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Robert Hanes Gray

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THE SUPREME COURT, ACCOUNTING, AND
THE TAX ACCRUAL OF "TRUE" INCOME

ROBERT IANES GRAY*

A self-assessed tax, to be effective, must be determined by generally understood or understandable rules governing the computation of the tax base, and the results of that computation must conform with the taxpayer's general sense of fairness. This is true of a tax on wages, on investment income, and on business profits. It is, oddly enough, also true of a tax on corporate income.

From one point of view, a business corporation is merely a group of investors and employees engaged in an enterprise for profit, a very large part of which must be paid to the federal government, not because profit, as profit, has been earned, but because profit has been earned by a group of individuals who have been organized in a particular fashion. The heavy tax burden of the corporate privilege, collected by a government not ordinarily granting it, is reckoned by, and to a substantial degree is based on, the collective judgments and approximations of a number of people, primarily those charged with the duty of estimating corporate income.1

During the life span of a sizeable business, millions (billions) of items will have been acquired and disposed of, and more or less standard procedures will have been established internally2 to sort, record, and summarize the vast amount of information collected in connection with those items. The statistical problem would be a comparatively simple one if it were convenient to wait until the end of the life of the enterprise before determining the financial success of a business. A comparison of the items contributed to the business by owners with

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1"It is important that accountants keep in the forefront of any discussion of income, its composite nature as the resultant of positive (credit) and negative (debit) elements." P. Grady, Inventory of Generally Accepted Accounting Principles for Business Enterprises 411 (1965).

2Customarily found through the chart of accounts and in the accounting manual.
the items distributed to them during and at the end of its activity would afford a measure of gain or loss. But the need for information by owners, managers, and tax collectors cannot be postponed until the conclusion of the indefinite life of the enterprise. Daily, monthly, and quarterly reports are frequently useful or necessary; annual reports are mandatory.

The computation of annual income typically requires the resolution of three related but distinct problems. The flow of items, for example, between a corporation and its shareholders, customers, and creditors (including employees and suppliers of goods and services) must first be evaluated and expressed in monetary terms. Those items relevant to income determination must then be identified. And finally, items so evaluated and identified must be allocated to the years for which income is to be estimated. The first problem, that of evaluation, frequently goes unrecognized or is treated perfunctorily, but, when it is considered, the better procedure is to value receipts at market and disbursements at cost. The second problem, that of identification, presents comparatively few difficulties: Stockholder transactions (contributions and distributions), and creditor transactions (loans and payments thereon, other than premium, discount and nominal interest paid and received) are readily eliminated at the outset, leaving for routine consideration the items resulting from the sale of goods and from services rendered (usually cash and receivables) and items consumed in producing those goods and services (buildings, machinery, raw materials, labor, and the like). But the third problem, that of timing, is quite another matter.

The determination of the income of an enterprise for a particular period is said to be "a most important task of accounting." Business activity is continuous. Expenditures in one year may relate to costs applicable to a number of years; receipts may be attributable to earlier years, or to transactions which will not be completed until some future time. Accounting conventions indicate the accepted bases for allocation in many situations; business judgment determines the allocation in other instances. The process is a constantly recurring one and decisions of varying importance are made throughout the year at all levels of the records keeping process. Many of the most important decisions, including those which can materially affect the income of the period, are made at year-end, that unhappy time when, like the stopped legislative clock, days and weeks pass into the new year before the books are finally closed. Business income, therefore, represents the net result of

a great many decisions; it is a composite concept which requires the application of carefully coordinated rules. The reliability of the net estimate depends in large part upon the consistency of that application and upon the degree of coordination.

In any industrial society the accounting process is so established, so bound in tradition, and, in many cases, so cumbersome or overloaded, that statutes, case law, or regulations which depart from customary accounting concepts of business income will almost certainly be ignored when minor items are affected and modified when major ones are involved. The Supreme Court decisions relating to the accrual of taxable income illustrate the point.

I. Taxable Income Antecedents: An Excise Measured by Gross Receipts.

When the Supreme Court in *Pollock v. Farmers Loan & Trust Co.* held unconstitutional the unapportioned Wilson Tariff Act of 1894 (the 1894 Act) "so far as it levies a tax on the rents or income of real estate," or "on personal property, or on the income of personal property," it did not end public demand for an income tax. Many believed that the question had not been fully presented to the Court, and that it would be held constitutional if reenacted.

Faced with the need for additional revenue generated by the Spanish-American War and with the possible apportionment restriction of the *Pollock* decision, Congress enacted the War Revenue Act of 1898 (the 1898 Act). Unlike the 1894 Act, Section 27 of the 1898 Act carefully distinguished between the subject and the measure of the tax. All persons "carrying on or doing" designated activities were required to

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4That is, minor in amount as to individual items, but often immense in the aggregate.

5157 U.S. 429 (1895); 158 U.S. 601 (1895).

6The Constitution provided that direct taxes "shall be apportioned among the several States" (art. I, § 2, cl. 3), and that "No capitation, or other direct, Tax shall be levied, unless in Proportion to the Census or Enumeration" (art. I, § 8, cl. 1). As to other taxes, the Constitution required that "all Duties, Imposts and Excises shall be uniform throughout the United States" (art. I, § 7, cl. 1).

78 Stat. 509, 553 (1894).

8157 U.S. at 583.

9157 U.S. at 601.

1030 Stat. 448 (1898).

11Section 27 of the 1894 Act provided that there shall be "paid annually upon the gains, profits, and income received . . . by every citizen . . . a tax . . . on the amount so derived . . ." and in like manner Section 32 of the Act provided for the collection of a tax "on the net profits or income of all . . . corporations . . . ."

1230 Stat. 464 (1898).
pay "a special excise tax equivalent to" a specified percentage of gross receipts.\textsuperscript{18}

The special excise easily withstood the challenge made in \textit{Spreckels Sugar Refining Co. v. McClain}\textsuperscript{14} that it was a direct tax. The Court held that Section 27 of the Act was a valid exercise by Congress of its authority under the Constitution. "Clearly the tax is not imposed on gross annual receipts of property, but only in respect of the carrying on or doing the business of refining sugar. It cannot be otherwise regarded because of the fact that the amount of the tax is measured by the amount of the gross annual receipts."\textsuperscript{15} Implicit in the apparent victory of form over substance\textsuperscript{16} was the propriety of the measure of the

\textsuperscript{18}The 1898 Act provided in part
That every person, firm, corporation, or company carrying on or doing business of refining petroleum, or refining sugar, or owning or controlling any pipe line for transporting oil or other products, whose gross annual receipts exceed two hundred fifty thousand dollars, shall be subject to pay annually a special excise tax equivalent to one quarter of one per centum on the gross amount of all receipts of such persons, firms, corporations, and companies in their respective business in excess of said sum of two hundred and fifty thousand dollars.

\textsuperscript{14}192 U.S. 397 (1904).
\textsuperscript{15}Id. at 411.
\textsuperscript{16}At the same time, however, form did have its advantage. The legislative technique of imposing a tax on the exercise of a privilege and of ascertaining the value of that privilege by a related measure provided some guidance to the executive and judicial branches of the government (and to the taxpayer) in determining the year for which items should be included in the measure of the tax. For example, the trial court in \textit{Spreckels} concluded that amounts which had been received for sugar after the enactment of the 1898 Act in payment for sugar sold and delivered before the enactment should not be included in the measure of the tax. The tax was on the business of refining sugar determined by gross receipts from that refining, and only the receipts generated by the business taxed should be included in the tax base. Spreckels Sugar Refining Co. v. McClain, 109 F. 76, 79 (C.C.E.D. Pa. 1901); \textit{acord}, American Sugar Ref. Co. v. Rutan, 123 F. 979 (C.C.D. N.J. 1903). The trial court in \textit{Spreckels} indicated, however, that a different result might have been reached if the tax had been "directly upon" gross receipts from refining, 109 F. at 79-80. In like manner, the relationship between the subject and the measure of tax also would seem to offer guidance in determining the items includable in the measure; only items of gross receipts attributable to sugar refining should be taken into account. But that proved to be a more difficult problem. Wharfage charges were said to be includable (the wharves were used almost exclusively to unload raw sugar for the refinery) but stevedoring charges were not (ships were ordinarily unloaded by their own crews, and occasional stevedoring services performed by the taxpayer represented compensation for ship's labor and not for refining activities). The lower courts had included in gross receipts interest on bank deposits and from securities, and dividends. See 109 F. at 79, and 113 F. 244, 246 (3d Cir. 1905); \textit{acord}, American Sugar Ref. Co. v. Rutan, 123 F. 979 (C.C.D. N.J. 1903). The Supreme Court reversed: Interest on bank deposits "had no necessary relation to
excise. The Court's approval (within a few years after it had decided that a tax “upon” income from property required apportionment) of the use of gross receipts as the measure of a tax on a business requiring substantial amounts of capital suggested interesting possibilities. Not only did it offer an obvious means of circumventing Pollock, but it also offered a means of avoiding technical problems of income definition. Having established the validity of a tax measured by gross receipts, the Supreme Court presumably would not be inclined to object to a tax measured by something less than gross receipts.

II. Taxable Income Antecedents: An Excise Measured by Gross Income (Less Statutory Deductions).

By 1909 Congress was again under heavy pressure, notwithstanding the Pollock decision, to impose a tax on income. President Taft, however, suggested that an attempt to obtain a reversal would “not strengthen popular confidence in the stability of judicial construction of the constitution,” and recommended (1) a tax on corporations measured by income, and (2) the adoption of a constitutional amendment removing the income tax apportionment restriction.

As drafted, the proposed bill would tax the privilege of doing business as a corporation measured by “income received” less “expenses actually paid.” As early as 1909, however, it was recognized by those having experience in such matters that any attempt to tax corporations on a cash receipts and disbursements basis would not be feasible. Twelve leading accounting firms, in a letter to Attorney General Wickersham dated July 8, 1909, insisted that for many corporations the determination of income on a cash basis was “absolutely impossible of application,” and suggested that accrual language, more appropriate to the needs of business, be substituted. Flatly rejecting the urgent recommendation, the Attorney General replied that “the bill was purposely framed to deal with receipts and disbursements made within the year,” that the words “actually paid” were used advisedly, and that the “theory of the framers of the bill in this respect differs from that which you advocate.”

Accordingly, “The Corporation Tax” law (the 1909 Act) approved August 5, 1909, required various business organizations, chiefly cor-

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the business of refining sugar,” and dividends, in the absence of a showing to the contrary, must be assumed to be “wholly apart from the particular business in which the holder of the stock was engaged.” 192 U.S. at 417.

2XVI Messages and Papers of the Presidents 7390.
4Stat. 11 (1909).
Corporations, to pay annually "a special excise tax" in an amount "equivalent to" a percentage of "the entire net income received . . . from all sources during such year." Net income was to be "ascertained by deducting from the gross amount of the income . . . received within the year from all sources" certain cash expenditures and losses to the extent provided in the statute. Left undefined, however, was the keystone to the entire measure of the tax—the "gross amount of the income."

Confronted with legislation which required the collection of a tax based on accounting concepts not generally followed by corporations,

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20 Deductions included
(first) all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business properties, including all charges such as rentals or franchise payments, required to be made as a condition to the continued use or possession of property; (second) all losses actually sustained within the year . . . including a reasonable allowance for depreciation of property . . .; (third) interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock . . .; (fourth) all sums paid . . . within the year for taxes . . .

Section 38, 36 Stat. 11, 113 (1909).

21 Difficulties expected by accountants were great, as exemplified in the letter to the Attorney General, referred to in text preceding footnote 18, supra:

Turning now . . . to . . . a large manufacturing concern producing all kinds of finished products out of purchases of ore and other raw materials, an accurate or even approximate statement of cash receipts and disbursements on income account is a practical impossibility at any time. Cash receipts arising from sales of products can be ascertained without much difficulty beyond requiring considerable extra work. But no system of accounting can give even approximately 'the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties.' Such expenses presumably must include the cost of the goods sold. Into this cost and following it through the intricate accounting which has been found to be necessary are raw materials actually used in manufacture, labor expended, and innumerable items of expense, which are taken into costs as they accrue quite irrespective of the date of payment. Very large inventories are carried of materials and supplies which are purchased at one period, paid for at another, and used at all sorts of times, in all sorts of quantities, and for all sorts of purposes, mainly for manufacture into products for sale, but to a large extent for additions to or extensions of the plant. Such as are used for the latter purpose are not, as we understand the proposed law, a proper deduction from gross income, and yet, long before they are used all identity between the materials themselves and the disbursements made for them has been lost. There is, in our opinion, no method in which any statement such as that called for in the proposed law can be prepared short of an entirely independent and separate set of books, designed to follow each bill paid through to
the Treasury Department could have either (1) required those corporations to rework in great detail their accounts for the year, or (2) rewritten the statute by promulgating a revision thereof in the form of Treasury regulations. But even if the government could have quickly devised a cash accounting system which would have satisfied minimum standards of fairness, the first alternatives would have imposed an unreasonable burden on the self-assessment process and would have invited widespread violations. For all practical purposes, the statute as written was impossible to administer. The second alternative offered the only feasible course for Treasury to follow; accordingly regulations were hurriedly promulgated on December 3, 1909, and were soon thereafter clarified and expanded by further Treasury Decisions. To accommodate the usual corporate taxpayer which kept books on an accrual basis, Regulations 31 provided, among other things, that "it is immaterial whether any item of gross income is evidenced by cash receipts during the year" or "whether the deductions are evidenced by actual disbursements in cash." Regulations 31 also contained provisions relating to cost of goods sold and cost of capital assets sold. These provisions must have been troublesome to draft. The Act defined "net income" and the deductions were specific. It would have been awkward to include in the regulations deductions not provided for by Congress. This was not necessary, however, because "gross amount of the income" had not been defined in the statute, and apparently the same result was reached by defining that term. Consequently, gross income of mercantile and manufacturing corporations was defined as the difference between sales and cost of goods sold, cost being determined through the use of inventories, while gross income of other corporations was defined merely as the gross revenue derived from the operation and management of business and property. In the definition of gross income from the sale of capital assets, however, a new element was added: Gross income included (1) only the excess of the sales price
over cost, or (2) where property had been acquired before 1909, only that part of such excess attributable to the period after 1908.26

The decision on the part of the executive branch of government to rewrite legislative concepts of income thus permitted corporations, not geared to cash accounting, to prepare their tax returns on the basis of information compiled from their regular system of accounts. Indeed, since the views of the accountants (rather than those of the Attorney General) for a time dominated the collection machinery, it is not unreasonable to suppose that many corporations merely reported income and business expenses as reflected in their respective accounting records.

The Supreme Court in Flint v. Stone Tracy Co.27 quickly settled threshold questions of constitutionality.28 The difference between the 1894 tax ("on" income) and the 1909 tax (on "business done in a corporate capacity" in an amount "equivalent to" a percentage of "entire net income") was said to be "not merely nominal, but rests upon substantial differences between the mere ownership of property and the actual doing of business in a certain way."29 The Court also made an early start in resolving the related problems of characterizing organizations subject to the excise and of determining when they were "carrying on or doing business."30 The statutory expansion of the measure of the tax to include income from all sources (including interest from state bonds, forbidden by Pollock31), instead of only the income from the business activity subject to the tax (as was the interpretation of the 1898 Act), eliminated numerous and difficult questions, and was readily approved by the Court.32

26Regulations 31, Articles 2 and 5.
27220 U.S. 107 (1911).
28The Supreme Court unanimously affirmed fourteen lower court judgments sustaining the excise. Id.
29Id. at 150.
31As Mr. Justice Field stated in Pollock
The law is also invalid in its provisions authorizing the taxation of bonds and securities of the States and of their municipal bodies .... These bonds and securities are as important to the performance of the duties of the State as like bonds and securities of the United States are important to the performance of their duties, and are as exempt from the taxation of the United States as the former are exempt from the taxation of the States.
157 U.S. at 601.
32The Court in Stone Tracy noted that the 1909 Act
bears internal evidence that its draftsman had in mind language used in the opinion in the Spreckels case, and the measure of taxa-
But matters relating to the computation of income presented the Court with difficulties of quite a different texture. Substantial variations in the provisions of other income tax laws left the Court virtually without judicial precedent. Accounting, still in its infancy, had not obtained such recognition or understanding as would exert much influence in legal matters as the 1909 Act clearly demonstrated. Furthermore, Congress had made it impossible for the Court to formulate within the framework of the Act a coherent concept of business income in adopting as the basic measure of the tax an exceedingly ambiguous term "gross amount of the income," in providing for a shockingly incomplete schedule of ill-defined deductions therefrom, and in limiting an important part of the analytical process to differences between cash receipts and cash disbursements. In addition, the format of the statute encouraged an isolated consideration of details rather than conceptual analysis. The Act, technically imposing a tax on "net income," required two steps to reach that amount: first, the elimination of unspecified items from gross receipts to reach gross income; and second, the deduction of specified items from gross income to reach net income. Gross income therefore represented not only a rudimentary statutory concept but also an intermediate stage in the ascertainment of taxable income. Since income is a composite concept with highly interdependent rules, any judicial definition of gross income which did not take into account allowable deductions, or any decision which allowed or disallowed deductions while disregarding related items of gross income, would violate that concept and lead to capricious distortions in the amount subject to tax.

Unlike the executive branch of government which had an opportunity to develop through regulations a comprehensive definition of rules to be followed in arriving at net income, the judiciary was limited by the adversary process to the immediate issue before the court, a limitation which focused attention on details. Coupled with a tradi-

220 U.S. at 166.

3The few cases arising under the Civil War income tax statutes and the various decisions under English acts dealt with substantially dissimilar legislation and were usually not considered helpful. See, Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509, 521 (1921). Cf. Lynch v. Turrish, note 149, infra.
tional reluctance to reexamine questionable (erroneous; obsolete) decisions, the judiciary was particularly ill-equipped, through the inevitable process of trial and error, to formulate acceptable criteria for the accrual of taxable income. Unless guidance was to be sought in Treasury rulings and regulations which reflected in important respects the views of the accounting profession, the bare bones of the grossly inadequate 1909 Act afforded the only conventional source materials from which the judiciary could work. The judicial process, limited to a consideration of the Act, consequently offered little prospect of producing a comprehensive and acceptable concept of business income.

