130 (Ct. Cl. 1938); Great Northern Ry. Co., 30 B. T. A. 691 (1934); Brooklyn Union Gas Co., 22 B. T. A. 507 (1931); American Cigar Co., 21 B. T. A. 464 (1930); Haverty Furniture Co., 20 B. T. A. 644 (1930). See also Carter, Rice & Co., 38 B. T. A. 687 (1933). Cf. Ruud Mfg. Co. v. Commissioner, 45 F. (2d) 63 (C. C. A. 3d, 1930).

[64]Commissioner v. Central United National Bank, 99 F. (2d) 568 (C. C. A. 6th,

paid an inadequate amount and were later required to pay in full had only one possible amount which could be properly deducted—[65] the actual tax required by law. This rule was followed even though the taxpayer was ignorant of the statute imposing the liability,[66] was improperly assessed by administrative officials,[67] or was litigating or otherwise disputing its validity.[68]

However, the theory that a taxpayer was never compelled to pay an unconstitutional tax or to pay more than was legally due under a lawful statute presented a number of difficulties. The presumption of validity of legislative and administrative action[69] may have appeared inconsistent with the attitude that the taxpayer should have known all along that the tax was excessive or collected under an unconstitutional statute. Certainly, the element of coercion had been recognized in similar situations when the taxpayer was attempting to recover such payments from the taxing authority.[70] In addition, the earlier deduction cases presented circumstances where the tax had been actually refunded so that the readjustment of the return for the year in question imposed no great burden.[71] And where there had been a refund and the government could not reopen the taxpayers' returns because of lapse of time, the inclusion of the refund in the taxpayers' gross income in the year received did not appear unjust since the over-deduction in the earlier year permitted the escape of legitimate taxes.[72] But

1938). Where the taxpayer is on a cash basis, the amount paid as the result of a compromise may be deducted as a tax in the year paid if collected under a valid tax statute. B. E. Levinstein, 19 B. T. A. 99 (1930).

[65]Bartles-Scott Oil Co., 2 B. T. A. 16 (1925); Red Wing Potteries, Inc., 43 B. T. A. No. 120 (1941).

[66]Elmhirst v. Diggin, 14 F. S. 782 (D. N. Y. 1936); Armstrong Cork Co. 24 B. T. A. 1 (1931). See Ruud Mfg. Co. v. Commissioner, 45 F. (2d) 63 (C. C. A. 3d, 1930) explained in Carter, Rice & Co. 28 B. T. A. 687 (1933). See A. R. R. 1153, I-2 C. B. 92.

[67]E. g., see Stimson Inv. Co. v. United States, 35 F. S. 498 (D. Mass. 1940).

[68]Hygenic Products Co. v. Commissioner, 111 F. (2d) 330 (C. C. A. 6th, 1940); Continental Baking Co. v. Commissioner, 77 F. (2d) 119 (Ct. App. D. C. 1935); Russell-Miller Milling Co. v. Helvering, 69 F. (2d) 393 (Ct. App. D. C. 1934); Helca Mining Co., 35 B. T. A. 454 (1937).

[69]E. g., see Cooley, Taxation (4th ed. 1924) §§ 188, 189, 1011, 1038, 1073, 1192, 1229. See also Stason, Judicial Review of Tax Errors (1930) 28 Mich. L. Rev. 637. In general, see Landis, The Administrative Process (1938) 123 et seq.

[70]Atchison, Topeka, & Santa Fe R. Co. v. O'Connor, 223 U. S. 280, 32 S. Ct. 216, (1912) (payment of unconstitutional state tax held to be involuntary and recoverable by the corporation). See Magill and Maguire, Cases on Taxation (3d ed. 1940) 233 et seq.

[71]Supra notes 57, 59 and 60.

[72]Nash v. Commissioner, 88 F. (2d) 477 (C. C. A. 7th, 1937) cert. den. 301 U. S. 700, 57 S. Ct. 930 (1937); Victoria Paper Mills Co., 32 B. T. A. 666 (1935); Houbigant,

where there had been no refund and none seemed probable, the disallowance of the full deduction worked a very real hardship; consequently the Board took the position that when a tax had been actually paid it could be deducted even though it was subsequently declared unconstitutional—at least where the tax had not been refunded before the filing of the petition or before the final determination of the tax liability for the year.[73] But even this latter tentative limitation was subsequently ignored; the present position of the Board of Tax Appeals in this rapidly changing area of tax law is that where the tax is paid before it is declared unconstitutional it may be deducted in the year paid or accrued even though it is subsequently refunded.[74] If the tax is accrued but not *paid* before being declared unconstitutional, the Board has refused to permit the deduction of the accrual.[75] However, in *J. A. Dougherty's Sons, Inc. v. Commissioner*,[76] the Board was reversed and the deduction of the accrued tax permitted.

The second characteristic of a tax, that it must be raised for a public purpose, has also been recognized. The orthodox view, under American constitutional law, is that a tax, to be valid, must be levied for a public purpose;[77] since this has been recognized by the several taxing authorities in the United States, this aspect of the definition has caused little difficulty—and even if it had, payments under such statutes should be treated like other unconstitutional exactions. But

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Inc., 31 B. T. A. 954 (1934). Similar practice was followed in Elsie S. Eckstein, 41 B. T. A. 746 (1940) where taxpayer deducted accrued taxes and later paid a smaller amount. On this general problem see Brown, Treatment for Federal Income Tax Purposes of Errors in the Deduction of Other Taxes (1937) 85 U. Pa. L. Rev. 385; Note (1938) 86 U. Pa. L. Rev. 868, 875 et seq.; Legislation (1939) 39 Col. L. Rev. 460. See also Maguire, Surrey, Traynor, Section 820 of the Revenue Act of 1938 (1939) 48 Yale L. J. 509, 719.

For conflicting treatment of the refund where the taxpayer received no tax benefit from the earlier tax payment or accrual, compare Central Loan & Inv. Co., 39 B. T. A. 98 (1939), and Jamieson Associates, 37 B. T. A. 92 (1938), with Universal, Inc. v. Commissioner, 109 F. (2d) 616 (C. C. A. 7th, 1940) and I. T. 3390, 1940-28-10325.

[73]Carter Mills, Inc., 42 B. T. A. 894 (1940). "To state that an unconstitutional statute should be considered void ab initio may be sound legal metaphysics and helpful in some circumstances, but, as the Supreme Court itself has said in a recent decision, it is a broad statement which 'must be taken with qualifications'." 42 B. T. A. at 898.

[74]M. & N. Cigar Manufacturers, Inc., 42 B. T. A. 1091 (1940).

[75]J. A. Dougherty's Sons, Inc., 42 B. T. A. 892 (1940); Estate of David Davies, 42 B. T. A. 965 (1940); Eckert Packing Co., 42 B. T. A. 1000 (1940).

[76]121 F. (2d) 700 (C. C. A. 3d, 1941).

[77]Supra note 52 (2).

foreign "taxes"[78] which fail to meet the public purpose requirement, have been excluded from the benefits of this section.[79]

Conventional discussions of the meaning of "taxes" frequently emphasize the motive of the legislature in enacting the so-called revenue measure. Many take the view that statutes enacted primarily for non-fiscal purposes do not represent an exercise of the taxing power.[80] Of course, a "tax" which is actually prohibitory in character does not enter into the present problem. But to the extent that the statute results in the collection of revenue it would seem clear that the payments thereunder should be deductible as taxes.[81] It is well recognized that all taxes represent various degrees of regulation[82] and this fact has not prevented the taxpayer from deducting such payments from his gross income. However, a statute which imposes a fine for misconduct is excluded from section 23 (c); such exactions are imposed by virtue of the police power and ordinarily not for the purpose of raising revenue.[83] Yet from the practical point of view it is apparent that it is often impossible to distinguish between sanctions in the form of fines and those in the form of taxes. A "penalty," for example, may describe payments exacted for misconduct of either a criminal or non-criminal nature. Penalties imposed for the non-payment of taxes may represent a fine for deliberate evasion,[84] a recovery of the expense in-

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[78]Foreign taxes are deductible under § 23 (c) in those cases where the taxpayer does not signify in his return his desire to accept the benefits of § 131, relating to credit for foreign taxes.

[79]Thus payments required of the taxpayer to meet reparation payments under the Dawes plan have been held to be payments to meet a public obligation required to secure peace and, therefore, for a public purpose. But a charge laid by a religious organization upon a member of the religious community has been ruled not to be a tax even though (1) it is spoken of as a tax; (2) legal provision is made for its collection; (3) it is assessed and collected by the taxing authorities; and (4) the payment is not voluntary. G. C. M. 8933, XI-1 C. B. 112.

[80]See (1941) 2 Wash. & Lee L. Rev. 191, 193, 194.

[81]For example, tariff duties, occasionally paid, should be deductible as taxes even though the general purpose and effect of the legislation is to prohibit the importation of the goods.

[82]There are many cases recognizing this principle. See, for example, United States v. Doremus, 249 U. S. 86, 39 S. Ct. 214 (1919); McCray v. United States, 195 U. S. 27, 24 S. Ct. 769 (1904); A Magnano Co. v. Hamilton, 292 U. S. 40, 51 S. Ct. 195 (1931); Sonzinsky v. United States, 300 U. S. 506, 57 S. Ct. 554 (1937).

[83]Quite frequently such receipts are used to defray the cost of administering the criminal law. Lutz, Public Finance (1936) 294. To the extent that the receipts represent the cost to the state of the activity controlled (and to the extent that a fine may be said to be imposed for the criminal's own good) the fine may be considered as being in the nature of a fee. See infra page 17 et seq.

[84]See United States v. Mitchell, 303 U. S. 391, 399, 58 S. Ct. 630, 633 (1938).

curred in investigating the fraud,[85] the amount of the unpaid tax,[86] or merely a charge for lateness.[87] However, little effort has been made to allocate "penalty" payments to the various elements involved in their exaction. Instead, the practice has been to look only to the name given the charge and accept this as decisive of the question at hand. Since some penalties may represent fines[88] there has been an inclination to treat *all* penalties as if they were fines.[89] But if the statute clearly separated the penalty from some recognized type of deductible expenditure a different result was reached.[90] Where a statute provided for the payment of a penalty plus one percent interest for each month's delay the interest was held to be deductible,[91] but where the statute provided for a penalty with an additional one percent for each month the amount due remained unpaid the entire sum was treated as a penalty and the deduction denied.[92] The fact that the reason for the additional payment was the same in both cases seemed to make no difference—the deductibility of the exaction depended upon the literal words of the statute requiring its payment. Likewise, in determining whether the payment is a "tax" or a "penalty" the customary practice

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[85]See 303 U. S. at 401, 58 S. Ct. at 634; (1939) 37 Mich. L. Rev. 647.

[86]A statute may provide a "penalty" for non-payment of a tax, but make no provision for the collection of the unpaid tax, e. g., see Connecticut General Statutes (1930) § 1403, described as an "Estate Penalty Tax."

[87]A statute may require the payment of the unpaid tax plus a "penalty" of a designated percent per annum. See infra note 92.

[88]Fines are not deductible. Paul and Mertens, Law of Federal Income Taxation (1934) § 25.04 and cases cited therein, note 21.

[89]For example, see Helen B. Achelis, 28 B. T. A. 244 (1933); Great Northern Railway v. Commissioner, 40 F. (2d) 372 (C. C. A. 8th, 1930).

[90]If the statute designated the payment as "penalty" it was not deductible. Supra note 89. See also O. 926, 1 C. B. 241, 242, revoked by G. C. M. 11358, XII-1 C. B. 29. But if the payment was designated as "interest" it was dedutcible. Penrose v. United States, 18 F. S. 413 (E. D. Pa. 1937); Harvey M. Toy, 34 B. T. A. 877 (1936); Evans v. Howard Fire Brick Co., 8 B. T. A. 867 (1927); I. T. 1317, I-2 C. B. 132.

[91]United States v. Jaffray, 97 F. (2d) 488 (C. C. A. 8th, 1938).

[92]Korsar & Co., 16 B. T. A. 952 (1929). This distinction was based on the analogy of a similar distinction recognized by the Supreme Court in dealing with a federal or state claim for penalties and interest on taxes due from a bankrupt. In People v. Jerswit, 263 U. S. 493, 44 S. Ct. 167 (1924), the New York franchise tax (under consideration in Korsar & Co.) was payable in advance. Upon nonpayment the statute imposed a penalty of 10 percent plus one percent for each month of delay. Since the bankruptcy act did not permit the recovery of a penalty from the bankrupt's estate, the claim for both the 10 percent and the 1 percent per month was disallowed. However, the Court did approve the allowance of simple interest on the unpaid tax. In United States v. Childs, 266 U. S. 304, 45 S. Ct. 110 (1924) the Court distinguished the above case on the ground that the 1 percent was in addition to the penalty and not 1 percent interest in addition to the penalty imposed by the federal statute under consideration.

has been to decide the question by a reference to the description given the exaction by the courts in some other connection. Language found in unrelated decisions has been lifted out of its context and compared with other isolated language and the deduction allowed[93] or denied[94] according to the fortuitous selection of words made by a judge in discussing some different or even hypothetical problem.

Interpretations of Section 23 (c) also purport to recognize the third characteristic of a tax. Generally speaking, fees and special assessments are not deductible—the fee by virtue of statutory interpretation,[95] the special assessment by express statutory provision.[96] But as was the practice with respect to statutes dealing with fines and penalties, there has been a tendency to adopt a mechanistic technique when dealing with fees and special assessments and to accept blindly the name given the payment by the local authorities.