The Supreme Court from the outset was thus placed in a difficult position and, understandably, failed to assume the initiative in applying orthodox income concepts. For example, in *Stone Tracy* the Court had concluded that Congress could constitutionally restrict the amount of interest expense deductible from gross income.34 "Such details are not wholly arbitrary."35 Such "details," however, could be ruinous, and while the conclusion regarding legislative power seems correct, it did not follow that that power had been blindly exercised by Congress. Since interest expense was normally charged against earnings, it was to be expected that an attack through statutory construction on the disallowance would continue, as it did in *Anderson v. Forty-Two Broadway Co.*36 In that case the Company had never earned a profit. Its paid-up capital stock was only $600 and its bonded indebtedness secured by mortgages on its real estate amounted to $4,750,000. Interest payments during the year aggregated $339,516.93 but interest (as interest) allowable as a deduction under the Act was only $36. Instead of a loss, the Company's "net income" as recomputed by the Commissioner amounted to $178,136.37 The lower courts, however, did not accept the Commissioner's determination and held that, while not deductible as interest, the disputed amounts were properly allowable under the provision of the Act which permitted the deduction of expenses required to be paid as a condition to the continued use or possession of pro-

34220 U.S. at 173-74.
35Id. at 173.
This provision may have been inserted with a view to prevent corporations from issuing a large amount of bonds in excess of the paid-up capital stock, and thereby distributing profits so as to avoid the tax. In any event, we see no reason why this method of ascertaining the deductions allowed should invalidate the act.

Id.
36239 U.S. 69 (1915).
37See the opinion below of the Circuit Court of Appeals, 213 F. 777, 778 (ad Cir. 1914), aff'g 209 F. 991 (S.D.N.Y. 1913).
The Supreme Court rejected that construction of the statute, and confined allowable interest expense to the specific deduction provided by Congress. In reversing the lower courts, the Court stated that the interest limitation was not an arbitrary classification and that it was reasonable to assume

that Congress deemed that where the indebtedness does exceed the capital it should no longer be treated as an incident, but that the carrying of the indebtedness should be considered as a principal object of the corporate activities, that the operations of such a corporation are conducted more for the benefit of the creditors than of the stockholders, and that the contribution of the corporation to the expenses of the Government should be admeasured with this fact in view.

The conclusion that the Company was operated for the benefit of creditors failed, however, to take into account the fact that the "contribution" was, to the extent of their equity, entirely at the expense of stockholders.

Aside from the evident hardship resulting from the Court’s interpretation of the Act in Forty-Two Broadway, a more foreboding point of view was reflected in that decision: It was held to be reversible error for the lower courts to seek "a theoretically accurate definition of 'net income' instead of adopting the meaning which is so clearly defined in the Act itself." Accordingly, the Court thereafter refused to deal comprehensively with the problems of income determination. As was stated later by many courts in various ways and in scores of cases interpreting successive income tax laws, deductions were a matter of legislative grace. Having sustained in Spreckels a business excise measured by gross receipts, constitutional questions regarding the power of Congress to eliminate items from gross receipts in arriving at a statutory tax base such as "gross income," or "net income," or some intermediate measure were thereafter effectively foreclosed. As to questions of statutory interpretation, provisions of the statute were to be

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38 See note 20, supra.

39 U.S. at 73. From the standpoint of the shareholder, the measure of corporate activity in relation to his investment demanded full recognition of the interest expense, and the lower courts agreed. But since the Supreme Court found the primary problem to be one of ascertaining the intent of Congress in selecting the subject of the tax (in this case corporate activity in behalf of creditors as well as shareholders), the measure of the tax was defined so as to effectuate that "intent."

40 Id at 72.

41 That conclusion also had been suggested by Mr. Justice Day who equated "income" with "gross income" in Stone Tracy when he stated that "the measure of the tax is to be the income, with the deduction stated . . . ." 220 U.S. at 146.

42 U.S. 397 (1904).
construed, item by item, and not construed as a part of a larger concept of taxable income.

Piecemeal interpretation rather than a conceptual approach to the Act was strikingly apparent in the early depletion cases. Net income, "so clearly defined in the Act itself," obviously could be determined only by subtracting statutory deductions from undefined "gross amount of the income." As noted above, Treasury had attempted to provide definitions of gross income in its rulings and regulations and from the outset had taken the position that, in the case of the sale of a capital asset, only that part of the receipts from a sale attributable to gain arising after 1908 was to be included in gross income, not the entire selling price. That ruling, with a technical modification, was then extended to mining and similar activities. Pre-1909 appreciation in value (the unearned increment) of ores and other deposits extracted and sold during the year was excludable from gross income and the actual cost of the ore in place was to be recovered as depreciation.

In Stratton's Independence, Ltd. v. Howbert, Treasury interpretations, while clearly relevant, were not discussed by the Court. The taxpayer, a British corporation profitably mining gold in Colorado, argued that by mining it was merely changing the form of assets already owned, that it was not thereby engaged in business for profit ("the enjoyment

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43 See text accompanying note 26, supra.
44 Art. 2, § 5, of Regulations 31 provided that
In ascertaining income derived from the sale of capital assets,... acquired prior to January 1, 1909, the amount of increment or depreciation representing the difference between the selling and buying price is to be adjusted so as to fairly determine the proportion of the loss or gain arising subsequent to January 1, 1909, and which proportion shall be deducted from or added to the gross income for the year in which the sale was made.
45 T.D. 1675, note 24 supra at ¶ 83-87, provided in part:
In the case of corporations whose business consists of mining... deposits of nature (ores, coals, gas, petroleum and sundry minerals) ...In the ascertaining of net income, deduction will be allowed for depreciation arising from exhaustion of deposits of ore, mineral, etc., and for depreciation and obsolescence of improvements... on the basis of the original capital investment cost of the properties ....A further deduction will also be allowed, though not including the same at all in the item of gross income...for the unearned increment represented in such properties as at January 1, 1909.... [determined by estimating] the fair market value at that date of the minerals, etc., in deposit...reduced to a unit value....The unit value...attached...to the capital assets disposed of during any year...should be used in determining the unearned increment at January 1, 1909, which may be excluded entirely from the item of gross income....
46 231 U.S. 399 (1913).
of the assets and the wasting thereof are in direct proportion, and proceed *pari passu*), and that it was, in effect, merely converting its capital assets from one form (gold ore) into another (gold coins). It followed, it was argued, that a tax on the conversion measured by the value of the property converted would be unconstitutional, citing *Pollock*. After considerable discussion the Supreme Court reached the not unexpected answer to the first question certified by the Circuit Court of Appeals: The taxpayer was engaged in business for profit within the meaning of the Act. In reaching that conclusion the Court disclaimed any intention of discussing basic income concepts (Congress had not intended to enact an “income tax” law), and professed little interest in “theoretical distinctions between capital and income.”

Not being unconstitutional, “glaringly unequal,” or “palpably unjust,” the Act was to be construed according to “its letter.” (Notwithstanding its disclaimer, the Court then proceeded to define “income,” thereafter much quoted, as “gain derived from capital, from labor, or both combined.”) Alleged inequalities between mining and other businesses were not deemed to be serious; “earnings of the human brain and hand” and income from patents were not unlike the exhaustion of ore deposits. Income computed for the purpose of the excise “need not be such an income as would have been taxable as such. . . .” Congress desired to approximate the benefit received by corporations from government, and it was reasonable for “Congress to fix upon gross income” as “a convenient and sufficiently accurate index of the importance of the business transacted.” The measure of the tax should be “easy of ascertainment and simply and readily applied in practice.” The Court had “no difficulty, therefore, in concluding that the proceeds of ores mined by a corporation from its own premises are to be taken as a part of the gross income of such corporation.”*47* Having thus answered the second question certified by defining the term gross income, as used in the Act, to include “proceeds of ores mined,” the Court came to the third question. Is the taxpayer, under the Act, “entitled to deduct the value of such ore in place and before it is mined as depreciation?” That question was answered in the negative, three Justices dissenting. The Court took the position that the words “value of the ore in place,” as used in the question certified, meant the difference between selling price and all other costs of extracting and selling the ores mined, an unacceptable method of valuation because it would have eliminated all taxable profits. The record, therefore, was said to preclude any inquiry

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*231 U.S. at 413-17.*
into the availability of the deduction, if the taxpayer had used some other method of valuation.\textsuperscript{48}

The Court in \textit{Stratton's Independence} followed its customary practice in dealing with excises. Finding the taxpayer to be a corporation engaged in business for profit, the measure of the excise was of little judicial interest.\textsuperscript{49} The Court thus failed to consider the real question in controversy, not an abstract interpretation of undefined "gross income" or of "depreciation," but whether the recovery of capital through mining operations was to be included in the measure of the tax. In view of the manner in which the questions were certified to the Court and because exclusions from gross receipts and deductions from gross income were but two approaches to the same problem, it was to be expected that the problem would again come before the Court, as it did soon thereafter, in three depletion cases,\textsuperscript{50} two of which\textsuperscript{51} were decided on the same day that the Court reached a basically con-

\textsuperscript{48}The Court held that inquiry into the matter of deductions had been prevented by the agreed statement of facts, and by the form in which the questions had been submitted to it for decision.

It would therefore be improper for us at this time to enter into the question whether the clause, "a reasonable allowance for depreciation of property, if any" calls for an allowance on that account in making up the tax, where no depreciation is charged in practical bookkeeping; or the question whether depreciation, when allowable, may properly be based upon the depletion of the ore supply estimated otherwise than by the mode shown in the agreed statement of facts herein....

231 U.S. at 422-23.

Earlier in the opinion the Court had noted that the taxpayer had not shown that "the so-called 'value of the ore in place,' or any other sum, was actually charged off upon the books of the company as depreciation." Id. at 406.

Nevertheless, the Court did observe that the valuation of the property and the amount of the depreciation were to be determined not upon the basis of latent and occult intrinsic values, but upon considerations that affect market value and have their influence upon men of affairs charged with the management of the business and accounting of corporations that are organized for profit and are engaged in business for purposes of profit and was clearly of the opinion that it was "quite inadmissible to estimate such depletion as if it had been done by a trespasser, to whom all profit is denied." Id. at 421.

\textsuperscript{49}The question of whether Congress could tax a given subject was for the Court to decide, the amount of the tax was thought to be a legislative matter. \textit{See Veazie Bank v. Fenno}, 75 U.S. (8 Wall.) 533 (1869).


\textsuperscript{51}\textit{Biwabik Mining} and \textit{Goldfield Consolidated}, note 50, supra.
In the first of those depletion cases, the lessor, Sargent Land Co., owned land in Minnesota acquired prior to 1907 which was subject to long-term mining leases requiring the lessee to pay specified amounts per ton for ore mined. In the second, a lessee, Biwabik Mining Co., conducted mining operations under "precisely similar iron ore leases." In the third, Goldfield Consolidated Mines Co. owned the ore body which it mined. In the case involving Biwabik Mining Co., it was stipulated that the quantity and quality of the ore body easily recoverable during the term of the lease could be determined "with extraordinary accuracy."

The district court had ruled that the royalties received by Sargent Land Co. did not constitute gross income because "the property was..."
worth no more to them in 1909, 1910, and 1911 than it was in 1906, 1907, and 1908." The Supreme Court reversed. Relying in part on a decision of the Minnesota court validating similar leases of state lands, leases which would have been void under the local constitution if held to be sales, the Court said that the payments received "were not in substance the proceeds of an outright sale of a mining property" but "were in fact rents or royalties ..." and as such came "fairly within the term income...." As to deductions, the only one discussed was depreciation. The Court reasoned that Congress must have used "depreciation of property" in the "ordinary and usual sense as understood by businessmen" and since Congress had provided an allowance (as such) for depletion in the 1913 and 1916 Acts, the Court concluded that depletion was not deductible under the 1909 Act. The rental payments were, therefore, fully includable in gross income without the benefit of any allowance for the ore mined.

Biwabik Mining Co. fared no better. Treasury rulings relating to lessees were not helpful. But the propensity to use "income" in its

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\(5\) T.D. 1606, note 24 supra, provided that "Corporations leasing mines and paying royalties on ore mined [are] not entitled to deduction for depreciation."
normally understood sense persisted. The Circuit Court of Appeals sustained the action of the taxpayer in excluding from gross income the January 1, 1909, value of ore mined during the year to the extent that such value exceeded the royalty payments. The lessee's existing interest, at the beginning of the taxing period, over and above the royalty which he must pay, amounted to $3,000,000; his entire interest was each year, so far as he went, con-

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63For example, the court in Biwabik Mining Co. said

[It is urged that we are not concerned with the meaning of 'income', because, under this statute, income is not the thing taxed, but is the measure of taxation. We do not appreciate the force of the claimed inference. 'Income' is a word capable of definition....

It would have been perfectly natural for Congress to decide that the tax which it was to impose upon the privilege should be measured either by the amount of business done thereunder or by the proved value of the privilege. Either would have been a logical basis for such taxation. If the former had been the adopted theory, the tax would have been measured by total receipts, or by total sales, or by total disbursements, or by some combination of these measurements, and any thought of profits would have been utterly foreign to the scheme of measurement. The most casual inspection of the laws shows that this theory was not adopted.... It is of the essence of the law that a corporation doing a business of $100,000 and making $50,000 profit, is to be taxed 1 per cent upon that profit, less the exemption, or $450, while a corporation doing a business of $10,000,000 and making no profit is not to be taxed at all. It is clear to a demonstration that Congress deliberately intended to tax the franchise according to its actual value to the user, as determined by the annual profit derived therefrom, without regard to its value as indicated by the amount of business done.

So, too, it is urged that we should not be concerned with this definition, because the statute itself carefully defines what the tax upon income shall be. As has been pointed out, this idea rests upon a clear misapprehension of the statute; the law does not purport to do this or anything like this. The statutory computation rests upon the assumption that we already know what income is as distinguished from other matters; otherwise, it would be impossible to state that gross income which is the foundation of that statutory computation.


64The appraised value of unmined ore amounted to $0.2875 per ton, required royalty payments were $0.30 per ton, a lump-sum payment by the lessee of $612,000 at the time the lease was acquired represented a cost of $0.03885 per ton, and the remainder of the appraised value, or $0.44865 per ton, represented the amount in controversy. (The appraised value was apparently reflected in the books of the company, see 247 U.S. at 121, a practice deemed prudent in view of Treasury rulings and court comment, and one frequently adopted in the mining industry.) The government had not appealed the trial court's allowance of cost depletion ($0.03885).

242 F. at 13. The Supreme Court was careful to note the government's failure to appeal the allowance of the partial deduction by the district court; "it follows that the correctness of that ruling is not open here." 247 U.S. at 126.
sumed and exhausted forever; ... these receipts were from the sale of capital assets and not from income. The Supreme Court disagreed. It reaffirmed its view of the legal effect of the leases expressed in Sargent Land and held that Biwabik Mining Co. took "from the property the ore mined, paying for the privilege so much per ton for each ton removed." The lessee was "in no legal sense a purchaser of ore in place." The full amount of the appreciation was subject to the tax.

Goldfield Consolidated Mines Co. had carefully followed Treasury rulings, including (delayed) book entries to record the January 1, 1909, value of the ore deposits which it owned and mined and had submitted a revised return which reflected the reduction in that value attributable to the year's mining operations (and, unlike the position taken by the taxpayer in Stratton's Independence, had reported substantial net income, $765,380.02). The Supreme Court, nevertheless, in answer to questions propounded by the lower court, summarily held that a mining corporation may not (1) deduct from gross income any amount whatever for depletion, or (2) deduct from gross proceeds "the cost value of the ore in the ground," even though ascertained in strict compliance with Treasury rules and regulations.

In the foregoing depletion cases, Treasury rulings and regulations were not at any time discussed, but it seems clear that a "sale" of the ore body would have brought into operation the exclusion provisions. Earlier in Stratton's Independence the Court had conceded that "the sale outright of a mining property might be fairly described as a mere

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65242 F. at 17.
66247 U.S. at 125-26.
68See note 45, supra.
69The Court noted that In view of the discussion of the nature of mining property in Stratton's Independence ... and the application of the principles therein laid down in the subsequent cases of Stanton v. Baltic Mining Co., 240 U.S. 103 [a case arising under the 1913 Act], and Von Baumbach v. Sargent Land Co. ... it is unnecessary to enter upon further consideration of the matters disposed of in those cases. 247 U.S. at 131-32.
70In addition to royalties, Sargent Land Co. had received amounts from sales of "stumpage, lots and lands." The case was remanded to the district court "for further proceedings, if any are sought, upon claim of right to deduct the value of the lands, lots and stumpage sold." Von Baumbach v. Sargent Land Co., 242 U.S. 503 at 523-28 (1917). The exclusion of March 1, 1913, value of mining property was approved in Eldorado Coal & Mining Co. v. Mager, 255 U.S. 522 (1921), notwithstanding the problem of valuation and the Court's earlier view of the "peculiar" nature of the mining industry. See Reinecke v. Spalding, 280 U.S. 227 (1930) (also dealing with March 1, 1913, value).
conversion of the capital from land into money." But neither the absence of a technical sale of ore deposits nor the division of interests in those deposits should have been conclusive. With a reasonable estimate of recoverable tonnage of known quality, the market value of the ore bodies could have been established and an amount per ton readily assigned to the cost of production, including, in the case of leased properties, an apportionment of unit value between lessor and lessee, as later Supreme Court cases clearly demonstrated.

Indeed, the inevitable shift in position to more orthodox income analysis became apparent on the same day that Biwabik Mining Co. and Goldfield Consolidated Mines Co. were decided. In Doyle v. Mitchell Brothers Co. the taxpayer, engaged in lumbering, sawmilling, and related activities, had purchased timber lands in 1903 from which it had cut timber during the tax years 1909 to 1912, inclusive, and in filing its tax returns had excluded from gross receipts the pre-1909 value of the timber cut. In sustaining the taxpayer, it was held that the "true intent" of the Act was to measure the tax by income (which "imports" "gain or increase"), not by the entire gross receipts from the sale of capital assets. Consequently, even though the statute did not

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231 U.S. at 414-15.

Various economic interests in mineral deposits were thereafter recognized. See, e.g., Palmer v. Bender, 287 U.S. 551 (1932) (lessee-transferor of oil leases); Bankers Pocahontas Coal Co. v. Burnet, 287 U.S. 308 (1932) (transfer of coal lands subject to lease); Burnet v. Harmel, 287 U.S. 103 (1932) (lessee of oil and gas properties); Lynch v. Alworth-Stephens Co., 287 U.S. 364 (1925). In Alworth-Stephens the taxpayer had leased mining properties from the owners and thereafter subleased them to others (all prior to 1913), the royalties received being substantially in excess of those paid. The March 1 value of the net royalties received in 1917 was claimed as a deduction for that year, and was disallowed on the theory that the taxpayer was not the owner of the leased properties. The Court agreed as to ownership but disagreed with the disallowance. Under the "general rule" of the 1916 Act a deduction was allowable for the "exhaustion of the property," and it was clear to the Court that the right of the taxpayer "to mine...the ore and reduce it to possession" was "property." 287 U.S. at 370. Sargent Land Co. and Biwabik Mining Co. were distinguished. The issues of depreciation and of ownership of the ore bodies, rather than the issue of exhaustion or depletion, were before the Court in those cases, and the question of the property interests of lessees "such as we have determined here, was not considered." Id. at 371. Thus, gain attributable to years prior to March 1, 1913, was excluded from taxable income regardless of whether it was realized from the outright sale of mining property, note 70, supra, or through the exhaustion of an ore body in the ordinary course of mining. The Court, however, continued to consider depletion as a legislative problem. See, e.g., Burnet v. Thompson Oil & Gas Co., 283 U.S. 301, 304 (1931). But see Helvering v. Falk, 291 U.S. 183 (1934), and Reynolds v. Cooper, 291 U.S. 192 (1934), where the Court provided relief for trust beneficiaries where the Act was silent.