Since many fees represent current business expenses they are deductible as such,[97] and the question of whether they are also deductible as "taxes paid or accrued" is of academic interest only. But some expenditures, such as incorporation fees, are capital charges, while others, such as passport fees,[98] may represent personal expenses; in either type of payment the taxpayer must usually rely upon section 23 (c) if he is to be successful in securing the deduction. Confronted on the one side by the rule that fees are not deductible as "taxes" and on the other side by the principle that all taxes are deductible irrespective of their relation to income, the judicial and administrative treatment of payments designated as "fees" has not been entirely consistent. Where the taxpayer makes no attempt to demonstrate the exact character of the "fee," its deduction is disallowed.[99] But if it is demonstrated that all of the characteristics of a tax are present, then it will

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[93] See B. E. Levinstein, 19 B. T. A. 99 (1930).

[94] Helen B. Achelis, 28 B. T. A. 244 (1933).

[95] E. g., see I. T. 3468, 1941-16-10684.

[96] Int. Rev. code § 23 (c) (4).

[97] For example, the cost of hunting and fishing licenses has been ruled not to be a payment or accrual of a tax and not deductible as such, but it may be deducted as a business expense if used in the taxpayer's trade or business. I. T. 3166, C. B. 1938-1, 133; I. T. 2999, C. B. XV-2, 139; I. T. 2796, C. B. XIII-2, 48. See also I. T. 2156, IV-1 C. B. 35.

[98] I. T. 2156, IV-1 C. B. 35.

[99] In Logan-Gregg Hardware Co., 2 B. T. A. 647, 648 (1925), the Board of Tax Appeals said that "a fee ... paid ... on account of an increase in capital stock, must be disposed of on the assumption that the sum paid represented a fee and not a tax. ... The fee is alleged to have been paid for the authorization to increase the capital stock, a capital transaction, and it is therefore not deductible." In Emerson Electric Manufacturing Co., 3 B. T. A. 932, 936, the Board, again without discussion, said

be treated as such. Thus in *Holeproof Hosiery Co.*[100] it was said that since

> "the exaction from the petitioner was in substantial excess of any special benefits accruing to it; that it bore little, if any, relation to the cost of any service rendered by the State, or to reasonable compensation for any trouble or expense on the part of the State on account of the increase in the petitioner's authorized capital stock; that the receipts of the office of the secretary of state from this and similar charges greatly exceeded the portion of the expenses attributable to the performance of any service to the State in connection with the charges; that the receipts were used for general State purposes and considerable revenue was derived in this way; and, in short, that there was a taking under the guise of taxation. Under such circumstances we hold that the amount paid was a tax.. and deductible."

In *United Gas Improvement Co. v. Burnet*,[101] however, a curious proviso was added to the general rule. The Board had held that a "bonus" paid in order to increase the authorized capital stock of the taxpayer corporation was a fee and not a tax *in spite of the fact that the factors present in Holeproof Hosiery Co. were present to an even greater extent in the later case.*[102] An early state decision, in passing upon the constitutionality of the local act, had said that it was not a tax[103] and a federal court had also held that it was not a tax for the purpose of the National Bankruptcy Act.[104] Since a district court had followed the bankruptcy decision in applying 23 (c) to the tax at hand,[105] the Board also held that it was not deducti-

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that "the fees paid... in connection with the amendment to the taxpayer's charter in order that it might increase its capitalization, is not a tax, but is a fee, and as such is deductible only if it falls within the provisions (relating to business expense). .. This item is a capital expenditure and not an ordinary and necessary expense."

[100]11 B. T. A. 557, 555 (1928). For subsequent decisions of the Board recognizing this rule see Clarence Whitman & Sons, Inc., 11 B. T. A. 1192 (1928); Borg & Beck Co., 24 B. T. A. 995 (1931); Michigan Central Railroad Co., 28 B. T. A. 437 (1933); Clark Thread Co., 28 B. T. A. 1128 (1933).

[101]64 F. (2d) 957 (C. C. A. 3d, 1933).

[102]E. g., the sum paid in the Holeproof case amounted to only $1,760 whereas the payments made in the United Gas Improvement Co. case exceeded $75,000. The payments were placed in the General Fund for the maintenance of the "running expenses of the government of the State of Pennsylvania." During each year in question the amounts collected by the Commonwealth of Pennsylvania exceeded $1,500,000. 25 B. T. A. at 1382, 1383.

[103]Commonwealth v. Erie & Western Transportation Co., 107 Pa. 112, 115 (1884). The bonus was said not to be a tax, but "an attempt... by one of the parties to the contract to exact an additional consideration and to impose an additional burden upon the exercise of one of the rights granted in the charter."

[104]Commonwealth v. York Silk Mfg. Co., 192 F. 81 (C. C. A. 3d, 1911).

[105]Greensburg Coal Co. v. United States, (W. D. Pa. 1929) VIII-2 C. B. 319.

ble.[106] The Circuit Court of Appeals for the Third Circuit, relying upon its earlier decision relating to the treatment of the "bonus" as a preferred claim in bankruptcy and upon the state decision as to its constitutionality, agreed with the Board that the payment was not a tax. Although both the Board and the Circuit Court of Appeals stressed the *quid pro quo* aspect of the bonus and treated the payment as if it were the purchase of a right-of-way or some special privilege, subsequent rulings of the Board have clearly shown that charges demanded by the state for the privilege of increasing the authorized stock of a corporation which are exacted for the purpose of revenue and without reference to cost or benefit may be deducted as taxes.[107] In view of these later decisions, the *United Gas Improvement Co.* case apparently permits the deduction of all taxes exacted as a condition precedent to the performance of an act or the exercise of a privilege except those which a state or federal court has said were not "taxes." A fee or a similarly described charge may be deducted as a tax if it can be demonstrated that the payment is essentially a tax,[108] or if the fee in question is like some other fee which has been construed to be essentially a tax;[109] but if a court at some time has said that the payment is *not* a tax, then a tax it cannot be even though all of the characteristics of a tax are present.[110]

Although a special assessment may be considered as merely another type of a fee,[111] its treatment under the various federal income tax statutes has been unique. Unlike a fee which may be deducted only if it

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[106] 25 B. T. A. 1382 (1932).

[107] Michigan Central R. Co., 28 B. T. A. 437 (1933); Clark Thread Co., 28 B. T. A. 1128 (1933).

[108] Holeproof Hosiery Co., 11 B. T. A. 547 (1928); Borg & Beck Co., 24 B. T. A. 995 (1931).

[109] Michigan Central R. Co., 28 B. T. A. 327 (1933); Clark Thread Co., 28 B. T. A. 1128 (1933).

[110] See Summerville Tubing Co., 36 B. T. A. 347 (1937).

[111] "A special assessment is distinguished from a tax on the grounds that it is a payment made once and for all to defray the cost of a specific improvement to property and levied according to the particular benefit accruing to each property owner. A fee is distinguished from a special assessment on the ground that it is a recurring charge, and from a tax on the ground that the service financed by it confers a measurable special advantage to the taxpayer. Some writers (e.g. Plehn, Carl C., Introduction to Public Finance, 5th ed. New York 1926, p. 332) recognize no significant distinction between a fee and a special assessment." Haig, Taxation, 14 Encyclopaedia of the Social Sciences (1934) 532. On this last point, see also 2 Fairchild and Others, Elementary Economics (3d ed. 1936) 9, 10.

falls within some other provision of the act,[112] a special assessment is, in many cases, deductible as a *tax*—and being deductible as a tax, the expenditure need not meet the business expense requirement. It may thus seem strange that the courts would be more strict with respect to an expenditure which was denied as the result of statutory interpretation[113] than one which was expressly prohibited by Congress.[114] The factors which distinguish a fee from a tax apply with at least equal force to special assessments and the reasons which deny the deduction of the one unless it is a business expense apply to the other.

The Civil War income tax laws made no mention of special benefits or assessments.[115] Since the payments were compulsory and were exacted by a government unit they were thought of as taxes and were deductible as such in the year in which they were paid.[116] Consequently, assessments for street grading and similar improvements were permissible deductions even though the payments were in the nature of capital expenditures and such permanent improvements could not ordinarily be deducted as current expenses.[117] However, the impropriety of the allowance was recognized in the Act of 1894 which expressly denied the deduction of "taxes assessed against local benefits."[118] With the exception of the Corporate Excise Tax Act of 1909,[119] a special assessment provision has been included in all subsequent income tax statutes.[120] In 1918 the disallowance was

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[112]Fees are frequently deductible as a business expense. Supra note 97. Fees paid as a part of the taxpayer's personal expense are not deductible. I. T. 1301, I-1 C. B. 133. See also I. T. 3511, 1941-43-10874.

[113]Fees are not mentioned in § 23 (c).

[114]"In computing net income there shall be allowed as deductions: ... (c) Taxes paid or accrued within the taxable year, except— ... (4) taxes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not exclude the allowance as a deduction of so much of such taxes as is properly allocable to maintence or interest charges." Int. Rev. Code § 23.

[115]12 Stat. 292 (1861); 12 Stat. 432 (1862); 13 Stat. 223 (1864); 16 Stat. 256 (1870). During 1865 an unsucessful attempt was made to amend the tax deduction provision by adding the words "or assessments."

[116]1 I. R. R. 196; 3 I. R. R. 188, 204; 5 I. R. R. 115; Bump's Federal Internal Revenue Laws (1870) 291; White, The Federal Income Tax Law (1913) 55. But compare T. D., April 28, 1865 with T. D., April 13, 1867, reprinted in Digest of Internal Revenue Decisions 1864-1898 (1906) 34, 101.

[117]See 2 I. R. R. 61; 5 I. R. R. 130; 7 I. R. R. 58, 60; 11 I. R. R. 50, 73 in Bump, op. cit. supra note 116.

[118]28 Stat. 509 (1894).

[119]See 36 Stat. 11, 112, § 38 (2d). Cf. Caldwell Milling Co., 3 B. T. A. 1232, 1233 (1926).

[120] 38 Stat. 114 (1913) § 11 (B). Although the Act of 1913 did not except special benefits paid by corporations [see § 11 (G.) (b)], Treasury Regulations 33, Art. 153,

materially modified when nondeductible special benefits were limited to those "tending to increase the value of the property assessed"[121] and in 1928 it was further restricted by excluding from this prohibition that part of the assessment "properly allocable to maintenance and interest charges."[122]

One rationale of the nondeductibility of special benefits is that such benefits constitute a permanent improvement to the taxpayers' property and being in the nature of a capital expenditure the total amount should not be deducted in a single year; if the expenditure is to be deducted at all it should be amortized over the useful life of the improvement. Those benefits which are of a temporary character do not represent capital investments but are in the nature of a current expense; having no useful life beyond the year in which the obligation is incurred, they should be deducted in the year paid or accrued. In those cases where the special "benefit" does not actually improve the value of the taxpayers' property it should not, of course, be treated as a special assessment, but should be treated as any other compulsory exaction by a taxing authority—that is, it should be deducted as a tax. From an examination of the statute and its history it is thus arguable that the prohibition against the deduction of special benefits was added to the act to prevent the illogical deduction of expenditures which were not taxes[123] but which had been erroneously treated as such in the administration of the Civil War acts.[124] A special assessment was not a tax and was not to be deducted as a tax.[125] It is further arguable that the 1918 amendment[126] was

denied the deduction. For subsequent treatment of the deduction see 39 Stat. 756 (1916) §§ 5 (a) (3d), 6 (a) (3d), 12 (a) (4th), 12 (b) (4th); 40 Stat. 300 (1917) §§ 214 (a) (3), 234 (a) (3); 42 Stat. 227 (1921) §§ 214 (a) (3), 234 (a) (3), 245 (a) (6); 43 Stat. 253 (1924) §§ 214 (a) (3), 234 (a) (3); 44 Stat. 9 (1926) §§ 214 (a) (3), 234 (a) (3); 45 Stat. 791 (1928 § 23 (c); 47 Stat. 169 (1932) § 23 (c); 48 Stat. 680 (1934) § 3 (c); 49 Stat. 1648 (1936) § 23 (c); 52 Stat. 447 (1938) § 23 (c). Int. Rev. Code § 23 (c) (4) reprinted supra note 114.

[121] 40 Stat. 1057 (1918) §§ 214 (a) (3) (c), 234 (a) (3) (c). Cf. Paul and Mertens, Law of Federal Income Taxation (1934) § 25.24, n. 64.

[122] 45 Stat. 680 (1928) § 23 (c) (3).

[123] Support for this view is found in the fact that, although the 1913 Act did not expressly deny a deduction for special benefits paid by a corporation, the regulations excluded such payments without the necessity of a statute. See supra note 120.

[124] Supra note 116.

[125] But note the use of language in the present act, supra note 114.

[126] "There shall be allowed as deductions: .. (3) Taxes paid or accrued within the taxable year imposed... (c) by the authority of any State... not including those assessed against local benefits of a kind tending to increase the value of the property assessed." 40 Stat. 1057, §§ 214 (a), 234 (a).

not added for the purpose of permitting the deduction of *all* special benefits of a kind which did not tend to increase the value of property, but was added for the purpose of insuring that such "benefits" would not be automatically excluded as a deduction. That is, payments may be in the form of a special assessment when, in fact, the payment may be either a tax or an ordinary fee. If the payment is actually a tax or a fee, then the denial of the deduction of "special benefits" was not intended to cover such exactions; their deductibility would depend upon the usual rules relating to such payments. It is also arguable that the 1928 amendment[127] relating to interest and maintenance charges did not make such charges deductible in all cases—the purpose again was merely to prevent the automatic exclusion of such assessments. As is true of the other types of payments made to government units, there is nothing in the statute which prohibits an examination of the "benefit" to ascertain its exact character for the purpose of determining the extent of its deductibility; upon analysis, the payment would be deducted or not as the other provisions of Section 23 should indicate.