247 U.S. 179 (1918).

Id. at 184-85. Earlier in the opinion the Court, in its analysis of the Act, had said that the legislative purpose was not to tax property as such, or the mere
provide for a deduction for capital costs or pre-1909 value, the Court held that the taxpayer was correct in excluding from gross receipts "the admittedly accurate valuation as of December 31, 1908, of the stumpage cut and converted during the year covered by the tax." Treasury regulations "correctly" interpreted the Act. Gross income did not mean gross receipts, but even if it did, the same result could be reached through depreciation. It was "a mere question of methods, not affecting the result."75

*Hays v. Gauley Mountain Coal Co.*76 and *United States v. Cleveland Cincinnati, Chicago & St. Louis Railway Co.*,77 dealt with purchases of shares of stock in other corporations prior to the effective date of the 1909 Act and sales of such stock during taxable years after that date. The Court in *Gauley Mountain* distinguished *Gray v. Darlington*78 which had held that certain sales of government bonds were not taxable under the 1867 income tax legislation79 on the ground that the language of the two statutes was "different in material particulars,"80 and reaffirmed the principle that only that portion of the gross receipts representing gain arising after the effective date of the Act was to be "regarded as 'gross income.'"81 The Court then turned to the problem of allocation. In *Cleveland Railway* the December 31, 1908, value of the shares had been stipulated; the Circuit Court of Appeals held that only the excess of the sales price over the stipulated value should be included in gross income. In *Gauley Mountain* there was no evidence of market value; the Commissioner had spread the gain ratably over the entire period the shares were held, so only that part of the gain allocated to years after 1908 was included in gross income. Both methods of allocating pre-1909 gain were approved. As was stated in *Gauley Mountain*, the method to be used was "a matter of conversion of property, but to tax the conduct of the business of corporations organized for profit by a measure based upon the gainful returns from their business operations and property from the time the Act took effect.

*Id.* at 185.

*Id.* at 188-89. The analogy of the claim for depreciation of mining properties was said to be "superficial," since the Court had previously held that the removal of ores "cannot be regarded as depreciation within the meaning of the act." *Id.* at 188.

75247 U.S. 189 (1918).
76247 U.S. 195 (1918).
7782 U.S. (15 Wall.) 63 (1872).
78Act of March 2, 1867, ch. 169, § 13, 14 Stat. 478 (1867). The 1867 Act was interpreted to tax only annual gains, with certain exceptions.
79247 U.S. at 191.
80*Id.* at 193.
detail to be settled according to the best evidence obtainable, and in accordance with valid departmental regulations.”

The Supreme Court in Gauley Mountain also summarized its strangely ambivalent position regarding the accrual of income under the 1909 Act. The Act “measured the tax by income received within the year for which the assessment was levied, whether it accrued in that year or in some preceding year while the act was in effect; but it excluded all income that accrued prior to January 1, 1909, although afterwards received while the act was in effect.”

Accrual accounting had been considered and rejected by the Court earlier in McCoch v. Insurance Company of North America. Additional to reserves for unpaid losses (whether actually adjusted, in process of adjustment, or resisted), not “required by law,” had been disallowed as deductions from gross income in that case. Somewhat later in Maryland Casualty Co. v. United States, the Court also disallowed taxes, salaries, brokerage and reinsurance unpaid at the end of the year but at the same time held that premiums received by an agent, although not subject to attachment as the company’s property while in the agent’s possession, were “received” by the insurance company.

In the few cases decided by the Supreme Court under the 1909 Act, with the exception of Mitchell Brothers, Gauley Mountain and Cleveland Railway where Treasury regulations were followed, the Court ignored those regulations and insisted on cash basis accounting in a corporate world of accrual. Given two reasonable interpretations of the Act, the Court, following the “letter” of the law, chose the one producing the greater distortion in income and thereby reemphasized the view expressed in Stratton’s Independence that “income” within the meaning of the 1909 Act “need not be such an income as would have been taxable as such.”

Treasury, however, in its rulings and regulations had been more pragmatic in yielding to customary business practice in its efforts to collect the revenue. As a result, Supreme Court pronouncements were largely of academic interest to corporations which had filed returns under the 1909 Act. In retrospect, those returns, by not reporting income

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82Id.
83Id. at 192.
84244 U.S. 585 (1917).
85The 1909 Act provided for additional deductions for insurance companies, including “the net addition, if any, required by law to be made within the year to reserve funds ….” 36 Stat. 113.
86251 U.S. 342 (1929).
87The “receipt by the agent is regarded as receipt by his principal.” Id. at 347.
88251 U.S. at 416, note 46 supra,
on a cash basis, were in violation of the law. Nevertheless, it may be assumed that they were, for the most part, accepted as filed.

But even though its decisions had negligible impact upon federal revenues collected under the 1909 Act, the Court's approach to matters dealing with the computation of taxable income foreshadowed unnecessary difficulties in the administration of subsequent income tax laws, all of which embodied basic flaws of the 1909 Act. The Court displayed an astonishing indifference to the distortions which resulted from a literal interpretation and enforcement of the Act and to customary business practices regarding the accrual of current transactions, practices which provided the basis for the self-assessment of the tax. And when the Court denied the accrual of pre-1909 gain to a taxpayer engaged in mining and on the same day permitted it to one engaged in lumbering, the amounts being determined with reasonable accuracy in both cases, the Court displayed a misdirected respect for the doctrine of *stare decisis* and for easily distinguishable cases decided, not with regard to the problem of ascertaining business income for the taxable year, but by the application of ancient legal principles to irrelevant questions of title. But perhaps more unfortunate was the apparent determination of the Court to resolve difficult accounting (valuation) problems by the simple expedient of refusing to consider them. In its blanket rejection of a deduction or an exclusion because of the "peculiar" nature of the mining industry, the Court not only succeeded in provoking congressional reaction (overreaction), unresolved more than a half century later, but it also rejected a basic practice customarily employed in the determination of periodic income, the use of estimates when certainty is impossible.

III. An Income Tax on Gross Income (Less Statutory Deductions):

The 1913 Act.

With the adoption of the sixteenth amendment, the Chairman of the Ways and Means Committee, Congressman Underhill, requested Congressman Cordell Hull to prepare implementing legislation. Congressman Hull, in turn, requested a committee of accountants to assist him in the work of drafting the bill. The bill, after many changes, became Section II of the Tariff Act of October 3, 1913 (the 1913 Act) and reflected some of the suggestions of the accountants, but certainly

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9"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."
1038 Stat. 114, 166 (1913).
not in the manner intended. The bill, divided into two parts, one applying to individuals and the other to corporations, would impose a tax on net income "arising or accruing" during the taxable year. Individuals would be permitted to deduct business expenses "actually incurred," interest "accrued and payable," and taxes "accrued within the year." But when providing for corporations, the bill reverted to the pattern of the 1909 Act. Ordinary and necessary expenses, interest, and taxes would be deductible from gross income "received" only if "paid" within the year.

The approach, eccentric at best, to allow individuals ordinarily on a cash basis to report income and expense when accrued but requiring corporations, normally accruing income and expenses, to report on a cash basis, was properly rejected by the Senate Finance Committee. Unfortunately, instead of revising the bill to accord with customary practice, the individual deductions were conformed with those permitted corporations. Consequently the 1913 Act was a mixture of cash and accrual terminology, with cash requirements prevailing in the operative provisions. The tax was imposed on net income "arising or accruing" during the year, but net income was to be ascertained by deducting paid expenses from gross income received. The provisions of the 1913 Act relating to corporations, in common with those of the 1909 Act, were impossible to administer as written, and Treasury modifications, similar to those issued under the earlier Act, were again necessary.82

IV. Income as a Constitutional Concept: Problems of Valuation and of Identification.

Congress incorporated in the 1913 Act the worst features of the 1909 Act, cash accounting, undefined gross income, and inadequate deductions. It failed to include the best feature of the earlier Act, the distinction between the subject and the measure of the tax (a distinction which had effectively sterilized Pollock), and thereby made inevitable the injection of questions of constitutionality in an already impossible problem of formulating under the Act an acceptable concept of business income. The ill-advised sixteenth amendment failed to characterize "taxes on incomes,"93 and questions regarding the tax base, formerly matters largely of congressional discretion,94 thereafter acquired ominous constitutional overtones.

82Regulations 33 (January 5, 1914). See, for example, Articles 96, 97, 101, 104, 105 106, 107, 114, 129, 125, 158 and 161.
83Note 90 supra.
84Note 49 supra.
The decision to abandon the corporate excise as a separate revenue measure and to provide for a tax "upon" corporate income in conjunction with a tax "upon" individual income, aside from the needless complexities created by interrelated provisions, made proper characterization of the new tax by the Supreme Court a matter of considerable difficulty, not yet resolved. Arguably the inclusion of important parts of the 1909 Act in the corporation sections of the 1913 Act reflected not only congressional approval of earlier Treasury interpretations of the provisions so reenacted, but also congressional intent to enact the income tax as an excise, an expansion and reenactment of the 1909 Act to include individuals as well as corporations. After Pollock, Congress was careful to distinguish between the subject and the measure of a tax when it drafted the 1898 and 1909 Acts. Before Pollock that distinction was not explicit; the privilege taxed could be readily inferred from the statute, and that appeared to be sufficient. The Civil War taxes "upon" income had been collected as valid excises, and it could be assumed that Congress intended, and the amendment permitted, the 1913 Act to be considered in the same light. But if that had been the intention of Congress, it should have been clearly indicated in the statute.

The Constitution required that direct taxes be apportioned and excises be uniform. The sixteenth amendment merely provided that income taxes need not be apportioned. Pollock declared that an income tax on income from property was, in effect, a tax on property and a direct tax, invalid for want of apportionment. And on first impression it would seem to follow, a fortiori, that an unapportioned income tax on property itself would be invalid. The sixteenth amendment removed the requirement of apportionment of "taxes on incomes," and a statute which taxed non-income items was not, as to those items, relieved from apportionment by the amendment. But excises which were measured by non-income items had a long history of judicial approval. As early as 1794 Congress had imposed an annual tax (unapportioned) "on" carriages which was held to be constitutional in Hylton v. United States, notwithstanding the contention that it was a direct tax. And as late as 1914 an annual tax (unapportioned) on the "use" of foreign-built yachts had been valid in Billings v. United States; and among many other taxes sustained by the Court were

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9Note 6 supra.
90Note 90 supra.
97U.S. (3 Dall.) 150 (1796).
98232 U.S. 261 (1914).
excises measured by the value of property transferred (Knowlton v. Moore),
by gross receipts (Speckels) and by gross income reduced by designated but limited deductions (Stone Tracy).
Both before and after Pollock the Court had given Congress wide latitude in enacting excise laws.

For almost a hundred years following Hylton, direct taxes were thought to include only capitation taxes and taxes on real estate. Pollock broadened the category to include personal property. If the sixteenth amendment should be considered a constitutional reversal of Pollock (although unhappily worded if that were the purpose), the income tax once more would be subject to the requirement of uniformity, and direct taxes subject to apportionment would again be limited to capitation taxes and taxes on real property. As an excise, the subject of the tax would ordinarily fall within the unquestioned taxing power of Congress, and the measure of the tax, within very broad limits, would be a matter of legislative discretion.

But if the sixteenth amendment had the effect of writing Pollock into the Constitution and, at the same time, relieving “taxes on incomes” from the necessity of apportionment, income taxes would continue to be, in effect, direct taxes requiring apportionment when not laid on income. So interpreted, form rather than substance would then become of primary importance in fiscal legislation. For if an unapportioned income tax could not include non-income items, presumably an unapportioned tax could, if in the form of a conventional excise; and since, in substance, the difference between a tax on income and a tax on a privilege measured by income is imperceptible, Congress could easily reach a desired result through careful legislative draftsmanship. Matters of form had sufficed to distinguish the valid refining tax of 1898 and the valid corporation tax of 1909 from the unconstitutional income tax of 1894, and there should be no reason to suppose that Pollock acquired a vitality from the sixteenth amendment which it did not have before the amendment was adopted.

A third possibility, one more in keeping with the language of the sixteenth amendment, would be to consider the amendment as a neutral factor in the classification of the income tax. Pollock would stand or fall on its own merits. Whether direct or indirect, a tax on an item which the Supreme Court deemed to be income need not be apportioned. Other constitutional questions regarding taxes would be decided without reference to the amendment. So construed, the unhappy deci-
sion to follow the route of constitutional amendment recommended by President Taft merely postponed straightforward action by Congress which would, sooner or later, directly challenge Pollock, notwithstanding the asserted fear that such action would "not strengthen popular confidence in the stability of judicial construction of the constitution." Judicial restraints on federal fiscal power imposed by a sharply divided Court in Pollock, restraints subsequently diluted to matters of form rather than substance, obviously invited legislative encroachment.

The effect of the sixteenth amendment upon the fiscal power of Congress was considered at some length by Mr. Chief Justice White in Brushaber v. Union Pacific Railroad Co. and in Stanton v. Baltic Mining Co. In much the same way that it had first considered the 1909 Act in Stone Tracy the Court in Brushaber summarily rejected a great many arguments against the 1913 Act. Basic constitutional validity was firmly established, and a number of provisions of the Act were expressly upheld, including a limitation on the amount of interest deductible by corporations. The limitation on the amount of deductible interest was again considered and declared valid in Tyee Realty Co. v. Anderson, decided the same day as Baltic Mining which sustained a limitation on the depletion deduction, new in the 1913 Act, over the taxpayer's contention that the limitation deprived it of some four-fifths of its depletion for the year.

In discussing constitutional limitations on congressional fiscal power, the Chief Justice said that in the field of income taxes the power of Congress was "complete and plenary." The amendment did not confer any new power of taxation but "simply prohibited" that power "from being taken from the category of indirect taxation to which it inherently belonged" and placed "by a mistaken theory" in

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102 Note 17 supra.
103 240 U.S. 1 (1916).
104 240 U.S. 103 (1916).
105 220 U.S. 107 (1911).
106 The interest deduction permitted a corporation was limited to "interest accrued and paid within the year on its indebtedness to an amount of such indebtedness not exceeding one-half of the sum of its interest bearing indebtedness and its paid-up capital stock." Section II(G)(b) (third), 38 Stat. 173 (1913).
107 240 U.S. 115 (1916). "The tax does not rest upon income in the true sense of the word." Id. at 116.
108 Depletion was limited to "5 per centum of the gross value at the mine of the output for the year." Section II(G)(b) (second), 38 Stat. 172-73 (1913).
109 Computed on the basis of March 1, 1913, value of the ore.
110 240 U.S. at 112.
111 240 U.S. at 17; 240 U.S. at 112. See text accompanying notes 116 and 139 infra. See also note 143.
the category of direct taxation. The suggestion that an income tax should be classified as a direct tax was flatly rejected, since the income tax, if a direct tax, would be exempt not only from the requirement of apportionment but also from the rule of uniformity, "thus giving power to impose a different tax in one State or States than was levied in another State or States." Not being a direct tax, there was no difficulty, therefore, in concluding, as the Court did in Baltic Mining, that an income tax under the sixteenth amendment could include "the gross product of the working of the mine." Furthermore, "independently of the effect of the operation of the sixteenth amendment," it was settled in Stratton's Independence "that such a tax is not a tax upon property as such because of its ownership, but a true excise levied on the results of the business of carrying on mining operations."

The sixteenth amendment accordingly was said to restore the income tax to the category of indirect taxes to which "it inherently belonged." And both Baltic Mining and Tyee Realty (where items of gross income were not in question) demonstrated that Congress had considerable latitude in defining net income. But more important, the sixteenth amendment was, in effect, declared redundant at least so far as corporate income taxes were involved because an income tax, ascertained by subtracting from gross income such deductions as Congress might provide, was declared to be a "true excise" on business activity despite the fact that the 1913 Act, unlike the 1909 Act, imposed a tax "upon" income and did not, in so many words, specify the privilege taxed.

In emphasizing the point that the sixteenth amendment merely re-established the income tax as an indirect tax, the Chief Justice in Baltic Mining unfortunately overstated his position. Notwithstanding the clear authority of Congress to tax "incomes from whatever source derived, without apportionment," the Chief Justice volunteered the observation that "the Sixteenth Amendment conferred no new power of taxation."

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112 U.S. at 112-13.
113 U.S. at 12.
114 U.S. at 112-14.
115 Id. at 114. A more limited view was expressed in Willcuts v. Bunn, 282 U.S. 216, 227-28 (1931): In sustaining the income tax on gain from the sale of municipal bonds, Mr. Chief Justice Hughes, writing for a unanimous Court, stated that the "federal income tax acts cover taxes of different sorts [citing Brushaber and Baltic Mining].... The tax upon profits made upon purchase and sales is an excise." See also Morrissey v. Commissioner, 296 U.S. 344, 355 (1935).
116 U.S. at 17; 240 U.S. at 112. See text beginning at note 199 infra.
In Baltic Mining the tax was on receipts (reduced by such deductions as were permitted by Congress) which contained a possible element of gain. That element of gain was less apparent in the stock dividend cases. Unlike the 1913 Act which failed to define dividends,117 the 1916 Act expressly included stock dividends in taxable income,118 and the later legislation was enacted before the stock dividend controversy under the earlier Act was argued before the Supreme Court in Towne v. Eisner.119 The problem in Towne, nominally one of statutory interpretation, was considered in the shadow of that congressional action. Relying heavily on its decision in a case dealing with life tenants and remaindermen,120 the Court held the 50% stock dividend declared out of pre-1913 surplus to be nontaxable. The shareholder was "no richer" and the declaring corporation "no poorer" after the distribution "than they were before." And even if additional advantage had been received, it was de minimis.121 Expressed somewhat differently, the stock dividend was said not to be a "dividend;" it was, in effect, nothing more than a stock "split up,"122 a conclusion not unlike that reached today in conventional accounting analyses dealing with relatively large stock distributions.123

The constitutional question reached the Court some two years later in Eisner v. Macomber.124 The Court, assisted by the Government's concession that the "mere issue of a stock dividend makes the recipient no richer than before,"125 reverted to the overall valuation analysis of

117Net income included "dividends, securities,...and income derived from any source whatever." Sections II(B) and II(G)(a), 38 Stat. 166, 167, 172 (1913).
118The 1916 Act provided that net income shall include "dividends," and "dividends" shall be held to mean any distribution out of earnings and profits accrued since March 1, 1913, "whether in cash or in stock of the corporation... which stock dividend shall be considered income, to the amount of the cash value." Sections 2(a) and 10, 39 Stat. 756, 757, 766 (1916).
119245 U.S. 418 (1918).
121If the taxpayer "gained any small advantage by the change, it certainly was not an advantage of $417,450, the sum upon which he was taxed." 245 U.S. at 426.
122245 U.S. at 427. The lower court noted that capital stock was increased "from $3,000,000 to $4,500,000, par." 242 F. 702, 704 (S.D.N.Y. 1917).
123See, for example, Accounting Research Bulletin No. 43, Chapter 7, Section B, reprinted in P. GRADY, INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES 206-08 (1965).
125252 U.S. at 214. The concession was made in connection with the argument that the issuance of stock certificates reflecting accumulated corporate gains was an appropriate time to tax those gains to the shareholders, citing Collector v. Hubbard, 79 U.S. (12 Wall.) 1 (1870), which involved the provision of the 1864
the earlier decision, and reiterated the view that a stock dividend took nothing from the property of the corporation and added nothing to that of the shareholder—it was "merely bookkeeping." Pollock prohibited an unapportioned tax on income from property. The sixteenth amendment adopted that interpretation; it merely removed the necessity of an apportionment of taxes laid on income. Apportionment of taxes on capital was still required. It was thus essential "to distinguish between what is and what is not 'income'," and to apply the distinction "according to truth and substance, without regard to form." That conclusion made it impossible to consider the tax on stock dividends as a valid excise, because the dual aspect of an indirect tax had been recognized as early as Hylton v. United States, and a strict insistence on "truth and substance, without regard to form," would destroy most excises.