In apparent accord with these principles, the early departmental opinions and rulings provided that assessments paid for local benefits such as streets, sidewalks, and levees were in the nature of capital expenditures and not deductible in the year paid,[128] but that assessments for the maintenance and repair of local benefits, as far as such assessments could be allocated to property necessary to the conduct of the taxpayer's business, could be deducted as a *business expense*.[129] However, the permanent improvements, although not deductible in full in the year paid, could be amortized over a period of years and deducted from gross income if they represented a proper business expense or depreciation charge.[130]

Unfortunately, the Board of Tax Appeals in one of its early decisions inaugurated a policy of refusing to analyze many types of special assessments. In *Caldwell Milling Co.*[131] the taxpayer claimed

[127]The Act of 1928 provided that "the provision relating to the nondeductiblity of special benefits shall not exclude the deduction of so much of such taxes as is properly allocable to maintenance and interest charges." 45 Stat. 791, § 23 (c).

[128]I. T. 1246, I-1 C. B. 135; I. T. 1653, II-1 C. B. 121; I. T. 2164, IV-1 C. B. 34. Belfast Investment Co., 17 B. T. A.213 (1929); F. A. Smith, 11 B. T. A. 301 (1928).

[129]G. C. M. 821, V-2 C. B. 38; Reg. 45 (1920 ed.), Art. 133; Reg. 62, Art. 133; Reg. 65, Art. 133; Reg. 69, Art. 133.

[130]G. C. M. 5589, VIII-1 C. B. 83. See I. T. 2164, IV-1 C. B. 34. See also O. D. 373, 2 C. B. 123, revoked by I. T. 2462, VIII-1 C. B. 253, on the recommendation of G. C. M. 5866, VIII-1 C. B. 200. See also, letter of D. H. Blair, Commissioner, reprinted in Prentice-Hall, 1940 Federal Tax Service, Par. 13,200.

[131]3 B. T. A. 1232 (1926). See also Belfast Investment Co., 17 B. T. A. 213 (1929).

that since the 1918 Act expressly denied the deduction, as a tax, of amounts "assessed against local benefits of a kind tending to increase the value of the property assessed,"[132] he should be permitted to deduct as a tax an amount paid in discharge of an assessment which allegedly did not increase the value of his property. The Board, relying upon the statement found in *Norwood v. Baker*[133] that an "exaction from the owner of private property of the cost of a public improvement in substantial excess of the special benefits accruing to him is, *to the extent of such excess,* a taking, under the guise of taxation, of private property for public use without compensation," noted that this principle was recognized by the jurisdiction in which the assessment had been made; since the taxpayer's claim for the deduction would not have been necessary if the assessment had been contested in the proper forum (assuming the contention well-founded), the Board concluded that the company should not be permitted to obtain a deduction through an inquiry striking at the constitutionality of the local statute.[134] In thus refusing to permit the deduction of the full amount in the year paid or accrued the Board, of course, merely prevented the taxpayer from distorting his taxable income for the year; the "tax" was a non-recurrent variety and this particular exaction would not be repeated during the life of the "improvement." It should, therefore, have been deferred and an aliquot part deducted each year—just as any special assessment. But in *F. M. Hubbell Son & Co.*[135] the Board refused to permit the tax-free recovery of "nondeductible" special benefits. The corporation had duly capitalized the curbs, sidewalks, and sewers adjacent to its property for which it had been required to pay a special assessment and this amount had been taken into consideration when computing its annual depreciation. The Board recognized that the action of the corporation was consistent with good accounting practice and that, for the purpose of determining capital gain or loss, this capitalization was proper.[136] However, with respect to depreciation the Board refused to treat the improvement as a depreciable asset. The deduction for depreciation was limited to property in which the taxpayer had a capital investment; since the corporation made no direct income use of the property, the earlier rulings of the Commissioner were disapproved and the deduction for depreciation

[132]Supra note 126.
[133]172 U. S. 269, 278, 279, 19 S. Ct. 187, 195 (1898).
[134]See the discussion in 3 B. T. A. at 1236.
[135]19 B. T. A. 612 (1930).
[136]Champion Paper Co., 10 B. T. A. 433 (1928).

on special assessments denied. With the approval of the Board's action by the Circuit Court of Appeals,[137] the present authority is to the effect that special assessments for permanent improvements may not be deducted in the year paid or accrued—and this is consistent with sound accounting practice. Furthermore, there are statements to the effect that such improvements may be added to the basis of the assets benefited for the purpose of ascertaining capital gain or loss.[138] But it has been expressly held that the decline in value of business property may not be fully recovered if part of the value is due to a special benefit.[139]

Just as assessments for permanent improvements do not represent the payment of "taxes," so assessments for the maintenance[140] of such improvements do not represent the payment of "taxes." Maintenance assessments more nearly resemble current expenditures than capital investments and they should be deducted in the year paid or accrued; but being in the nature of an expense which is not a tax, the deduction should be allowed only if it is incurred in connection with the taxpayer's trade or business—and as has been indicated, the early regulations accepted this view. Furthermore, the 1928 amendment[141] which excluded from special assessments amounts "allocable to maintenance and interest charges" does not require a construction which results in an affirmative authorization of the deduction of *all* such charges. It may be argued that the purpose of Congress was not to permit the deduction in all cases; it was merely to state that the deduction was not to be denied in all cases—whenever the assessment constituted an ordinary business expense it was deductible. However, subsequent regulations have not interpreted Section 23 (c) (4) in

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[137]The decision of the Board of Tax Appeals was sustained in F. M. Hubbell Son & Co. v. Burnet, 51 F. (2d) 644 (C. C. A. 8th, 1931), cert. den. 284 U. S. 664, 52 S. Ct. 41 (1931). See G. C. M. 9461, X-1 C. B. 120. See also G. C. M. 11330, XI-2 C. B. 247, and I. T. 2667, XI-2 C. B. 248, revoking O. B. 613, 3 C. B. 149.

[138]National Lumber & Tie Co. v. Commissioner, 90 F. (2d) 216 (C. C. A. 8th 1937); F. M. Hubbell Son & Co., 19 B. T. A. 612 (1930); Champion Paper Co., 10 B. T. A. 433 (1928).

[139]F. M. Hubbell Son & Co. v. Burnet, 51 F. (2d) 644 (C. C. A. 8th, 1931). Cf. Clinton Cotton Mills, Inc. v. Commissioner, 78 F. (2d) 292 (C. C. A. 4th, 1935); Helvering v. F. & R. Lazarus & Co., 308 U. S. 252, 60 S. Ct. 209 (1939).

[140]In this connection it is necessary to distinguish between improvements and maintenance. Thus, where a street was resurfaced with the granite blocks of the old surface, but over a new concrete foundation, the assessment was not for maintenance, but for a permanent improvement since the effect was to provide practically a new pavement. I. T. 1246, I-1 C. B. 135.

[141]45 Stat. 680, § 23 (c) (3).

this manner. All assessments against local benefits made for the purpose of maintenance or repair are deductible.[142]

The same liberality of treatment was not at first accorded assessments for the purpose of paying interest on improvement district obligations. As is true of maintenance assessments, assessments to meet interest charges do not involve the payment or accrual of taxes—when made in connection with the taxpayer's trade or business such payments resemble legitimate business expenses and should, in such cases, be deductible. But in spite of this very real similarity between interest and maintenance assessments, the Income Tax Unit in 1924 ruled that that part of a special assessment which was collected for the purpose of paying interest on improvement district bonds could not be deducted—the bonds were not the obligation of the taxpayer and he was not paying interest on his own debt.[143] Four years later the Board of Tax Appeals, in *F. A. Smith*,[144] reached the same conclusion. However, when the taxpayer sought to deduct the payment as a tax rather than interest he was more successful. In *Andrew Little*[145] the Board clung to its position that the assessment could not be deducted as interest, but since the taxpayer had also claimed the deduction as a tax his contention was sustained. Arising before, but not decided until after Congress had expressly provided that the prohibition against the deduction of special benefit should not include amounts "allocable to maintenance and interest charges," the Board was of the opinion that the 1928 Act made no change in the existing law and that such "taxes" were properly deductible under the earlier acts. *F. A. Smith* was distinguished on the ground that the petitioner had not separated the interest from the rest of the assessment and that he had not "raised the specific issue as to whether

[142] Reg. 103, Sec. 19.23c-(3). However, the validity of this regulation may be questioned. In Lee Wilson & Co., 25 B. T. A. 840 (1932) the taxpayer was permitted to deduct an assessment for maintenance as business expense. The deduction was allowed in Chapman & Dewey Lumber Co., 25 B. T. A. 1166 (1932), on the authority of Lee Wilson & Co. Neither case is authority for the position taken in the regulations that all such assessments are deductible since the payments in both decisions were clearly connected with the taxpayer's trade or business and arose under the Acts of 1921, 1924 and 1926. See Lizzie H. Glide, 27 B. T. A. 911, 915 (1920), where it was said that the 1928 provision was "explanatory" rather than "amendatory."

[143] I. T. 2044, III-2 C. B. 98.

[144] 11 B. T. A. 301 (1928). In Claud Nichols Comstock, 15 B. T. A. 769 (1929), the deduction was again denied. But interest on overdue assessments was deductible. Evens & Howard Fire Brick Co., 8 B. T. A. 867 (1927).

[145] 21 B. T. A. 911 (1930).

an assessment for interest on the district's bonds constituted a tax of a kind tending to increase the value of the property assessed."[146]

The failure to examine the character of assessments for *permanent* "improvements" (which had not been repeated in those decisions dealing with interest and maintenance assessments) continued to cause difficulty in those cases where assessments were made for *temporary* improvements. In *Oscar Michell*[147] the taxpayer was assessed by the City of Duluth for sprinkling the street in front of his residential property. The assessment was made pursuant to a provision in the city charter authorizing the city council to "order the construction of any sidewalk or sewer, or the sprinkling of any highway... and may cause the cost of such construction or sprinkling... to be assessed against the property specially benefited." The assessment was disallowed by the Commissioner on the ground that it was a special benefit, but the Board held it to be deductible as a tax on the ground that the sprinkling of a street "was not an improvement intended to increase the value" of the taxpayer's property and that it was a tax levied to pay "one of the incidental expenses that are incurred by the municipality for the public interest."[148] In reaching this conclusion, however, the Board failed to realize that the purpose of compulsory "improvement" to a taxpayer's property is to bring about a public benefit.[149] The sprinkling of the street was an advantage to the public and the property-owner just as the paving of the same street would result in both a special and a general benefit—but the fact that a street pavement also benefited the public has not been a basis for treating a special assessment therefor as a tax. Sprinkling the street resulted in a temporary benefit to the property assessed and it should have been so recognized. The amount paid or accrued should not be deducted as a tax; if the

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[146]21 B. T. A. at 915. Claud Nichols Comstock, 15 B. T. A. 769 (1929) was explained by saying that there "the only issue was whether the assessment for interest on drainage district bonds could be deducted by the taxpayer as interest paid, and that decision is followed in the case at bar." For later decisions, see Lee Wilson & Co., 25 B. T. A. 840 (1932); Chapman & Dewey Lumber Co., 25 B. T. A. 1166 (1932); Lizzie H. Glide, 27 B. T. A. 1264 (1933).

[147]27 B. T. A. 101 (1932).

[148]27 B. T. A. at 105.

[149]"Suppose that the city authorities decide to pave a certain street. There will generally result a material advantage to the owners of land fronting that street on the account of the rise in the value of such land.... The city government undertakes a new street pavement, not from any desire to benefit particularly the owners of the land, but because the interests of all the people of the city will be promoted by a better surface on that street." 2 Fairchild and Others, Elementary Economics (1936) 9, 10.

property benefited was used in the taxpayer's trade or business the assessment should be deducted as a business expense, but if the property was used as his private residence the assessment was nothing more than a personal expense and it should not have been deducted from his gross income. Thus the result reached by the Board may be justified *if* the assessment involved business property, but the analysis may be criticized. Where the Board treated an assessment for interest as a tax the result reached in the specific case was probably correct since interest payments, like taxes, may be deducted even though not connected with the taxpayer's income producing activities.[150] This is not true of ordinary expenses. Maintenance charges, regardless of whether they are for repairs or for some temporary betterment, may not be deducted from gross income unless they are a business expense.

While it is often difficult to discover the character of an exaction described as a "tax," a "fine," a "penalty," or a "special assessment," it seems apparent that, in cases of importance at least, there should be no objection to a litigant demonstrating the inaptness of the description. Thus in determining whether a penalty in question is a fine, a fee, an interest charge, or the collection of a back tax, the circumstances pertinent to the solution of this problem should be considered instead of arbitrarily denying the deduction merely because it is given the name "penalty." The Supreme Court has recently pointed out that the name given the "tax" or "penalty" is not conclusive;[151] the legal effect of the payment is determined by its purpose and not its description. Furthermore, the nondeductibility of a penalty has been seriously questioned. The recent practice has been to consider the reason for imposing the penalty claimed as a deduction. Suggestions are to be found to the effect that a penalty may be deducted as a business expense if the evidence is clear that the penalty is imposed because of negligence rather than because of fraud.[152] This practice could be carried to a degree consistent with a reasonably certain allocation of penalty payments to the various purposes served by the exaction. To the extent that the penalty represented a fine it would be treated as such and the

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[150]"In computing net income there shall be allowed as a deduction: ... (b) All interest paid or accrued within the taxable year on indebtedness ..." Int. Rev. Code § 23 (b).

[151]United State v. Constantine, 296 U. S. 287, 55 S. Ct. 223 (1935).