A perplexing mixture of statutory and constitutional interpretation appeared in the Court's decision in Edwards v. Cuba Railroad Co. in which it was held that subsidies paid by the Cuban Government to the taxpayer during the years 1911 to 1916, inclusive, were not "income." The "no richer than before" test, not referred to in the opinion, was obviously inappropriate because the assets of the taxpayer were clearly increased by the amount of the subsidies received. Instead, the Court, disagreeing with the Government's contention that the subsidies were advance payments for transportation services later to be performed by the taxpayer, said that the payments were not income because they were in partial reimbursement of capital expenditures, not for the payment of dividends, interest or anything else properly

income tax law which taxed shareholders on their respective shares of corporate earnings, whether distributed or not, a case said to be inconsistent with Pollock and not to be followed. 252 U.S. at 218.


The validity of the tax as an excise was discussed in neither the majority nor in the minority opinion.

Note 97 supra. Mr. Justice Chase said that "I believe some taxes may be both direct and indirect at the same time. If so, would congress be prohibited from laying such a tax because it is partly a direct tax?" 1 U.S. (3 Dall. at 174) at 152.

268 U.S. 628 (1925), aff'g Cuba R.R. v. Edwards, 293 F. 664 (S.D.N.Y. 1921) (holding that the subsidy payments were not "income in any practical business sense." 298 F. at 666).
chargeable to or payable out of earnings or income. The subsidy payments taxed were not made for services rendered or to be rendered. They were not profits or gains from the use or operation of the railroad. . . .

Mitchell Brothers had referred to "income" as used in the 1909 Act as conveying "the idea of gain or increase arising from corporate activities," and the subsidies clearly represented increases in assets arising from corporate activities; but even if that were not the case, the 1909 Act expressly included income from all sources. The measure of the excise was not limited to income from corporate activity subject to the tax, and the sixteenth amendment contained similar language equally broad, as did the 1913 and 1916 Acts. Furthermore, the meaning of "income" in the 1909 Act was said by the Court "not to be distinguished from" the meaning of "income" as used in the 1913 and 1916 Acts. Nevertheless, the Court concluded that subsidies "were not profits or gains from the use or operation of the railroad, and do not constitute income within the meaning of the sixteenth amendment." Presumably Congress had not intended to tax subsidies under the 1909 Act; it could not under the 1913 and 1916 Acts.

Constitutional objections were more than a substitute for statutory interpretation in National Life Insurance Co. v. United States which involved the computation of taxable net income of insurance companies. Section 245 of the 1921 Act provided, among other things, for a deduction from gross income of (1) tax-exempt interest and (2) 4% of certain reserve funds, the latter deduction being reduced, however, by the amount of the former. Inasmuch as an insurance company with tax-exempt interest would have the same taxable net income as an otherwise identical insurance company receiving fully taxable interest, the Court declared the reserve fund adjustment invalid. "Congress has no power purposely and directly to tax state obligations by refusing to their owners deductions allowed to others."

368 U.S. at 633. Compare Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950) (assets received from community groups to locate or expand plants represent capital contributions which are depreciable) with Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943) (extension of taxpayer's facilities paid for by customer not depreciable).

247 U.S. at 185.
Note 32 supra.
Note 90 supra.
In both Acts the tax was upon income "from all sources."
968 U.S. at 631.
Id. at 633.
508 (1928).
Stat. 261 (1921).
U.S. at 522.
Stone Tracy\textsuperscript{42} had sustained the inclusion of tax-exempt interest in the measure of the 1909 corporate excise, and William E. Peck & Co. v. Lowe,\textsuperscript{143} after the Amendment, had upheld the tax on income from exports. Yet Pollock v. Farmers' Loan & Trust Co.\textsuperscript{144} still governed some aspects of a tax described as an "income tax." Although the Court was soon thereafter to begin its retreat from the doctrine of derivative immunity,\textsuperscript{145} for a time the express constitutional power of Congress "to lay and collect taxes on incomes, from whatever sources derived, without apportionment" was not so construed. The power did not extend to a tax on the income from state bonds.

In its decisions in Tyee Realty and Baltic Mining the Supreme Court had upheld an income tax on capital.\textsuperscript{146} When a taxpayer operated at a loss, as in Forty-Two Broadway,\textsuperscript{147} the disallowance of a proper charge against revenue could produce statutory "net income" even though the net assets of the taxpayer actually decreased during the year as a result of those operations. The exaction of an income tax further accelerated that decrease. In no sense could the tax be considered other than a "contribution" to the Government of a part of the

\textsuperscript{142}Text accompanying note 27 supra.

\textsuperscript{143}247 U.S. 165 (1918). The Court said that the sixteenth amendment had "no real bearing" on the question of whether the tax on income from exports violated the constitutional prohibition against federal taxation of "articles exported from any state." Art. I, § 9, cl. 5. As had been pointed out in Brushaber and Baltic Mining, the amendment did not extend the taxing power "to new or excepted subjects." 247 U.S. at 172. But aside from the sixteenth amendment, a nondiscriminatory income tax on the profits of exportation was not laid on "articles in course of exportation," and was not, therefore, "laid on property while being exported." 247 U.S. at 174. See also Barclay & Co. v. Edwards, 267 U.S. 442 (1924); National Paper & Type Co. v. Bowers, 266 U.S. 373 (1924).

\textsuperscript{144}Note 5 supra.

\textsuperscript{145}The Court upheld the tax on the gain from the sale of state bonds in Willcuts v. Bunn, 282 U.S. 216 (1931) and sustained in Denmon v. Slayton, 282 U.S. 514 (1931), the statutory disallowance of a deduction because of the receipt of tax-exempt interest,—the deduction of interest on indebtedness incurred or continued to purchase or carry tax exempt obligations. Section 214(3)(c) of the 1921 Act, 42 Stat. 227 (1921). It was a permissible classification to prevent tax avoidance.


\textsuperscript{146}A tax on gross income would frequently result in the taxation of capital, because there is no necessary relationship between gross income and income. Obviously many businesses with gross income operate at a loss, frequently leading to insolvency, yet the Court has repeatedly said that Congress has the power to tax gross income. See, e.g., Deputy v. DuPont, 308 U.S. 488, 493 (1940); cf. White v. United States, 305 U.S. 281, 292 (1939); Helvering v. Winmill, 305 U.S. 79, 84 (1938); Helvering v. Independent Life Ins. Co., 292 U.S. 371, 381 (1934); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934).

\textsuperscript{147}Notes 36 and 37 supra.
taxpayer's capital. Nevertheless, the Court sustained various provisions which could make that result possible under the sixteenth amendment. Yet Macomber held a tax on a stock dividend invalid because it was an unapportioned tax on capital, and in so deciding the Court insisted (without discussing Tyee Realty and Baltic Mining) that effect must be given to matters of substance rather than form. It followed from Macomber that an income tax on the beneficial use by a taxpayer of his own property would also require apportionment. The Court thus recognized two inconsistent views of the sixteenth amendment. When dealing with general business activity, the income tax was valid as an excise, but, when specific transactions were considered a direct tax analysis was adopted. As a result of Tyee Realty and Baltic Mining, a taxpayer operating a business at a loss (which obviously made him poorer than before) was subject to an unapportioned income tax, while under Macomber and Cuba Railroad a taxpayer receiving a stock dividend (which made him neither richer nor poorer than before), or subsidies (which made him richer than before) was not. Under either view, the Court made it abundantly clear that whatever the standards might be, the sixteenth amendment did not require the computation of income in accordance with generally accepted accounting principles.

V. Income as a Judicial Concept: Transactions, Corporations and Annual Accounting.

The failure of the Supreme Court to reconcile its views of the proper classification of the income tax under the Constitution, a matter within its particular province, presaged greater vacillation in less familiar areas where constitutional questions were not in issue. For example, the problem of allocating income to periods before and after March 1, 1913, should have been an easy one. The Court, however, solved it in ways which led to conflicting precedents, precedents later preserved by inadequate distinctions and applied in the areas of annual accounting and closely controlled corporations with unsettling results.

See Helvering v. Independent Life Ins. Co., 292 U.S. 371 (1934); Rockford Life Insurance Co. v. Commissioner, 292 U.S. 382 (1934). These cases dealt with the disallowance of real estate expenses attributable to property owned and occupied by the taxpayer. By way of dictum the Court in Independent Life Insurance Co. said that

If the statute lays taxes on the part of the building occupied by the owner or upon the rental value of that space, it cannot be sustained, for this would be to lay a direct tax requiring apportionment. ... The rental value of the building used by the owner does not constitute income within the meaning of the Sixteenth Amendment.

292 U.S. at 378-79.
The "no richer than before" test used in Towne was applied by the Court shortly thereafter in Lynch v. Turrish. In this case the taxpayer received a liquidating dividend in 1914 following the sale of timber lands by the corporation making the distribution. All appreciation in value of the taxpayer's shares of stock, as well as the corporation's assets, had taken place prior to March 1, 1913. The conversion of the corporation's property and of the taxpayer's stock (real property to personal property; stock to cash) represented, in effect, sales of assets without gain attributable to a taxable period after March 1, 1913, and the case could have been decided on that ground without further discussion. Instead, the Supreme Court expressly approved the reasoning of the lower court which had declared the liquidating dividend to be tax-free on the authority of two decisions interpreting specific provisions contained in the 1864 and 1867 income tax laws, provisions not present in the 1913 Act: (1) That the March 1 value of the corporate assets had accrued to the shareholders before the effective date of the 1913 Act, so the corporation's distribution of the proceeds from the sale of those assets did not result in taxable gain, citing Collector v. Hubbard, a case involving the 1864 law which expressly provided for the inclusion in the taxable income of a shareholder of his portion of corporate profits, whether distributed or not, and (2) that gain on the sale of assets which had appreciated in value over a number of years was not taxable in the year of realization, the Court citing Gray v. Darlington, a case which the Court had refused to follow only two weeks earlier in Gauley Mountain, pointing out material differences in the language of the 1867 and 1909 Acts (differences which were also present with respect to the 1913 Act).

247 U.S. 221 (1918).

The original transaction was in the form of an option to purchase all of the stock of the corporation from shareholders. At the request of the option holder the transaction was revised to provide for a sale by the corporation of its assets, followed by liquidation. Id. at 223-24.

242 The facts were admitted on demurrer. 247 U.S. at 222.

243 See Hellnich v. Hellman, 276 U.S. 233 (1928). The Court concluded that assets received in the liquidation of a corporation should be treated as amounts received from the sale of stock, not as a dividend. For a discussion of the March 1 problem by Mr. Justice Cardozo, see United States v. Safety Car Heating & Lighting Co., 297 U.S. 88 (1936).

79 U.S. (12 Wall.) 1 (1870). Within two years the Supreme Court was to declare Hubbard overruled by Pollock. Eisner v. Macomber, 252 U.S. 189, 218 (1919).


82 U.S. (15 Wall.) 68 (1872). Darlington was also declared inapplicable to later income tax statutes in Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 599 (1921).

76 supra.

79 Text accompanying note 79 supra.
In *Southern Pacific Co. v. Lowe*\(^{158}\) and in *Gulf Oil Co. v. Lewellyn*,\(^{159}\) the Court again held that distributions of pre-March 1, 1913, earnings were not taxable to shareholders. Again, as in *Turris*, the Court did not rest its decisions on the generally recognized and easily understood principle that gain which had accrued before the effective date of the 1913 Act was not taxable under that Act. In *Southern Pacific* dividends had been declared out of pre-1913 surplus of a wholly-owned subsidiary and distributed to its parent corporation through intercompany balances. The Court took the unfortunate position that the distribution was "only constructive, being carried into effect by bookkeeping entries."\(^{160}\) The Court said that surplus accrued prior to 1913 represented "capital"—capital which had accrued to the parent corporation prior to the 1913 Act and "underwent nothing more than a change in form when the dividends were declared."\(^{161}\) In *Gulf Oil*, the dividends also had been declared out of pre-1913 surpluses of wholly-owned subsidiary companies and distributed through the transfer of intercompany balances. The Court again ignored the pre-March 1 aspect of the problem, comparing the overall effect of the distribution upon the position of the shareholder. The Court held that the parent corporation, "disregarding the forms gone through," was, as in *Towne*, "no richer than before."\(^{162}\) The dividends were not taxable.

The use of the "no richer than before" test in determining whether dividends were taxable, basic to the decisions in *Turris* and *Southern Pacific* (with reinforcement by a disregard of the corporate entity)\(^{163}\) of necessity was subsequently abandoned. The recipient shareholder's equity in a corporation is reduced by the amount of a dividend, regardless of when the corporate income was earned. But instead of following

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\(^{158}\) 247 U.S. 330 (1918).

\(^{159}\) 248 U.S. 71 (1918).

\(^{160}\) 247 U.S. at 333.

\(^{161}\) 247 U.S. at 335-36.

While the two companies were separate legal entities yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, acting merely as its agent and subject in all things to its proper direction and control. And besides, the funds represented by the dividends were in the actual possession and control of the *Southern Pacific* as well before as after the declaration of its dividends.

*Id.* at 337. Both companies, however, maintained their separate identity for other federal tax purposes, including the filing of separate tax returns. See *National Carbide Corporation v. Commissioner*, 336 U.S. 422, 430 n.8 (1939).

\(^{162}\) 248 U.S. at 72.

\(^{163}\) The entity was disregarded in *Southern Pacific* in the sense that accumulated earnings of the subsidiary corporation were deemed to have accrued to the parent; the language in the opinion, however, was much broader than that point required.
the lead of Congress in distinguishing between distributions out of income earned before March 1, 1913, and distributions out of income earned after that date, the Court adopted a man-in-the-street test when it decided *Lynch v. Hornby* and *Peabody v. Eisner*, decisions handed down the same day as *Turrish* and *Southern Pacific*. In *Hornby*, a dividend which was "extraordinary in amount," paid in substantial part from appreciation accrued before, but realized by the distributing corporation after March 1, 1913, was held to be fully taxable under the 1913 Act as was the "extra" dividend in *Peabody*, a dividend which was paid in cash and in shares of stock of another corporation (Baltimore & Ohio common and preferred stock), the entire value of which was taxable even though that dividend was in excess of the earnings accumulated subsequent to March 1, 1913. The Court in *Hornby*, recognizing that the overall problem was not unlike that of *Towne*, said that the receipt of a dividend, extraordinary in amount, "might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing." Noting that Congress had excluded such distributions when it enacted the 1916 Act, the Court nevertheless held that gain accrued before March 1, 1913, was subject to tax under the 1913 Act, if realized in the form of a dividend, because dividends were, "in the ordinary sense of the word," income, and that Congress, after the adoption of the sixteenth amendment, could without apportionment tax "everything that became income." In the space of a single day the Court thus reached basically inconsistent conclusions based on two astonishing (and subsequently embarrassing) lines of reasoning when it decided on the one hand that income accrued prior to March 1 was taxable, if distributed as an extraordinary dividend, but was not taxable on the other hand if distributed by a subsidiary to its parent corporation or if distributed in liquidation.

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247 U.S. 339 (1918).

248 U.S. 347 (1918).

245 U.S. at 344.

From the point of view of the man-in-the-street, the entire gain from the sale of capital assets, acquired before but sold after March 1, could be said to be income "in the ordinary sense of the word," whereas a persistent argument of taxpayers, referred to favorably in Statton's Independence, was that a mere conversion of a capital asset into cash did not increase the taxpayer's wealth and, hence, did not generate taxable income. That persistent view was again advanced by the taxpayer in Merchants' Loan & Trust Co. v. Smietanka and was perfunctorily rejected by the Court, as it had been under the 1909 Act in Gauley Mountain. The Court again distinguished Gray v. Darlington, and Turrish was limited to its facts. In Smietanka the Court professed to be "entirely satisfied" with the definition of the word "income," approved in Macomber, a definition "believed to be the commonly understood meaning of the term." It did not comment on the middle ground taken by the Commissioner in assessing tax only on that part of the gain from the sale of assets attributable to the period following February 28, 1913, notwithstanding its earlier approval in Hornby of a tax on the entire amount of the extraordinary dividend paid from gain accrued prior to March 1.

Treasury regulations under the 1909 Act, approved in Mitchell Brothers, provided that gain or loss from the sale of a capital asset ("the difference between the selling and buying price") was to be "adjusted so as to fairly determine the proportion of the loss or gain arising subsequent to January 1, 1909." The net result of the entire transaction having been ascertained, gain or loss was allocated between nontaxable and taxable years either by reference to the January 1, 1909, value or on a straight-line method when the January 1 value was not available. Congress thereafter in the 1916 Act recognized the exclusion of pre-March 1 gain or loss, but not in the manner earlier provided by Treasury regulations. Instead of allocating the gain or loss of the entire transaction, the Act provided that the fair market value of the property on March 1, 1913, if acquired before that date, "shall be the

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370 231 U.S. 399 (1913); see text accompanying notes 46 and 70 supra.
371 255 U.S. 509 (1921).
372 Note 76 supra.
373 "Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets...." 252 U.S. at 207, citing Statton's Independence, Ltd. v. Howbert, 231 U.S. 399, 415 (1913).
374 255 U.S. at 519.
375 Note 73 supra.
376 Regulations 31, Article 2(5).
basis for determining the amount" of such gain or loss. Presumably the difference between the value of the property on that date and its selling price would determine the amount taxable or deductible.

When the March 1 value fell somewhere between original cost and final selling price, it made no difference which approach was applicable, the earlier Treasury regulations or the approach of Congress in the 1916 Act. Taking either approach, taxable gain or deductible loss would be the same amount, whether computed by allocating gain or loss from the entire transaction (the difference between original cost and selling price), as suggested by Regulations 31, or by treating the March 1 value as capital (the difference between March 1 value and selling price, not requiring allocation), as the language of the 1913 Act would seem to require.

If, however, the March 1 value was either higher or lower than both purchase price and selling price, the choice of approach made a great deal of difference. The distinction between the accrual of gain or loss on March 1, 1913, and the allocation of gain or loss from a transaction extending over a period of years became acute. Gain or loss accrued on March 1 did not represent a closed business transaction and, although accepted as a matter of course when dealing with such matters as inventories, accrual could produce profit or loss for the period following March 1 substantially greater than that realized from the transaction as a whole and thereby produce a so-called paper profit or loss. The Supreme Court, under such circumstances, with the assistance of a confession of error by the Government, declined to accept the implications of accrual accounting. In Goodrich v. Edwards and in Walsh v. Brewster, the Court held that where the cost of assets purchased prior to March 1, 1913, exceeded the March 1 value, the subsequent sale

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179Sections 2(c) (gains of individuals), 5(a)(4) (losses of individuals), and (12) (corporations), 39 Stat. 756-57 (1916). The 1918 Act combined the gain and loss provisions in Section 202(a), 40 Stat. 1057 (1919).
181191 U.S. 527 (1921). Two transactions were before the Court. The first presented no difficulty because the selling price of the asset exceeded March 1 value and that value exceeded cost, so that the only increase after February 28, 1913, was taxable. But in the second transaction, stock acquired in 1912 for $291,600.00 with a March 1 value of only $148,435.50 was sold in 1916 for $269,346.25; appreciation subsequent to the adoption of the sixteenth amendment was not taxable because the entire transaction did not result in gain.
182255 U.S. 526 (1921). Bonds purchased in 1894 for $191,000 had declined in value to $151,845 on March 1, 1913, and were sold in 1916 for $191,000. Other bonds purchased in 1902 and 1903 for $231,800 had a March 1 value of only $164,480, but were sold in 1916 for $276,150. Accruals were disregarded in both cases, and gains were computed for each transaction with the result that the first transaction escaped tax and the second produced only $44,850 of taxable gains.
of the assets for more than March 1 value did not result in taxable gain unless and to the extent the proceeds of the sale exceeded the original capital investment. In United States v. Flannery\textsuperscript{183} and in McCaughn v. Ludington\textsuperscript{184} the Court again adopted the transactional rather than the accrual approach and held that where the March 1 value exceeded cost, the deductible loss, if any, could not amount to more than the excess of the original investment over the proceeds of the sale. Only actual gains and actual losses were recognized, and even then only to the extent such gains and losses were attributable to taxable periods after February 28, 1913.\textsuperscript{185}

The Court subsequently refused to reconsider its construction of the basis provision of the 1916 Act or to give serious attention to the language of a similar provision of the 1918 Act. In Flannery, decided under the 1918 Act containing several clearly defined basis provisions,

\textsuperscript{183}268 U.S. 98 (1925). Stock purchased prior to 1913 for less than $95,175 was sold for that amount in 1919. The March 1 value was $116,925. The loss attributable to taxable years was disallowed.

\textsuperscript{184}268 U.S. 106 (1925). Stock purchased prior to 1913 for $32,500.00 with a March 1 value of $37,050.00 was sold in 1919 for $3,866.91. The deductible loss was only $28,633.09.

\textsuperscript{185}In Heiner v. Tindle, 276 U.S. 582 (1928), the case was returned to the lower court to determine the value of a residence at the time it was converted (prior to 1913) to rental property. If the value at the time of conversion exceeded March 1 value, only the loss attributable to the period after February 28, 1913, was allowable. If the value at the time of conversion should be less than March 1 value, only the difference between the value at the time of conversion and the proceeds of the sale was deductible. Adjustments to March 1 value, and to the value of the residence on the date of conversion, were not discussed. At the new trial the language of the Supreme Court was literally followed. Value at conversion date having been determined to be $140,000.00, the difference between March 1 value ($125,000.00) and selling price ($73,706.79), or $46,293.21, was deductible as a loss. 27 F. 1012 (W.D. Pa. 1928). The applicable statutes did not require, or necessarily suggest (italics supplied by the Court notwithstanding), the results reached in Goodrich and Flannery. In Goodrich, quoting with added emphasis from the 1916 Act (Sections 2(a) and 2(c)), the Court noted that the tax was imposed on "gains," and "for the purpose of ascertaining the gain derived from the sale or other disposition of property [acquired before March 1, 1913], the fair market price or value of such property as of [March 1, 1913] shall be the basis for determining the amount of such gain derived." 255 U.S. at 535. Repeating its definition of income from Stratton's Independence, note 46 supra, supplemented by Macomber, note 173 supra, as being "the definition" approved by the Court, the word "gain" was again emphasized. The Court, disregarding the legislative history of the 1916 Act (the Ways and Means Committee bill had provided for the allocation of gain pro rata over the time the capital asset was held; that provision was eliminated by the Senate Finance Committee which adopted the basis approach), then concluded that it was "thus very plain" that the statute taxed the proceeds of sales of property "to the extent only that gains are derived thereupon by the vendor." 255 U.S. at 535. The Court thus insisted on its own transactional computation of taxable gain even though the basis provision in the Act provided for a different method of arriving at the amount taxable.
including March 1 value, the Court found it unnecessary to consider in detail "contentions" regarding "the construction that should be given to the provisions of the Act of 1918 in reference to deductible losses." The "question should be resolved according to earlier decisions," because decisions "affecting the business interests of the country should not be disturbed except for the most cogent reasons." Only "actual" gains or losses, therefore, initially determined without regard to taxable years, were to be taken into account, a point of view which, if logically followed, would make the accrual and annual reporting of many kinds of business income impossible.

The transactional determination of gain or loss applied by the Supreme Court in dealing with capital assets acquired before and sold after March 1, 1913, was also applied by the Court for a time as a test for the determination of other types of post-March 1 income. In Bowers v. Kerbaugh-Empire Co., Kerbaugh-Empire had obtained through the New York agent of a German bank numerous loans during the years 1911-1913 for which it received dollars and gave its notes payable in German marks. Those funds were "contemporaneously advanced" (on terms not specified in the opinion) to its wholly-owned subsidiary company, H.S. Kerbaugh, Incorporated, engaged in large-scale construction work, and were lost by the latter corporation during the years 1913-1918. In 1921 the Alien Property Custodian demanded

\[\text{268 U.S. at 105.}\]
\[\text{Id.}\]
\[\text{Congress thereafter found difficulty in arriving at a satisfactory basis provision for pre-March 1 acquisitions. That provision was frequently changed in successive laws. For the current provision see Int. Rev. Code of 1954 $ 1053.}\]
\[\text{Considered as a form of inventory valuation, the Court, recognizing only "real" gains and losses, required the use of cost or (March 1, 1913) market, whichever was lower, in computing the amount of a deductible loss, but required the use of cost, or (March 1, 1913) market, whichever was higher, in computing the amount of a taxable gain, the result being that gains and losses were measured by different standards. In addition, an overall transactional computation sufficed in some cases, a periodic computation in others, but under no circumstances would the latter be permitted to exceed the former. Indeed, as was said by the Court in Flannery, the March 1 basis provision in the statute was "merely a limitation upon the amount of the actual gain or loss that would otherwise have been taxable or deductible ...." 268 U.S. at 103. See also Burnet v. Porter, 283 U.S. 230 (1931); Burnet v. Henry, 283 U.S. 229 (1931); Burnet v. Houston, 283 U.S. 223 (1931).}\]
\[\text{269In New York Life Ins. Co. v. Edwards, 271 U.S. 109 (1926), the amortization of premium on bonds purchased was held not to be deductible under the 1913 Act, because it was not a "loss actually sustained within the year .... All of the securities might have been sold thereafter above cost. The result of the venture could not be known until they were either sold or paid off." Id. at 116.}\]
\[\text{270Id. U.S. 170 (1926).}\]
\[\text{The subsidiary claimed and was allowed deductions for the losses during 1913-1918, but such losses exceeded income by more than the exchange profit of the parent corporation. Id. at 175.}\]
and received the dollar equivalent of the marks which Kerbaugh-Empire owed the German bank. Because of the greatly depreciated value of the mark, Kerbaugh-Empire was able to liquidate its bank liability for an amount substantially less than the dollars it had originally received, and the Commissioner claimed that the difference represented taxable income.

The Supreme Court, observing that taxes on income from some sources were direct taxes, citing Pollock, that the sixteenth amendment eliminated the apportionment required of taxes on "income," and that substance over form should be emphasized, suggested that since the financial transactions of Kerbaugh-Empire and the construction activities of H.S. Kerbaugh, extending over a decade, had resulted in a combined loss, the Constitution prohibited an unapportioned tax on the advantageous exchange transaction. Rejecting the analogy of a short sale, the Court described the results of the various activities in terms of consolidated corporate accounts:

> When the loans were made and notes given, the assets and liabilities of [Kerbaugh-Empire] were increased alike. The loss of the money borrowed wiped out the increase in assets, but the liability remained. The assets were further diminished by payment of the debt.²⁹²

The companies, however, were not consolidated for tax purposes. The separate cash losses of H.S. Kerbaugh did not, as such, wipe out the increase in the separate assets of Kerbaugh-Empire resulting from the bank loan.²⁹³ Admittedly Kerbaugh-Empire originally received more dollars from the bank than it paid to the Custodian in full satisfaction of its debt. That settlement could hardly be considered a renegotiation of the purchase price of marks or a gratuitous cancellation of indebtedness. Standing alone, the bank transaction resulted in gain to Kerbaugh-Empire. Its net assets were substantially increased, not reduced, by the payment to the Custodian of an amount less than the liability discharged thereby. Whether any advances to and investments in H.S. Kerbaugh, lost as a result of the latter's misfortunes, were deductible by Kerbaugh-Empire was a related but distinct problem.

³⁴³/³⁴/³ If presumably the advances to the subsidiary were reflected in the books of the parent as dollar receivables in an amount equal to the cash obtained from the bank, and the losses of the subsidiary, still solvent, would not destroy the value of that asset; if insolvent after the losses, the value of the receivable would be impaired, but not necessarily destroyed. Contrary to the Court's approach, the problem was that of evaluation and of ascertaining the extent to which the deduction provisions permitted Kerbaugh-Empire to charge off bad debts and the loss, if any, of investment in H.S. Kerbaugh stock.
The decision in *Kerbaugh-Empire* embodied the worst features of each of three unsatisfactory decisions: *Cuba Railroad*, in which the sixteenth amendment was unnecessarily invoked to decide a case of statutory interpretation; *Southern Pacific*, in which the Court failed to distinguish between the earnings and profits of taxable entities; and *Goodrich*, in which the implications of periodic income accrual were rejected and gains were computed on a transactional basis. That there should be constitutional objections to a corporate tax on gains from foreign exchange transactions because of losses of another taxpayer incurred over a number of years in the unsuccessful performance of construction contracts was an astonishing suggestion—one that the Supreme Court thereafter avoided by inconclusive distinctions.

When the Court decided *Burnet v. Sanford & Brooks Co.* it was squarely faced with the irreconcilable conflict between annual accounting and its transactional theory of taxable income, found earlier in *Goodrich* and *Flannery*, and later in *Kerbaugh-Empire*. In *Sanford & Brooks* the taxpayer had abandoned dredging work conducted over a period of several years (1913-1915) during which time its expenses substantially exceeded reimbursements because of the unexpected character of the materials dredged. The taxpayer brought suit and obtained judgment for unreimbursed expenses in 1920 and received payment in that year. The Commissioner included the recovery in taxpayer's gross income for 1920, and the Supreme Court approved, taking the position that dredging expenses were not capital assets which must be recovered before gain can be recognized. Income must be reported annually, and reimbursement of expenses must be included in gross income in the year of recovery. The Court concluded that the sixteenth amendment did not prevent the taxation of income on an annual basis even though the amount taxed was part of a transaction which resulted in a net loss. *Kerbaugh-Empire* was distinguished:

In that case the taxpayer, which had lost, in business, borrowed money, which was to be repaid in German marks, and which was later repaid in depreciated currency, had neither made a profit on the transaction, nor received any money or property which could have been made subject to the tax.

The reference to the profitless *Kerbaugh-Empire* transaction as a distinguishing feature could not have been seriously advanced, however, because the Court in the opinion in which that theory of distinction was
was made rejected it by sustaining a tax on the profitless\textsuperscript{197} dredging transaction.

The second distinction made by the Court, that the taxpayer had not “received any money or property which could have been made subject to the tax,” was, in effect, repudiated within the year by the Court’s decision in \textit{United States v. Kirby Lumber Co.}\textsuperscript{198} In that case the taxpayer sold its bonds at par in 1923. Later in the same year it purchased some of those bonds in the open market at a discount. The question presented was whether the difference represented taxable gain. The Court held that it did, citing Treasury regulations to that effect, and correctly observed that as a result of the purchase of its bonds at a discount the taxpayer had freed “assets previously offset by the obligation of bonds now extinct.”\textsuperscript{199} The Court, however, inadequately distinguished \textit{Kerbaugh-Empire,}\textsuperscript{200} as it did again in \textit{Helvering v. American Chicle Co.}\textsuperscript{201} In the latter case, the retirement at a discount of bonds assumed\textsuperscript{202} by the taxpayer in an acquisition of the assets of another corporation was held to have given rise to taxable income. The Court explained \textit{Kerbaugh-Empire} by saying that in that case the “final outcome of the dealing was revealed—the taxpayer suffered a loss. Here, for aught we know, there was a substantial profit—certainly the record does not show the contrary.”\textsuperscript{203}

\textsuperscript{197}It was profitless in the sense that the entire dredging enterprise did not result in gain.
\textsuperscript{198}284 U.S. 1 (1931).
\textsuperscript{199}\textit{Id.} at 3.
\textsuperscript{200}Apparently misstating the facts, the Court said that in \textit{Kerbaugh-Empire} the taxpayer owned the stock of another company that had borrowed money repayable in marks or their equivalent for an enterprise that failed. At the time of payment the marks had fallen in value, which so far as it went was a gain [for the taxpayer]. But the transaction as a whole was a loss, and the contention was denied. Here there was no shrinkage of assets and the taxpayer made a clear gain.
\textsuperscript{204}U.S. at 3. After \textit{Sanford \& Brooks}, however, the “transaction as a whole,” extending over a period of years, was not a valid test. Annual reporting dictated otherwise. And the “shrinkage of assets,” also present in the earlier case (in the form of dredging losses) did not prevent the taxation of a profitless reimbursement of that loss. The distinction in \textit{Kirby Lumber} obviously failed to take into account \textit{Sanford \& Brooks}, decided only ten months earlier.
\textsuperscript{201}291 U.S. 426 (1934).
\textsuperscript{202}The value of the consideration received by the assuming corporation, and the market value of the obligation assumed, not given in the statement of facts, suggest interesting questions when considered in light of \textit{Crane v. Commissioner}, 331 U.S. 1 (1947).
\textsuperscript{203}291 U.S. at 429-31. In \textit{American Dental Co.}, 318 U.S. 322 (1943), cancellations of rent and interest liabilities (accrued and deducted for tax purposes in prior years) by creditors in straightforward business transactions (resulting in substantial
Finally, in *Commissioner v. Jacobson*, a individual taxpayer (rather than a corporation, as in *Kirby Lumber*) purchased his outstanding bonds for less than face value, and the discount was held to be, not a "gift," but taxable income. Reverting again to its transactional concept of income, the Court noted that in the case under consideration the "proceeds of the obligations were not traced into identifiable losses offsetting the debtor's realized gains from the discharge of these obligations." Thus the recurring dicta that loan transactions must be tested by overall results, as in *Goodrich*, and not by annual determinations, as in *Sanford & Brooks*, kept alive the flickering light of *Kerbaugh-Empire*.

The Court's early views regarding closely controlled corporations, like its transactional test for gain, also proved to be troublesome. Disregard of the corporate entity, suggested by *Turrish*, *Southern Pacific*, and *Gulf Oil*, and implicit in *Kerbaugh-Empire*, had found another form in *Weiss v. Stearn* where the Supreme Court held that reincorporation in the state of original incorporation and a "mere change" in the "technical ownership of an enterprise" did not give rise to taxable gain to a shareholder exchanging shares of stock in the old corporation for shares in the new. The Court's theory was that "Something more is necessary—something which gives the stockholder a thing really different from what he theretofore had," citing *Towne* in addition to *Southern Pacific* and *Gulf Oil*.

Credits to the taxpayer's surplus were held to be excludable from gross income as "gifts." The Supreme Court noted that: "Possibly because it seems beyond the legislative purpose to enact income taxes for savings on debts, courts have been astute to avoid taxing every balance sheet improvement brought about through a debt reduction." *Id.* at 327. See also *Bogardus v. Commissioner*, 302 U.S. 34 (1937). In *Dobson v. Commissioner*, 320 U.S. 489 (1943), the Court affirmed a Tax Court decision which held that the current recovery of part of a loss from the sale of stock in an earlier year (the entire transaction, including the recovery, resulted in a loss) was not taxable, because "no principle of law compels the Tax Court to find taxable income in a transaction where as a matter of fact it found no economic gain and no use of the transaction to gain tax benefit." *Id.* at 506.

Section 215 of the 1939 Act, adding § 22(b)(9) to the 1939 Internal Revenue Code to provide special treatment for the discharge of such indebtedness of corporations in certain cases, was said to indicate that such gains were recognized as not having been excluded from gross income by § 22(b)(9) or by any other Section.” *336 U.S.* at 44. *See* INT. REV. CODE of 1954, §§ 108, 1017.

"Something more" had been found earlier in *United States v. Phellis*, 257 U.S. 156 (1921); *Rockefeller v. United States*, 257 U.S. 176 (1921) and *Cullinan v. Walker*, 262 U.S. 134 (1923), and was later found in *Marr v. United States*, 268 U.S. 536 (1925). *See also* New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934) (dealing with a loss deduction claimed by a successor company).
The theory of the Stearn case understandably caused the issue to be raised in Burnet v. Commonwealth Improvement Co. as to whether or not a sale by a corporation to its sole shareholder (an estate) required "something more" to justify an income tax on the corporation as a result of the transaction. From an economic point of view, the combined enterprise (corporation and sole shareholder) was "no richer than before" as a result of the sale between the owner and its incorporated pocketbook or, if additional advantage had been gained, it was, as in Towne, de minimis—not a gain in the amount of $1,055,953.12, as computed by the Commissioner. That argument, however, was not effective because the two entities for years had filed separate tax returns and a loss in the amount of $28,125 had been claimed by the corporation on the identical transaction before the Court, a recomputation of basis by the Commissioner on audit producing the gain in question. Although the parent and subsidiary companies in Southern Pacific also had filed separate tax returns, the Court asserted that the case before it did not present "peculiar facts" such as those present in the earlier case. The gain was taxable.