[152]See United States v. Jaffray, 97 F. (2d) 488 (C. C. A. 8th, 1938). There is a historical basis for the deduction of both fines and penalties. See T. D., July 27, 1866, reprinted in Digest of Internal Revenue Decisions 1864-1898 (1906), (fines and penalties imposed for violating excise laws deductible from the profits of the business for which they were incurred, but not from the income from other pursuits).

payment disallowed; but that part of the penalty imposed for lateness or which represented the unpaid tax would be treated in the same manner as all interest payments and back taxes. In those cases where the statute makes no provision for the payment of interest on past due taxes, but merely imposes a penalty, some part of the penalty should be considered as interest. Similarly, where the statute does not provide for the collection of the unpaid tax, but merely imposes a large penalty, it would appear that that part of the payment equal to the unpaid tax could properly be considered a deductible tax within the meaning of 23 (c). And finally, if it is possible to allocate any part of the penalty to the cost of discovering the non-payment of the tax, that part so allocated should be treated as a fee and deducted only in those cases where similar fees may be deducted.

This same care should be exercised in determining the deductibility of a fine since a fine also has the double disadvantage of being excluded as a business expense as well as a tax. It sometimes happens that fines are imposed for the purpose of raising revenue—traffic violations offer ample opportunity for this practice.[153] If it is clearly shown that the purpose of the "fine" was to raise revenue and not to impose punishment, it is arguable that such payments should be deducted as taxes.

When the Treasury Department and the Board of Tax Appeals are left free to determine the nature of a payment designated as a fee the results conform to the orthodox concept of a tax; but when a state or federal court has first passed upon the nature of the exaction (even though the decision has no direct bearing on the problem at hand) the problem of analysis is forgotten and the letter of an irrelevant opinion taken as decisive.[154] The Supreme Court has clearly indicated that a state decision may not be used as a basis for reaching a result contrary to the intention of Congress.[155] Where fees are collected for some special privilege and the amounts do not materially exceed the cost to the government, the payments are usually classified as fees and the deductions denied. But it is not to be supposed that the states could change this result by merely tagging the fees with the official

[153]See Lutz, Public Finance (1936) 294.

[154]See the discussion in Clark Thread Co., 28 B. T. A. 1128, 1152, 1153 (1933), where this different treatment was recognized by the Board. Cf. G. C. M. 597a, V-2 C. B. 168; I. T. 2570, X-1 C. B. 115; Mim. 4595, 1937-1 C. B. 63.

[155]E. g., see Burnet v. Harmel, 287 U. S. 103, 53 S. Ct. 74 (1932); Lyeth v. Hoey, 305 U. S. 188, 59 S. Ct. 155 (1938); Morgan v. Commissioner, 309 U. S. 626, 60 S. Ct. 424 (1940); United States v. Pelzer, 312 U. S. 399, 61 S. Ct. 659 (1941).

title of "taxes." Neither dicta nor decisions will bring the fee within the tax deduction provision when the purpose is to deprive the federal government of revenue. If random remarks and even express holdings will not be permitted to justify the deduction as a tax those payments which are not taxes, then similar statements should not be used to deny the deduction of payments which are actually taxes but which are not so described.[156]

This same approach should be taken in determining the deductibility of payments made to secure licenses. Such payments may represent merely the cost to the state of issuing the license or the cost of regulating the business subject thereto—in which event the payment should be treated as a fee. However, many licenses are required merely for the purpose of raising revenue and they should be treated as any other tax.[157] Where the charge is a combination of the two, the combination tax-fee payment should be allocated to its proper category whenever the available information is sufficient to warrant the proration.[158]

The inclusion of the special benefit provisions in the tax deduction section has led to considerable difficulty and confusion. The failure to recognize that special assessments are not "taxes" has given rise to the doctrine that all special assessments, except those clearly excluded by the statute, may be deducted as taxes. The result of this unfortunate association has been a tendency to exclude for most purposes those special assessments which were specifically declared not to be taxes; on the other extreme there has been a tendency to permit the deduction of all special benefits which were not specifically excluded as taxes. Irrespective of whether the payment represented a capital charge or personal expense there has been a refusal to examine the character of the exaction in order to determine its deductibility. Furthermore, it has been suggested that a charge for a special benefit, even though it contributes nothing to the general support of the taxing authority, may be deducted as a tax if the local assessment is so framed that the property subject to the exaction is not the same as the property benefited; an improvement assessed against the real property benefited would not be deductible, but the same improvement

[156]See, for example, the remarks of Magruder, Circuit Judge, concerning the effect to be given to the characterization of a tax by a state court in George S. Colton Elastic Webb Co. v. United States, 116 F. (2d) 202, 204 (C. C. A. 1st, 1940).

[157]See Holeproof Hosiery Co., 11 B. T. A. 547, 554 (1928).

[158]The burden should be on the taxpayer to satisfactorily demonstrate the validity of his allocation. Cf. Sprague—Sells Corp., 30 B. T. A. 1165 (1934).

assessed against the personal property of the taxpayer could be deducted from his gross income.[159]

As a result of the failure to analyze the nature of the various exactions labeled as "special assessments," the rulings lead to the conclusion that all special assessments for temporary improvements, for maintenance, for interest, and even for permanent improvements—if the charge is not technically assessed against the property benefited—may be deducted as "taxes paid or accrued."[160] If the amount in question is in the nature of an ordinary special assessment which represents a permanent improvement, then the payment is not deductible either as a tax in the year paid or accrued or as depreciation over the life of the improvement. Even though studies of special assessments have shown that in some cases the property subject to the assessment has been actually injured rather than improved,[161] a payment described as a special assessment will nevertheless be treated as a benefit and the deduction denied. A taxpayer who has been forced to expend a large sum of money in payment of a non-beneficial improvement has contributed just as much to the public revenues as the person who paid the same amount in ordinary local taxes—the fact that the payment is earmarked for a particular purpose should make no difference. If the taxpayer is able to show that the benefit received is substantially less than the amount of the assessment he should be permitted to deduct the assessment;[162] but as is true of assessments for maintenance, the burden should be upon the taxpayer "to show the allocation of the amounts assessed to the different purposes." If this cannot be done, none of the amount so paid should be deductible as a tax.

If the deduction is not to become even more capricious than the language of section 23 (c) requires,[163] it is imperative that an effort

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[159]In G. C. M. 821, V-2 C. B. 38, it was said that Mississippi levee district "taxes" assessed against real property were not deductible, but that "taxes" of the same district assessed against personal property were deductible.

[160]Compare the accounting treatment of such assessments. Paton, Essentials of Accounting (1938) 302.

[161]In general, see Hahne, Special Assessments and Licenses (1936) 183 Annals Am. Academy Pol. Sci. 130; Hahne, Special Assessments, in 14 Encyclopaedia of the Social Sciences 276, 277, 278; Spengler, The Increment Tax Versus Special Assessments (1935) 21 Nat. Tax Ass'n. Bulletin 14. See also Simpson, Changing Theory of Property Taxation, (1939) 29 Am. Econ. Rev. 453, 465; Graham, Special Assessments in Detroit (1930) 21, 22; Burnstan, Special Assessment Procedure (1929) 84, 91.