In Gregory v. Helvering, as in Stearn, substance rather than form prevailed and the corporate entity was again disregarded. The Court held that the nonrecognition provisions of the 1928 Act, dealing with spin-offs, were not applicable to a short-lived corporation formed solely for the purpose of meeting the terms of the statute even though the statute was followed to the "letter." The transaction was simply "an operation having no business or corporate purpose," the corporation was a "contrivance." Griffiths v. Commissioner and Higgins v. Smith added to the
confusion. In those cases the Court held that amounts recovered in respect of a fraud claim previously transferred to a wholly-owned corporation were taxable to the transferor-shareholder (Griffiths), and that a loss on the sale of assets by a shareholder (Smith) to his wholly-owned corporation was not deductible. Yet a similar attempt on the part of a shareholder to disregard his corporation as a tax entity was promptly rejected in *Moline Properties, Inc. v. Commissioner*,217 the Court again attempting to resolve the uncertainty created by *Southern Pacific*.218 But it was not until *Interstate Transit Lines v. Commissioner*,219 decided "because of uncertainties in this area of important federal tax law,"220 that the Court finally came to grips with the intercompany problems suggested by *Southern Pacific* and *Gulf Oil.* In *Inter-

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218 *Southern Pacific* and *Gulf Oil* were referred to as "recognized exceptions" to the separate treatment which must be given corporations serving a business purpose, and "lay down no rule for tax purposes.... In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction." 319 U.S. at 438-39.
219 *Southern Pacific* and *Gulf Oil* were referred to as "recognized exceptions" to the separate treatment which must be given corporations serving a business purpose, and "lay down no rule for tax purposes.... In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction." 319 U.S. at 438-39.
220 *Id.* at 591 (referring specifically to *Moline Properties*, note 217 supra).
state, the parent corporation, not permitted to engage in interstate transportation in California, organized for that purpose a subsidiary company to engage in both interstate and intrastate transportation. An intercompany agreement required the parent to reimburse the subsidiary for all operating deficits, and liability thereby incurred under the contract was claimed as a deduction by the parent. The deduction was disallowed. "Whether phrased as the payment of an expense in a business conducted for a principal by an agent or as a case where equity and reality require that the separate corporate entities be ignored or as the incurring under contract of a necessary expense"220 it was held that to be deductible the reimbursement of the subsidiary's operating deficit must be an expense of the parent's business. The parent could not legally operate locally in California. The Court said that business conducted there was not the parent's business (or if the interstate portion should be so considered, the expense had not been allocated), and "[t]he mere fact that the expense was incurred under contractual obligation does not of course make it the equivalent of a rightful deduction..."222

Six years later certiorari was granted in National Carbide Corporation v. Commissioner223 "because of... conflict of opinion and the disagreement between courts as to the continuing vitality of Southern Pacific."224 Air Reduction Corporation (Airco) operated major areas of its business through wholly-owned subsidiary companies "employed as agents to manage and operate plants designed for the production of the products assigned to each, and as agents to sell the output of the plants." Airco furnished capital and executive management. The subsidiaries were required to pay Airco all profits earned in excess of nominal amounts.225 Declaring that the control exercised by Airco over its subsidiaries did not differ in principle from that exercised in Moline Properties,226 the Court held that the "agency" contracts requiring the payment of substantially all of the profits to Airco were not effective. "Our decisions requiring that income be taxed to those who earn it, despite anticipatory agreements designed to prevent vesting of the income in the earners..." foreclosed the result sought by Airco.227

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220. 319 U.S. at 591.
221. Id. at 594.
222. 236 U.S. at 422 (1949).
223. Id. at 426. The Tax Court, 8 T.C. 594 (1947) (three judges dissenting), had been reversed by the second circuit, 167 F.2d 904 (2d Cir. 1948).
224. Id. at 425. Agent compensation was fixed at 6% of outstanding capital stock ranging from 50 to 125 shares of $100 par value each, or compensation in an aggregate amount of $1,550 per annum.
225. Id. at 433-34.
226. Id. at 436.
To be a true agent, its "business purpose must be the carrying on of the normal duties of an agent." 228

The Airco subsidiaries were obviously engaged in business as separate entities (in the sense that that term is generally applied to corporations) and were not dormant companies without assets or useful business purpose. Airco's control alone did not, in orthodox legal terminology, make them agents. 229 The contracts with Airco used agency terms, but the power of the subsidiaries to alter legal relations between Airco and third persons was not established; non-agent independent contractors might more aptly characterize the subsidiary companies. The Court's decision did approve, in effect, a shift by the Commissioner of income from Airco to its subsidiary companies, and that appears to be the substance of the decision. To pay three companies an aggregate of $1,350 per year to manage assets of some $20,000,000 with annual sales of more than that amount, producing over $4,000,000 in income, indicates something less than arm's length dealing between taxable entities. The parties, not having provided for reasonable compensation, were not permitted to object to the Commissioner's reallocation, particularly since the Court viewed assets advanced by Airco to its subsidiaries as "capital contributions rather than loans." 230 Although the Court failed to establish a clear guide for future decisions (other than to indicate that a corporation ordinarily will be taxed as such, unless the Commissioner finds it a "sham or unreal"), 231 the Court again clearly made the point that Southern Pacific "lays down [no] rule for tax purposes." 232

National Carbide also illustrated another point. Disregard of the corporate entity in Turrish and Southern Pacific, without an articulation of valid reasons therefor, furnished little direction for either Treasury or the taxpayer. Those early cases involved distributions of pre-March 1 earnings. Congress seemed to regard such distributions as being exempt from tax, 233 and much confusion could have been avoided, if the cases had been decided accordingly. Hornby, decided the same

228 Id. at 437. The Court noted that even a corporate agent may be disregarded by the Commissioner "if it is a sham or unreal." Id. at 437 n.20.

229 See RESTATEMENT (SECOND) OF AGENCY § 14(m) (1958).

230 U.S. at 435.

231 Note 228 supra. See also Moline Properties, note 217 supra.

232 U.S. at 432. See also note 218 supra.

Our reluctance to erase Southern Pacific from the books has been due not to the belief that it lays down a correct rule for tax purposes generally, but to the fact that it concerns 'very peculiar facts' which make it distinguishable from later cases .... 336 U.S. at 432. "By its very terms, the decision is limited to its precise facts." Id. at n.12.

233 Note 118 supra.
day as *Turrish* and *Southern Pacific*, unaccountably went the other way. In order to distinguish the cases, the Court was forced to rely on inapplicable interpretations of Civil War income tax legislation in *Turrish* and to ignore a paying subsidiary company in *Southern Pacific*, in an attempt to avoid a conflict with its reasoning in *Hornby*. The Court’s failure to admit its error in *Hornby* and to redefine *Turrish* and *Southern Pacific* accordingly, has led to needless litigation. It was not until *National Carbide* that some semblance of direction was suggested: Whether holding agency powers or not, closely held corporations must be dealt with on an arm’s length basis by their respective owners for purposes serving genuine business needs, and transactions between the parties must be evidenced by contemporaneous (accounting) records clearly reflecting the facts. Contentions inconsistent with those records, and ambiguous relationships between the corporation and its owner will invite Treasury action designed to produce maximum public revenue.

VI. “True” Income and Accounting: Some Problems of Valuation and of Timing.

In *Stratton’s Independence* the Supreme Court disavowed any attempt to formulate a proper definition of income. Congress did not intend by the 1909 Act to enact an income tax law.234 Undefined “gross income” was a “sufficiently accurate index”235 of the privilege taxed. Later in *Cuba Railroad* it was said that the meaning of income as used in the 1909 Act was “not to be distinguished from” the meaning of income as used in later revenue legislation,236 and statements of like import were made in other cases.237 As the Supreme Court in substance has correctly indicated, the post-sixteenth amendment income tax laws did not impose a tax on business income as that term was generally un-

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236See e.g., *Burnet v. Harmel*, 287 U.S. 103 (1932):
And before the 1921 Act this Court had indicated (see *Eisner v. Macomber*, 252 U.S. 189, 207), what it later held, that ‘income,’ as used in the revenue acts taxing income, adopted since the Sixteenth Amendment, has the same meaning that it had in the Act of 1909. *Id.* at 109.
237*Southern Pacific Co. v. Lowe*, 247 U.S. 330 (1918) the Court stated:
Certainly the term “income” has no broader meaning in the 1913 Act than that of 1909 (see *Stratton’s Independence v. Howbert*, 231 U.S. 399, 416, 417), and for the present purpose we assume there is no difference in its meaning as used in the two acts.

*Id.* at 333.
understood. Taxable income is a vague statutory concept promulgated by Congress without clear reference to any well-developed system of income determination and the Supreme Court from the outset has interpreted income tax legislation in a manner which has further blurred that already inadequate concept. In matters of constitutional (sixteenth amendment) interpretation, the Court has been without a satisfactory point of reference. Disapproval of congressional action was largely measured by the Court's own definition of 1909 Act income. That definition was formulated originally in Stratton's Independence where "theoretical distinctions between capital and income" were not deemed relevant. The definition, which served little useful purpose in the case in which it was announced, has failed to provide a helpful guide under the amendment where the distinction was held to be important.

As early as 1916 Congress had supplemented Treasury attempts to provide workable rules for computing business income by incorporating relief provisions in the 1916 Act. Without making changes in basic legislation, Congress authorized alternate systems of income determination in Section 13(d) of the Act which provided that a corporation "keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income," may, subject to Treasury regulations, "make its return upon the basis upon which its accounts are kept." As authorized by Section 13(d), Treasury formally ruled that the deduction of accrued expenses would be permitted corporations which accrue such charges "on their books," provided (1) "such accounts approximate as nearly as possible actual liabilities," and (2) that the "income accruing to the corporation" is returned "on the same basis." Since Section 12(a) of...

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238 See note 173 supra.
240 T.D. 2433, 19 TREAS. DEC. INT. REV. 5 (1917). The Commissioner was not required to make an election between the taxpayer's books and a cash basis tax return, but could require adjustments to book income in order to determine taxable income. United States v. American Can Co., 280 U.S. 412 (1930); Niles Bement Pond Co. v. United States, 281 U.S. 357 (1930). The Supreme Court appeared to consider distortions resulting from annual accounting a virtue in Lucas v. Structural Steel Co., 281 U.S. 267 (1930). The Court declared that a taxpayer engaged in the fabrication and erection of structural steel was required to use inventories of its steel on hand in order "to assign to each period its profits and losses." Id. at 268. The Court disapproved the taxpayer's use of the base stock method of inventory valuation because it tended to equalize income over a period of years and was thus deemed to be inconsistent with annual accounting required by Congress for income tax purposes.
the 1916 Act expressly permitted corporations to deduct certain expenses in the year "paid," it was necessary to reconcile those specific cash basis provisions with the general language of Section 13(d). That problem of reconciliation reached the Court in *United States v. Anderson.* The court below (the Court of Claims) in two cases had permitted the deduction in 1917, the year the 1916 munitions tax was assessed and paid. One taxpayer, Burton-Richards Co., had accrued on its books in 1916 a reserve of $140,000 for munitions tax liability. The reserve was eliminated, however, as of December 31, 1916, and a similar reserve was set up by a charge to surplus but in the lesser amount of $86,541.95. The munitions tax return for 1916 was filed and tax in the amount of $86,541.95 was paid in 1917. Later in 1917 the return was examined and 50% of the amortization deduction claimed therein was disallowed, resulting in $25,877.50 additional munitions tax liability, which was also paid in 1917. The second taxpayer, Yale & Towne Manufacturing Co., as of December 31, 1916, set up a reserve for taxes which included an estimated munitions tax in the amount of $247,763.19. That amount was reported and paid in 1917, but on review an additional 1916 munitions tax of $7,933.60 was demanded and paid in 1917.

In reversing the conclusion of the Court of Claims that the 1916 munitions taxes were deductible in 1917, the Supreme Court held that Section 12(a) of the 1916 Act providing for the deduction of taxes paid did not apply when taxpayers did not or could not report on a cash basis. The Court said that Section 13(d), which went beyond Treasury rulings and regulations granting relief from the strict cash basis provisions of earlier legislation, was intended to permit taxpayers to keep their books and make their returns "according to scientific accounting principles, by charging against income earned during the taxable period, the expense incurred in and properly attributable to the process of earning income during that period." Since the taxpayer's "true


242 269 U.S. 422 (1926).
243 Yale & Towne Mfg. Co. v. United States, 60 Ct. Cl. 440 (1925); Anderson v. United States, 60 Ct. Cl. 106 (1925).
244 60 Ct. Cl. at 107-09.
245 60 Ct. Cl. at 446-47.
246 269 U.S. at 440.
income for the year 1916 could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year."\textsuperscript{247} Consequently, the Court held that the taxpayer must follow a consistent practice; it may not deduct some accrued expenses and not others. As to the argument that the munitions tax had not "'accrued" in 1916, Mr. Justice Stone observed that in advance of assessment "all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it."\textsuperscript{248} For the "purposes of accounting and of ascertaining true income," the munitions tax "did not stand on any different footing than other accrued expenses."\textsuperscript{249} In any event, Mr. Justice Stone concluded, Section 13(d) did not use the word "accrue" or "accrued," but "merely provides for a return upon the basis upon which the taxpayer's accounts are kept, if it reflects income."\textsuperscript{250}

It should be noted that Mr. Justice Stone did not say that the munitions tax must be deducted only in the year in which "all events" occurred which fixed the amount of the tax and determined the liability to pay it. The emphasis was upon the ascertainment of "true income" by deducting all expenses attributable to the production of that income. Books of account which properly reflected income must be followed for tax purposes and the related expenses allowed, "accrued" or not.

In \textit{Anderson}, strictly speaking, "all the events" which fixed the amount of the munitions tax had not actually occurred in 1916. The taxpayers were unquestionably liable, but the amount of liability was measured by munitions profits. Those profits were determined in part by estimates and allocations\textsuperscript{251} necessarily made after the year had actu-

\textsuperscript{247}Id. In both \textit{Burton-Richards} and \textit{Yale & Towne} the Commissioner had disallowed as 1917 deductions not only the munitions tax reported in the 1916 returns as filed but also the additional 1916 munitions tax assessed and paid in 1917. The Supreme Court did not refer to the additional assessment; instead, the Court concluded that "the reserves for taxes which appeared on [Yale & Towne's] books in 1916 were deductible under § 13(d) of the Act of 1916 and Treasury Decision 2433 in its income tax return on the accrual basis for that year." 269 U.S. at 442. Finding that Burton-Richards kept its books on the accrual basis, the Court rejected its 1917 claims for refund because it had not met the burden of proving "the facts establishing the invalidity of the tax." \textit{Id.} at 443.

\textsuperscript{248}269 U.S. at 441; see Treas. Regs. § 1.461(a)(c) (1964) incorporating the "all events" test.

\textsuperscript{249}269 U.S. at 441.

\textsuperscript{250}Id.

\textsuperscript{251}The 1916 munitions tax was 12\frac{1}{2}\% of net profits computed by deducting from the gross amount received or accrued for the year from the sale of munitions the following items to the extent they were related to munitions: (1) cost of raw
ally ended, but prior to the closing of the accounts. Furthermore, in both cases decided by Anderson, the munitions profits were reestimated and were substantially increased after the returns had been filed in 1917. The determination and redetermination of munitions income in 1917 were events necessary to the exact computation of the 1916 munition tax liability, but those events were considered irrelevant, and properly so, in solving the real question at hand, the ascertainment of the year to which the munitions tax should be attributed. The munitions tax was generated by 1916 income, and was clearly attributable to that year. The tax was deductible in 1916, not 1917.\footnote{252}

A somewhat more troublesome problem was presented in American National Co. v. United States.\footnote{253} The taxpayer was engaged in the business of lending money for which it received five-year, 5\% mortgage notes. Taxpayer also received from the borrower at the time the original loan was made a second note which was payable in two years and was equal to 10\% of the mortgage note. The taxpayer would then sell the first note with a side agreement by the taxpayer to pay the purchaser an additional 1\% for each of the five years the loan remained outstanding.\footnote{254} In its accounting records the taxpayer (1) included the principal amount of the two-year note in income in the year it was received from the borrower and (2) included as an expense in the year the five-year note was sold its maximum contractual liability as a result of the side agreement, 5\% in the aggregate. Whenever the borrower paid his five-year note before maturity, the taxpayer's estimated liability under the side agreement was accordingly reduced, and the excess expense deduction in the earlier year was adjusted in the later year by a credit to income. The Commissioner disallowed the maximum estimated liability as a result of the agreement in the year the agreement was entered into but allowed that part of the obligation which became due in the taxable year. The Supreme Court disagreed. The Court held that the liabilities

materials, (2) running expenses, (3) interest, (4) taxes, (5) losses, and (6) a reasonable allowance for amortization, "account being taken of the exceptional depreciation of special plants." 99 Stat. 780, §§ 300-02 (1916).

\footnote{252}{See also Aluminum Castings Co. v. Routzahn, 282 U.S. 92 (1930). For another aspect of Anderson, see Fawcus Machine Co. v. United States, 282 U.S. 375 (1931), where for excess profits tax purposes the 1918 income tax was deemed to have been paid out of 1918 income even though the 1918 Act was not enacted until February 24, 1919, and the amount of 1918 taxes could not have been finally computed on December 31, 1918. But see Niles Bement Pond Co. v. United States, 281 U.S. 357 (1930) (where the British income tax, based on different fiscal periods, was before the Court).}

\footnote{253}{274 U.S. 99 (1927).}

\footnote{254}{The taxpayer "from and after 1916" sold many of these notes directly to investors, Id., at 102,
of the taxpayer to the investors were not “analogous to obligations to pay interest on money borrowed, but were expenses incurred in selling the loan notes.” The method of accounting adopted by the taxpayer “clearly reflected the true income.” The commission notes, 10% of the original loan, had been included in gross income at full face value in the year of acquisition, and it was deemed proper to permit the deduction of the full 5% potential liability under the side agreements in the year the side agreements were made.