[162]See National Lumber & Tie Co. v. Commissioner, 90 F. (2d) 216(C. C. A. 8th, 1937) where the taxpayer successfully sustained his contention that he should be permitted to show, for the purpose of computing the loss on the sale of assets, what part, if any, of the Louisiana levee taxes were assessed against local benefits.

[163]Cf. Helvering v. Queen Ins. Co., 115 F. (2d) 341, 342 (C. C. A. 2d, 1940).

be made to permit the allowance of payments falling within the orthodox definition of a tax. At best the implied limitation which prohibits the taxpayer from deducting those taxes not technically imposed upon him but which he indirectly pays causes a great amount of unfairness. It is difficult to comprehend the desirability of a deduction which depends so much upon the methods adopted by the several states to raise local revenue. To accentuate this disparity of treatment by refusing to examine payments which, if analyzed, would clearly fall within the provisions of the present statute is far less understandable.

Yet even if care is exercised and formal considerations ignored, the existing deduction of taxes is highly unsatisfactory. To amend the statute to permit the deduction of all taxes actually borne by the taxpayer—whether imposed directly upon him or not—is, of course, infeasible.[164] Aside from the administrative problems involved, the loss of revenue resulting from the larger allowance prohibits this attempt during a period of tremendous national deficits. Consequently, in order to remove the unfairness of section 23 (c), an amendment which would deny the deduction of any tax other than a tax incurred in the taxpayer's trade, business, or profession appears desirable.[165] The accounting problems appear much less formidable than those created by the pseudo-economic conceptualism of the present law.

To a limited extent Congress has recognized the impropriety of the broad tax deduction of the Civil War statutes.[166] Because of the irrelevance of the exaction in computing annual income[167] and because of the difficulty involved in determining the taxpayer entitled to the deduction, estate, inheritance, legacy, succession, and gift taxes were finally removed from the list of deductible taxes.[168] The deduction of

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[164]For some of the difficulties involved in attempting to estimate this burden see Haig and Shoup, The Sales Tax in the United States (1934) 29 et seq.

[165]This was seriously urged during the early operation of the present income tax statute. Montgomery, Income Tax Procedure (1917) 352. See also Seligman, The Income Tax (1914) 684; Plehn, Introduction to Public Finance (1931) 243, 244. For a more recent criticism see Paul, The Emergency Job of Federal Taxation (1941) 27 Corn. L. Q. 3, 19.

[166]"In computing net income no deduction shall in any case be allowed in respect of—(5) Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this chapter." Int. Rev. Code § 24. Pursuant to this provision and Treasury Regulations 103, § 19.24-4,it has been ruled that a state income tax paid on the exempt compensation of state employees is not deductible from gross income. I. T. 3353, 1940-1 C. B. 44.

[167]See the Committee Reports reprinted in 1939-1 (Part 2) C. B. 570, 605.

[168]Int. Rev. Code § 23 (c) (3). In general, see Paul and Mertens, Law of Federal Income Taxation (1934) §§ 25.50, 25.51, 25.52, 25.53, 25.54, 25.55.

federal income, war-profits, and excess-profits taxes was denied because of the adverse effect of the deduction upon the productivity of the income tax—a loss of revenue which the national government could not afford during the first World War.[169] In addition, citizens of the United States residing abroad may not deduct the foreign tax on income from sources within the United States which is not subject to the federal income tax, or taxes "properly allocable or chargeable against amounts excluded from gross income" because earned outside the United States.[170] Nonresident alien individuals may deduct only those taxes connected with income from sources within the United States—[171] the tax may be either foreign or local, but it must be related to the income subject to the federal tax.[172] Nonresident citizens of possessions of the United States who are not citizens of the United States are treated, in this respect, like nonresident aliens.[173] No taxes may be deducted by nonresident foreign corporations,[174] but such resident corporations may deduct, as in the case of nonresident alien individuals, only those taxes connected with income from sources within the United States.[175]

If the exception should be made the rule and taxes treated as any other expenditure and the deduction permitted only if a business expense, one of the glaring inequalities of the present legislation would be corrected. Taxes relating to the individual's personal expenditures would not be allowed—regardless of whether the exaction was technically imposed upon him or passed along in the form of higher prices;

[169]1939-1 (Part 2) C. B. 67. The deduction of the federal income tax has met with varied treatment. For example, the deduction was denied in the Act of 1864 (13 Stat. 223). The Acts of 1870 (16 Stat. 256), 1894 (28 Stat. 509), 1909 (36 Stat. 11), 1913 (38 Stat. 114), and 1916 (39 Stat. 756) permitted the deduction. With the Act of 1917 (40 Stat. 301), all subsequent income tax statutes have prohibited the deduction. In United States v. Hudson, 299 U. S. 498, 57 S. Ct. 309 (1937), the Supreme Court held that the tax on transfers of interests in silver bullion was an income tax. This caused a revocation of I. T. 2899, C. B. XIV-1, 67, which permitted the deduction from gross income, by I. T. 3049, C. B. 1937-1, 139. The latter ruling was revoked and the deduction again permitted on the ground that the tax on silver was a "special income tax" and not of the same "general" character as the "Federal income tax" referred to in § 23 (c) 1. Mim. 4587, C. B. 1937-1, 74.

[170]Int. Rev. Code § 116 (a). Hubbard v. United States, 17 F. S. 93 (Ct. Cl. 1936).

[171]If the non-resident alien individual receives an amount of $23,000 or less from sources within the United States, no deduction for taxes is permitted. Int. Rev. Code §§ 211 (a) (1) (A), 211 (a) (2). For treatment of residents of contiguous countries subject to special treaty provisions see § 211 (a) (3).

[172]Int. Rev. Code § 213. Waldorf Astor, 31 B. T. A. 1009 (1935).

[173]Int. Rev. Code § 252.

[174]Int. Rev. Code § 231 (a). Treas. Reg. 101, Art 232-1.

[175]Int. Rev. Code § 231 (b) (c) 232.

but business taxes would be deductible in either event— both direct and indirect taxes would be included in the cost of operations. Thus subtracted from total revenues if a business tax and ignored if a personal tax, the local tax policy of the states would no longer be of such paramount importance; a person in one state who paid directly a certain amount for the support of local government would have no income tax advantage over a person in another state who paid the same amount in indirect taxes.[176]

That persons with the same income and the same exemptions should pay the same tax is not only a theoretical ideal—the present income tax rates make it a practical necessity. And even more important during this period of emergency, the removal of that part of the deduction which places a disproportionate burden upon a part of the public will result in an appreciable increase in the national revenue. It is difficult to believe that there can be a valid objection to a revision of Section 23 (c) which increases both the productivity of the federal income tax and the accuracy with which it apportions the national fiscal burden.

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[176]Cf. Note (1941) 55 Harv. L. Rev. 255.