In Anderson, “true” income could not be determined without deducting from the year’s gross income “the total cost and expenses attributable to the production of that income during the year.” In American National, the Court’s attention was also directed to the determination of “true” income, but the interrelated problems of valuation and of timing were not carefully examined. Aside from the question of bad debts, the two-year notes should have been reported, strictly speaking, at current market value, not in the principal amount payable two years later. And the maximum amounts payable under the side agreements should have been adjusted downward, in the light of experience, by anticipating and estimating prepayments of principal by the makers of the notes. In addition, such adjusted future payments under the side agreements also should have been discounted to present value. Amounts payable five years in the future obviously did not have the same immediate “cost” as like amounts payable currently. Consequently, while accepting the Court’s view that the obligations were not “analogous to obligations to pay interest,” the interest factor nevertheless was present. Perhaps the Court assumed that compensating accounting errors permitted the reflection of “true” income. But such an assumption, if made, would be suspect, in view of the early insolvency of the taxpayer. But whatever may have been the Court’s assumption, the Court, for a period of time at least, took the view that “true” income was book income, if revenues and expenses were accrued on a consistent basis.

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255 Id. at 105.
257 Although not a practice generally followed, as such, in estimating future expenses, the impact is frequently reflected in the amounts estimated.
258 The receiver for the taxpayer filed the claim for refund of tax paid as a result of the Commissioner’s disallowance of the potential selling expense. 269 U.S. at 435.
259 [It is the purpose of the [1918] Act to require returns that clearly reflect taxable income. That purpose will not be accomplished unless income received and deductible disbursements are treated consistently.” United States v. Mitchell, 271 U.S. 9, 12 (1926).
Unlike recurring costs associated with related income, such as the tax involved in *Anderson* and the selling expense involved in *American National*, losses represent quite a different problem. Losses being counter-productive and difficult, sometimes impossible, to predict, the 1909 Act and subsequent Acts understandably did not attempt to match losses with income; losses were deductible in the year "sustained." In *United States v. S.S. White Dental Manufacturing Co.*, the taxpayer's entire investment (shares of stock and receivables) in a German subsidiary company was held to be deductible in 1918, the year the German government seized the property of the subsidiary. The "taking" was said to be legal and there was no real opportunity for immediate judicial redress. Even though a small amount was recovered in 1922 from the remaining assets of the subsidiary, and a claim with the Mixed Claims Commission had been allowed (but not paid) in 1924, the 1918 seizure was, nevertheless, a closed transaction; any recovery in respect of the asset "might be secured not as a matter of right, but as a matter either of grace to the vanquished or exaction by the victor." The Court took the further view that a loss may become complete enough for deduction without the taxpayer's establishing that there is no possibility of an eventual recoupment. It would require a high degree of optimism to discern in the seizure of enemy property by the German government in 1918 more than a remote hope of ultimate salvage from the wreck of the war. The Taxing Act does not require the taxpayer to be an incorrigible optimist.

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261 Note 20 supra.  
262 274 U.S. 938 (1927).  
262 274 U.S. at 402-03. On the other side of the conflict, Armistice, November 11, 1918, marked the appropriate event making obsolescent buildings used to produce munitions which would not be needed after that date, and gave rise to a deduction in 1918. United States Cartridge Co. v. United States, 284 U.S. 511 (1932). Prohibition presented similar problems of timing of losses after the initial question of deductibility had been resolved. In *Clark v. Haberle Crystal Spring Brewing Co.*, 280 U.S. 384 (1930), and *Renziehausen v. Lucas*, 280 U.S. 387 (1930), the Court declared that the allowance for obsolescence did not include the loss of goodwill (including trademarks, trade brands, and trade names) of a brewery destroyed by prohibition even though the amount of the loss was not in dispute. But in *V. Loewers Gamorinus Brewery Co. v. Anderson*, 282 U.S. 638 (1931), and *Burnet v. National Industrial Alcohol Co.*, 282 U.S. 646 (1931), the taxpayers were permitted to deduct obsolescence losses of tangible property. It was shown "that the imminence of prohibition became known in January of 1918 and that it took effect in January of 1920." 282 U.S. at 645. The amount deductible for the years 1918-1919 was not before the Court. In *Burnet v. Niagara Falls Brewing Co.*, 282 U.S. 648 (1931), however, the Court said that:

Neither the cost of obsolescence nor of accruing exhaustion, wear
In *White Dental*, the fact of loss had been determined by seizure of assets by the German government and had been currently recognized in the taxpayer's books. But where loss had not been ascertained in the earlier years, attempts to reopen those years met with predictable judicial resistance. As the Court held in *Sanford & Brooks*, new items relating to past years must be included in current income, a generally accepted accounting practice based on convenience, and on a reluctance to change earlier reports, frequently published and often widely distributed. The decisions of the Court in dealing with items of prior years were understandably based on somewhat different grounds. In *Sanford & Brooks*, the fiscal needs of the government were stressed, and earlier in *Lewellyn v. Electric Reduction Co.* a second and entirely different, subjective, approach had been adopted. The taxpayer had made a prepayment for goods in 1918 to a seller who proved to be irresponsible. Litigation was not instituted until the following year, and was not terminated until several years thereafter. The Court said that

There is nothing in the findings from which we could conclude that [the taxpayer] in 1918 had ceased to regard his rights under the contract as having value or that there was then reasonable ground to suppose that efforts to enforce them would be fruitless.

...and tear that is properly chargeable in any period of time can be measured accurately. A reasonable approximation of the amount that fairly may be included in the accounts of any year is all that is required.


*Note 194 supra.*

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See United States v. Lewis, 340 U.S. 590 (1951), where excess bonus returned to employer was held to have been received under a "claim of right," and year of receipt may not be reopened. But see Freuler v. Helvering, 291 U.S. 85 (1934), where excess payments by trustee to beneficiaries were not includable in income. Prior years, however, may be examined to determine tax aspects of a current deduction. *See Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), where a prior year was examined to determine whether repayment gave rise to a regular or a capital loss; *United States v. Skelly Oil Co.*, 394 U.S. 678 (1969), where the deduction for refunds of overcharges for natural gas sold in earlier years was reduced by percentage depletion allowed in earlier years as a result of those overcharges. Compare *Douglas v. Commissioner*, 922 U.S. 275 (1944). See also Intr. Rev. Code of 1954, §§ 1250 and 1245 (sales of certain depreciable property). For important legislative changes in the consequences of annual accounting, see §§ 172 (carryback and carryover of net operating losses), 1212 (capital loss carryovers), and 1901-1905 (income averaging).

*Note 275 U.S. 243 (1927).*

*Id.* at 247.
The Court then concluded that the loss may not be deducted “before
the future fails to justify [the taxpayer’s] hopes.”

Reluctance to reopen earlier years was also reflected in the Court’s
treatment of voluntary payments made in recognition of past services.
In *Lucas v. Ox Fibre Brush Co.* such payments, reasonable in
amount, were held to be deductible in the year paid, not in the years
during which the services had been performed. The Court rejected the
Commissioner’s contentions that the deduction in the year paid dis-
torted income for that year, and that “the basic principle to be applied
is that true net income is to be taxed.” Instead, the Court took the
position that the statutory authority of the Commissioner to regulate
methods of accounting did not justify the allocation to previous years of
a proper payment made in the current year
when the obligation to pay was incurred during that year and not
previously. In the present instance, the expense could not be at-
tributed to earlier years, for it was neither paid nor incurred in
those years. There was no earlier accrual of liability. It was de-
ductible in the year 1920 or not at all. Being deductible as a
reasonable payment, there was no authority vested in the Com-
missioner to disregard the actual transaction and to readjust
the income on another basis which did not respond to the
facts.”

*Anderson* was distinguished on the ground that “liability for the muni-
tions tax at a fixed rate had accrued in the earlier year (1916) and was
a charge on the business of that year, although the precise amount
was ascertained and was payable in 1917,” and *American National* was
distinguished on the ground that in that case “there was a contract pro-
viding definitely for the payment.” Absence of liability, rather than
the necessity for annual reporting, thus became a third justification for
the Court’s refusal to reopen returns for earlier years.

Items not carefully and reasonably estimated and not recorded in
the books of the corporate taxpayer for the year in which the deduction
was claimed obviously invited disallowance. In *White Dental* the loss
had been recorded in the books of the taxpayer in the year claimed for
tax purposes and was allowed. In *Electric Reduction* the loss had not

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268 Id.
269 281 U.S. 115 (1930).
270 Id. at 120.
271 Id.
272 Id. at 120-21.
273 In *White Dental* the entire amount of the investment as shown by its books
was charged off by the taxpayer in 1918 (although book income for that year
apparently did not bear the entire amount of the loss) and was claimed for tax
purposes in the 1918 return as filed. 274 U.S. at 400.
been so recorded and was disallowed. *Lucas v. American Code Co.*\(^{274}\) presented an intermediate situation. In that case liability was established by final judgment in 1923 for the breach in 1919 of an employment contract which, at the time of breach, had some eighteen years to run. Commissions that the former employee would have received in the year of discharge had been accrued on the books of the taxpayer in recognition of its possible liability. The Court held that neither the amount accrued in 1919 nor the amount of the judgment was allowable as a deduction for 1919. "Generally speaking, the income tax law is concerned only with realized losses, as with realized gains."\(^{275}\) While the facts "determining liability" had occurred in 1919, the amount to be recovered, if any, "depended in large part on future events."\(^{276}\)

The case at bar is unlike *Anderson*. There, the liability for the munitions tax at a fixed rate on the business done in 1916 had confessedly accrued in that year and was a charge on the business of that year, although the exact amount due may not have been then ascertainable and the tax was not payable until 1917.\(^{277}\)

A reserve in an amount equal to the compensation which the discharged employee would have received in 1919, set up on the taxpayer's books in that year, "had no relation to the apprehended loss,"\(^{278}\) and it was not so regarded by the taxpayer.

The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions. The reserve set up by the Company was of that character. It cannot be said that the loss actually paid by the Company in 1923 was, as a matter of law or of undeniable fact sustained in 1919.\(^{279}\)

In the Court's view "the mere fact that the exact amount of the liability had not been definitely fixed in 1919 would not prevent the deduction, as a loss of that year, of the amount later paid." That result did not follow in the case under consideration, however, because here "[t]he amount of the damages . . . was wholly unpredictable."\(^{280}\)
Predictability, of course, supplied a proper test for accrual. But while a taxpayer may not successfully allocate items to obviously improper years by making or failing to make bookkeeping entries, accounting records of public corporations reflecting carefully estimated losses should ordinarily be conclusive. In cases similar to *American Code*, the failure of the taxpayer to make a careful estimate of liability and to record such estimate in its accounts should adequately demonstrate, of itself, that either the item was unknown, perhaps because not sufficiently mature to be taken seriously, or the amount was so uncertain that a provision in the accounts was unwarranted. But the language of the Court was couched in terms of legal standards rather than accounting standards. Such accruals were permitted and required only when (1) the liability was established, and (2) the amount of liability was known or ascertainable with reasonable certainty.

The emphasis in *American Code* and in *Ox Fibre* on liability as an element essential to the accrual of an expense was both unfortunate and unnecessary. The need for annual returns adequately justified the Court's refusal to reopen earlier years. Establishment of the liability (or the right) of the taxpayer as a prerequisite to the accrual of an expense (or income) invoked the application of standards devised for purposes unrelated to the problem at hand, the computation of annual income, and assured an inflexibility which could prevent both the matching of expense with related income and the allocation of the results of that matching to the year earned. But with a busy Court, the unfamiliar "scientific principles" of accounting, deemed decisive in *Anderson*, could not easily compete with well-understood legal concepts, such as unconditional liability, held to be controlling in *Lucas v. North Texas Co.* In the latter case, the taxpayer owned timber lands and on December 27, 1916, delivered a purchase option in respect of its business properties. The holder of the option, solvent and fully able to make the purchase, examined title on the same day, found it satisfactory, and on December 30, 1916, having arranged for funds to make the purchase, notified the taxpayer that the option would be exercised. On the same day, December 30, 1916, the taxpayer "ceased operations and withdrew all employees from the land." The closing of the trans-

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281 U.S. 11 (1930).
282 See, for example, *Skelly Oil*, supra, footnote 265.
283 U.S. 88, 100 (1936), where a pre-1913 claim for patent infringement was not settled until 1925: "The value of the claim in action, uncertain at the time of settlement, was even more uncertain in February, 1915." No amount was excludable in respect of March 1, 1913 value.
action was held on January 5, 1917. The taxpayer, which kept its books on an accrual basis, recorded the gain from the transaction in its 1916 accounts. The Court held that income did not accrue as a result of the executory contract of sale made on December 30, 1916. The taxpayer did not prepare the papers necessary to effect the transfer or make tender of title or possession or demand the purchase price in 1916. The title and right of possession remained in it until the transaction was closed. Consequently, unconditional liability of vendee for the purchase price was not created in that year.

The Court said that the "entry of the purchase price" in the taxpayer's accounts "as income in that year was not warranted," and that the taxpayer "was not entitled to make return or have the tax computed on that basis, as it clearly did not reflect 1916 income."

In North Texas, the Court ignored the taxpayer's books of account, presumably closed in the usual manner, and decided that the question of timing turned on legal formalities. But the major activity of the taxpayer which produced the gains in question occurred prior to 1917; the taxpayer had closed down its operations and vacated the premises in 1916, following notice of the exercise of the option, and the accrual of the transaction in that year evidently seemed appropriate to the taxpayer. A high degree of probability that the transaction would be consummated, rather than unconditional legal liability, should have sufficed. The decision, if limited to capital assets, could provide, however, a degree of certainty, a guide useful in planning large transactions where the matter of tax timing becomes important. Having given public notice of the practice to be followed in similar situations, it may

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283Id. at 11-12.
284Id. at 13-14. Although not referred to in Anderson, the Court in North Texas noted the change in tax rates between 1916 and 1917. The War Revenue Act of 1917, ch. 63, §§ 4, 201, 40 Stat. 300, 302, 303, added 4% to the 2% rate of Section 10 of the 1916 Act, plus an excess profits tax of as much as 60%.
285Any requirement that those formalities must be completed before there can be an accrual of income is obviously unsuited to the timing of numerous, day-to-day transactions. As long as a system of cut-off accounting is consistently applied, the distortion of annual income is minimized, regardless of which of a number of related events is selected by the taxpayer to trigger the accrual.
286See I.T. 3485, 1941-1 CUM. BULL. 240, where the Treasury ruled in connection with the timing of the gain from the sale of securities that "with respect to a taxpayer reporting on the accrual basis it appears correct to say that such gain is returnable in the year in which the contract of sale was entered into and, therefore the purchaser's legal obligation to make payment to the taxpayer became reasonably certain in fact and ascertainable in amount," citing Spring City and North Texas!
287For the suggestion that a definite guide may provide a "blueprint for tax avoidance," see Jordan Co. v. Allen, 85 F. Supp. 437, 444 (N.D. Ga. 1949).
be assumed that properly advised taxpayers thereafter acted accordingly.\textsuperscript{288}

Having found a touchstone in unconditional liability, the Court, as well as knowledgeable taxpayers, thereafter readily solved problems of timing. The right of the taxpayer being assumed in \textit{Continental Tie \\& Lumber Co. v. United States},\textsuperscript{295} the accrual of estimated income was said to be required, although essential administrative action had not been taken to determine the amount of the accrual. In that case, the taxpayer had a claim against the United States pursuant to Section 204 of the Transportation Act of 1920\textsuperscript{290} (which provided for payments to short line carriers not operated by the Government during World War I, carriers assumed to have been injured as the result of the Government's operation of larger railway systems). The amount of the claim was to be determined by the Interstate Commerce Commission as provided in the Transportation Act and in accordance with the taxpayer's accounts, kept as prescribed by the Commission, a determination which "required in some degree the exercise [by the Commission] of opinion and judgment."\textsuperscript{291} Although that amount was not determined by the Commission and was not paid by the Government until 1923, the Court held the amount taxable in 1920, the year in which the "right to the award was fixed by the passage of the Transportation Act. What remained was mere administrative procedure to ascertain the amount to be paid."\textsuperscript{292} In spite of "inherent difficulties [the Court thought] it was

\textsuperscript{288}But see note 286 \textit{supra}.  
\textsuperscript{289}286 U.S. 290 (1932).  
\textsuperscript{290}41 Stat. 460 (1920).  
\textsuperscript{291}286 U.S. at 296. That the amounts received from the Government represented taxable income had been established on the same day in \textit{Texas \\& Pacific Railway Co. v. United States}, 286 U.S. 285 (1932). Section 209 of the Transportation Act of 1920 guaranteed certain railroads a minimum operating income for a period of six months after release from Government control, and the taxpayer claimed that the amount received from the Government pursuant to the provisions of that Section was a subsidy or gift and did not represent income within the meaning of the sixteenth amendment or the 1918 Act. In declaring the payment taxable the Court distinguished \textit{Cuba Railroad}, note 130 \textit{supra}, on the ground that the payments in that case were "conditioned upon construction work performed. Here they were to be measured by a deficiency in operating income, and might be used for the payment of dividends, of operating expenses, or capital charges, or for any other purpose within the corporate authority, just as any other operating revenue might be applied." 286 U.S. 290. There was nothing in \textit{Cuba Railroad}, however, to indicate that the use of the cash received from the Cuban government was in any manner restricted.  
\textsuperscript{292}286 U.S. at 295.
possible for a carrier to ascertain with reasonable accuracy the amount of the award to be paid by the Government."

Conversely, where the right of the taxpayer was in dispute, the timing of the accrual has seemed equally clear to the Court. In *North American Oil Consolidated v. Burnet*, the taxpayer operated oil properties claimed by the Government. Suit was instituted and a receiver appointed on February 2, 1916. The district court dismissed the suit in 1917 and the 1916 profits were paid over in 1917 by the receiver to the taxpayer. The litigation was terminated in 1922. "The income earned from the property in 1916 had been entered on the books of the [taxpayer] as its income. It had not been included in its original return of income [for 1916]," apparently on the theory that the receiver, not the taxpayer, was required by statute to report the income for tax purposes. With strong overtones of cash basis accounting, the Court held that the 1916 income was taxable in 1917, the year in which the taxpayer "first became entitled to receive" and "actually received" the money.

If a taxpayer receives earnings under a claim of right and without restrictions as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

The income earned in 1916 was not taxable in 1916 although included in the taxpayer's accounts for that year, because the taxpayer "was not required in 1916 to report as income an amount which it might never receive."
In Spring City Foundry Co. v. Commissioner, it was certain that the full amount of the item in question would never be received. Nevertheless, the Court required the accrual of the entire amount because the taxpayer's (largely worthless) "right" was clear. The taxpayer in 1920 had sold goods on open account to a customer who became bankrupt in that year. The taxpayer also in 1920 charged off on its books the full amount of the account. Although uncollectible in part, the entire amount was held to be includable in current sales, and to be reflected in 1920 gross income, because "it is the right to receive and not the actual receipt that determines the inclusion of an amount in gross income. When the right to receive the amount becomes fixed, the right accrues." Furthermore, there was not any deduction allowable. Provisions in the 1920 Act for (1) "losses sustained" and (2) "worthless" debts were declared by the Court to be mutually exclusive, and the claim against the bankrupt was not "worthless" in 1920. Undefined gross income, therefore, was interpreted to include worthless or partly worthless "rights" at face value. Appropriate deduction provisions, if any, must be relied on to eliminate or reduce the effect of that inclusion.

Even when dealing with the crude cash basis provisions of the 1909 Act, the Court in Mitchell Brothers had recognized that Congress intended to tax only "gain or increase," not gross receipts. A profitless transaction was taxed in Sanford & Brooks, but that result was made necessary by the requirements of annual accounting. In Spring City, however, where (1) the taxpayer's sale and (2) the purchaser's bankruptcy both took place in the same taxable year, the valuation of the account receivable could not in any substantial manner prejudice annual accounting procedures. On the contrary, that valuation was essential to the proper determination of the taxpayer's 1920 income. Whether treated as an exclusion from gross income or as a deductible loss, the choice was, as the Court had recognized in Mitchell Brothers, "a mere question of methods, not affecting the result." Neither method, however, was now permitted by the Court in Spring City. Reverting

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200292 U.S. 182 (1934).
201In later years the receiver distributed to the taxpayer assets aggregating 271/2% of its claim.
202292 U.S. at 184-85.
204292 U.S. at 189. It was not until 1921 that Congress provided for partly worthless debts. Act of Nov. 23, 1921, ch. 186, § 234(b)(5), 42 Stat. 255 (1921).
205Note 73 supra.
206Note 194 supra.
207Note 75 supra.
to the practice followed in *Stratton's Independence*, the composite character of income was again ignored; undefined gross income was determined without regard to the availability of an appropriate deduction, and defined deductions were strictly construed. As a result, loss transactions could be, and sometimes were, taxable as income.

The taxpayer had attempted the alternate routes of the exclusion and the deduction approach in *Brown v. Helvering* and had failed. The commission income of the taxpayer, an insurance agent, in effect was repaid by the taxpayer when policies on which he had earned and received commissions were thereafter cancelled. The returned commissions, based on the taxpayer's experience, averaged between 20% and 25% of the amounts received. For the first time, in 1923 the taxpayer claimed as an exclusion or as a deduction from gross income the estimated amount which he anticipated would have to be eventually refunded with respect to commission received during the year. The accounting treatment was disapproved by the Court which held that the entire amount of the commissions received must be included in gross income, the refund liability as to particular policies could not accrue so long as it remained contingent, and the claimed exclusion or deduction was not allowable. The Court also concluded that it was within the discretion of the Commissioner to require the taxpayer to follow his earlier method of accounting, a method which had not provided for the accrual of return commissions.

The taxpayer in *Brown* also attempted in 1923 to allocate to future years a part of the 1923 commissions on the theory that he was under an obligation to render future services in connection with the insurance policies which had generated the commissions. The Board of Tax Appeals had found no proof that the commissions were in any degree compensation for future services, and since the Commissioner had wide discretion regarding accounting methods, his rejection of the change also was not disturbed by the Court.

In *American National*, the taxpayer had been permitted to accrue and deduct estimated amounts payable pursuant to agreements with investors, but in *Brown* the taxpayer was not permitted to deduct estimated amounts payable pursuant to agreements with insurance companies. In each of those cases the contractual obligation to make pay-

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308 Note 46 *supra*.
310 Note 253 *supra*. 
ment was contingent upon decisions of third persons. Although the change in the taxpayer's accounting practice without the consent of the Commissioner (with consequent doubling-up of more than one year's deductions in the year of change), may have justified the result in Brown, the unfortunate reference to contingent liability added another precedent to the growing list of decisions cited in support of the liability theory of accrual.

Unconditional liability of another to the taxpayer as a test for accrual of income was also applied by the Court to deductions. In Dixie Pine Products Co. v. Commissioner the taxpayer used a solvent in its business which it claimed was not subject to the state gasoline tax. After paying and deducting that tax in 1936, the taxpayer brought an action in that year to enjoin future collections. A demurrer to the bill of complaint was sustained by the lower court in 1936, but was reversed and remanded on appeal in 1937. In 1938 the lower court perpetually enjoined collection of the tax, and that decree was affirmed in 1939. During 1937 local users of the solvent, with the exception of the taxpayer and one other, had paid the assessed tax. Although the taxpayer did not pay the gasoline tax in 1937, it accrued the asserted liability in its books and deducted that amount in its 1937 return. The Court disallowed the deduction because the liability had not "really" accrued in 1937. It was "contingent" and "contested."

It has long been held that in order truly to reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid... The taxpayer "might claim a deduction only for the taxable year in which its liability for the tax was finally adjudicated." The same approach was taken in Security Flower Mills Co. v. Commissioner. The taxpayer accrued in 1935 and claimed as a deduction for that year the processing tax on wheat processed in its mill during

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In American National, liability ended to the extent the notes were curtailed before maturity by the borrower; in Brown, liability ended upon the expiration of the policy without cancellation by the insured. I.e., commissions received in earlier years, repaid during the current year, plus estimated amounts credited to a (new) reserve for commissions currently received but repayable in the future.

1045 B.T.A. 286, 287-88 (1941).
10520 U.S. at 519 (citing Anderson).
10620 U.S. at 516 (1944).
10721 U.S. 281 (1944).
the entire year. Earlier in 1935 a part of the 1935 processing tax had been paid to the Collector, but suit was then instituted by the taxpayer to enjoin future collection. A temporary injunction was obtained in 1935 on the condition that the processing tax be paid into a depository. Although not stated as a separate item, the processing tax had been included in the sales price of flour sold to customers. The Court disallowed the deduction of all amounts not actually paid in 1935 to the Collector, whether impounded or not, and also refused to permit the taxpayer to exclude from gross income the tax collected from customers as a part of the sales price,310 because the taxpayer had "received the purchase price as such." That conclusion followed because the taxpayer "denied liability for, and failed to pay, the tax during the taxable year 1935, it was not in a position in its tax accounting to treat the Government's claim as an accrued liability."320

Although the failure-to-pay language in Dixie Pine and Security Mills suggested a contrary result, the Court in United States v. Consolidated Edison Co. of New York, Inc.321 held that an accrual basis taxpayer contesting 15% of the tax demanded, but paying the entire amount, could not deduct in the year paid that part of the real estate taxes which it actively contested after payment.322 The Court viewed the payment as a "mere deposit."323 The Court's decision that payment by an accrual taxpayer, in and of itself, should not determine the timing of a tax deduction is obviously sound. But the Court's holding that the disputed amounts were not deductible until the controversy was settled does not follow as a necessary conclusion.

Property taxes, generally attributable to specific periods of time, are customarily allocated to the business activities of those periods. Estimated amounts reasonably accrued in the books of the taxpayer for the appropriate tax year should be deductible, whether paid or not, or whether in dispute or not. Anderson decided that uncertainty as to amount of liability was not controlling, but proper matching of revenue and expense was. The fact of litigation should not defer the deduction of the amount of a tax accrued for other corporate purposes, for example, rate making, reports to shareholders, etc., any more than the amount of disputed munitions tax involved in the returns in Anderson deferred the deductions in that case. While the formal character of the

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310 Various amounts had been repaid to customers in 1936, 1937 and 1938.
321 U.S. at 284.
323 But see INT. REV. CODE of 1954, § 461(f) (now permitting the deduction of amounts paid in respect of contested items otherwise deductible).
324 U.S. at 391.
dispute in *Anderson* was not the same as that in *Consolidated Edison*, the threat of liability was as serious and as successful in ripening into actual liability in the former case as in the latter.

Unanticipated subsequent demands upon the taxpayer for the payment of additional items for prior years present somewhat different problems. Reopening the returns of an earlier year would be theoretically correct, as the Commissioner had contended in another connection in *Ox Fibre*, but practical necessity, recognized in *Sanford & Brooks*, dictates otherwise. As should be true of losses, the accrual of any other expense of doing business should be based on a reasonable estimate of the certainty of the event. Book recognition or non-recognition of the item, unless obviously an improper exercise of business judgment, should be determinative. As early as 1917 the Treasury had provided for the deduction of amounts credited to reserves “to meet liabilities, the amount of which and the date of payment or maturity of which is definitely not determined or determinable at the time liability is incurred.” Accepting the illustration used by the Court to decide *Consolidated Edison*, 95% of the property tax demanded by the local government in that case was ultimately determined to be payable and was paid. To allow the accrual for tax purposes of an amount demanded by the taxing authority, when such additional amount is reasonably recorded as an expense in the taxpayer’s accounts, appears to be well within the tolerance permitted for estimating tax deductions, as the facts in *Anderson* clearly demonstrated.

Furthermore, the distinction, as such, between uncertainty as to the amount of liability and uncertainty as to whether the contestant is subject to the liability, is an exceedingly doubtful one and was properly disregarded in *Consolidated Edison*. In *Dixie Pine* and in *Security Mills*, the threat of liability was not frivolous; it was sufficiently serious to induce actual payment after initial enactment, and competitors continued to pay such items although the validity of the local law giving rise to the item had been challenged and was being litigated. In both cases the amounts in question were reasonably certain and were reflected in the accounts of the taxpayers. The cases were, therefore, unlike *American Code* in which the amount of damages was said to be “wholly unpredictable.” To allow the current deduction of items in dispute under circumstances similar to those illustrated by *Dixie Pine*, Se-

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233“Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.” INT. REV. CODE of 1954, § 446; see Treas. Reg. § 1.446-1(a) (1961).
234Notes 244-45 supra.
curity Mills and Consolidated Edison would not appear to offer a threat to federal revenue, regardless of whether the dispute is centered around the subject of the tax, its constitutionality, or the proper amount payable. The fact that a matter is in controversy, whether litigated or not, should certainly be one important element to be considered in determining the reasonableness of the accrual, and the amount accrued, but not determinative. Controversy, in and of itself, should not bar the accrual. The Court in Consolidated Edison, however, held otherwise. In reaching that result, the Court treated the contest as to amount as being essentially a contest as to underlying liability. Consequently, the contested amount was held to be deductible only in the year of entry of the final court order determining liability. Just as the chance timing of a cash payment or a cash receipt may have little significance in the proper accrual of revenue and expense for income determination purposes, the culmination of events establishing unconditional liability may be equally irrelevant. Each test contains the same basic flaw: Neither a cash transaction nor a liability (or right) determination bears any necessary relation to the amount of income earned during the year, or to the expenses attributable to the earnings of that period. Indeed, from one important point of view, a modified system of cash accounting which includes inventories is to be preferred. The cash flow, at least, does have a measurable and immediate economic impact upon the current business affairs of the taxpayer.

Although the Court in Consolidated Edison gave conclusive effect to the fact of local litigation, it rejected cash accounting concepts with respect to the accrual of a deduction. Payment prior to the end of the local dispute did not accelerate the accrual of the expense in that case and, hopefully, receipt of prepaid revenue will ultimately not necessarily result in the immediate accrual of income. In North American Oil, the receivership, not the litigation, postponed the accrual of income. Transactions relating to the property in dispute during the year

Postponing the accrual of the contested amounts in Consolidated Edison had the effect of overestimating income in low tax rate years, and of transferring the deduction relating to those early years to World War II income and excess profits tax years. Excessive rigidity in dealing with deductions was also illustrated in Magruder v. Supplee, 316 U.S. 394 (1942), where the Court refused to permit a reasonable apportionment of property taxes between the buyer and seller of real estate. Legislative (state and local) notions of "tax day," determined by technical and frequently obscure factors, were substituted for generally accepted settlement practice. The substitution, however, was only temporary. Congress reversed Supplee in important respects to permit apportionment between buyer and seller. See Int. Rev. Code of 1954 § 16(d).

See note 322 supra for an indication of the congressional point of view,

Note 294 supra.
in question, notwithstanding the receivership, were recorded in the books of the taxpayer, and concepts such as "all events" and "claim of right" undoubtedly were ignored by the taxpayer in following its normal accounting procedures. The taxpayer's income tax return for 1916, but for its mistaken view that the receiver was required to file a return, presumably would have included the income in question. The basic consideration, therefore, was whether the receivership indicated a probable loss of the oil rights, so that the inclusion of the disputed income in the records of the taxpayer was without justification, or whether the receivership was merely perfunctory. The latter appears to have been the view of the taxpayer in keeping the business records and that evaluation, unless shown to be specious, should have been conclusive as to the year of accrual. If the threatened loss resulting from the litigation justified the Commissioner's postponement of the accrual, the accrual should have been timed to the removal of that threat, not by the payment of funds held by the receiver; accordingly, the removal of the serious threat of loss may have been the real, even though unexpressed, reason which justified the conclusion reached by the Court, but unhappily, that was not the reason stated. The opinion was constructed in terms reflecting a concept akin to cash basis accounting.

In Brown, as in Stratton's Independence and in North American Oil, the Court again refused to explore the valuation aspects of the problem under consideration. Putting to one side the change in accounting present in Brown, income from commissions received during the year should have been accrued and taxed only to the extent retention was not measurably threatened by his contractual obligations (liability) to make repayments. The taxpayer's experience had indicated a range within which such payments probably would be made, and at least the minimum anticipation of repayment should have been allowed by the Court. Whether such allowance should take the form of an exclusion from gross receipts or the form of a deduction from gross income, it was "a mere question of methods, not affecting the result."\textsuperscript{330}

North American Oil dealt with the receipt of income earned in an earlier year. Brown dealt with receipts subject to repayment. The basic problem was evaluation. When dealing with prepaid revenue, however, the problem becomes essentially one of timing. In Gauley Mountain the Court had approved the allocation of income between (1) taxable years and (2) prior, tax-free years on the basis of daily averages when more accurate information was not available.\textsuperscript{331} A similar allocation of

\textsuperscript{330}Text accompanying note 75 supra.

\textsuperscript{331}Text accompanying notes 76-82 supra.
prepaid receipts would appear to be equally reasonable. But in *Auto-
mobile Club of Michigan v. Commissioner*, the distribution of pre-
paid membership dues over the life of the membership agreement was
said to be "purely artificial" and bearing "no relation to the services
which [the taxpayer] may in fact be called upon to render for [a] mem-
ber." In a similar case, *American Automobile Association v. United
States*, the taxpayer's accounting system, "substantially identical"
with that used in *Michigan*, was supported by "expert accounting testi-
mony indicating that the system used was in accord with generally ac-
cepted accounting principles; that its proof of cost of member service
was detailed; and that the correlation between that cost and the period
of time over which the dues were credited as income was shown and
justified by proof of experience." Nevertheless, the allocation to fu-
ture years was disapproved, the Court somewhat illogically conclud-
ing that the federal revenue cannot be made "to depend upon average
experience in rendering performance and turning a profit." Quite to

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*353 U.S. 180* (1957) (Justices Burton, Clark and Harlan dissented). Earlier in *Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552 (1932), the Court had held that the premium received on bonds sold before March 1, 1913, was income in the year received, not a deferred credit to be written off over the life of the bond or a reduction in the amount of nominal interest currently payable. But in *Helvering v. Union Pacific Railroad Co.*, 293 U.S. 282 (1934), the Court held that discount on bonds sold before March 1, 1913, could be written off as a deduction over the life of the pre-March 1 bonds. See Treas. Reg. § 1.61-12(c)(2) (1957), relating to bonds issued at a premium after February 28, 1913, and Treas. Reg. 1.61-12(c)(3) (1957), relating to bonds issued at a discount. *See also* Great Western Power Co. v. Commissioner, 297 U.S. 543 (1936); Helvering v. Metropolitan Edison Co., 306 U.S. 522 (1939).

*353 U.S. at 189.*

The Commissioner determined that the [taxpayer] received the pre-
paid dues under a claim of right, without restriction as to their dis-
position, and therefore the entire amount received in each year
should be reported as income. The Commissioner relies upon *North
American Oil*. We cannot say, in the circumstances here, that
the discretionary action of the Commissioner... exceed[s] per-
missible limits.

*Id.* at 188-90.

*357 U.S. 687* (1961). *See also* Commissioner v. Milwaukee & Suburban Trans-

*357 U.S. at 691.* The Court relied heavily on the repeal by Congress of Sections 452 and 462 of the Internal Revenue Code of 1954, which had expressly permitted the
deferring of income and the accruing of anticipated expenses, respectively, and on
the enactment of Section 455 of the Code which permitted publishers to defer pre-

*Justices Douglas, Harlan, Whittaker and Stewart dissented.*

*687 U.S. at 692.* Relief, however, was provided immediately thereafter by
the contrary, profits were taxed on an average daily basis in *Gauley Mountain*, and important expenses, such as depreciation and interest, are frequently computed in a similar manner, of necessity.

The practice of allocating revenue over the life of membership contracts, disapproved in *Michigan* and *American*, was not a factor in *Schlude v. Commissioner*. In the latter case the prepaid fees from dance studio contracts had been deferred by the taxpayer and later taken to income on the basis of hours actually taught in the performance of the contracts. That practice was also disapproved by the Court. Customer's decisions concerning the time for taking lessons, rather than averages became the evil which destroyed the taxpayer's method of deferring income. The Court said that the services "were rendered solely on demand in the fashion of *Michigan* and *American*... Consequently the Commissioner was fully justified in including payments in cash or negotiable notes in gross income for the year in which such payments were received... The contract installments are likewise includable in gross income... for the year they become due and payable. For the accrual basis taxpayer 'it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income.'"

Beginning with the decision of the second issue in *Brown*, where the postponement of the accrual of income was denied because the taxpayer failed to establish a relationship between the receipt of overriding commissions and a contractual obligation to supply future services, and by perpetuation in *Schlude*, where both the relationships and the timing were clearly shown, the Court has refused to allow the deferral to future years of amounts actually received for future services,383

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382 U.S. 128 (1963). Justices Douglas, Harlan, Stewart and Goldberg dissented. Accounts inactive for more than a year were also closed into income. *Id.* at 132.

383 "Negotiable notes are regarded as the equivalent of cash receipts, to the extent of their fair market value, for the purposes of recognition of income." *Id.* at 136, n.10.

384 *Id.* at 137, citing *Spring City v. Commissioner*, 292 U.S. 182, 184 (1934). The Commissioner conceded that "future payments which were not evidenced by a note and which were neither due by the terms of the contract nor matured by performance of the related services" were not includable in gross income. 372 U.S. at 133. The Court noted that "percentage royalties" and "sales commissions for lessons sold" were deducted in the year paid, rather than being postponed with the related items of revenue. *Id.* at 136. The Court also noted that Congress had enacted a relief provision applicable to certain membership organizations, permitting the deferring of revenue, and thereby had indicated a "policy of treating this problem by precise provisions of narrow applicability." *Id.* at 135. See note 337 *supra*.

385 But see *Hagen Advertising Displays, Inc. v. Commissioner*, 407 F.2d 1105 (6th Cir. 1969) (suggesting that where amounts have been received in prepayment
even though such amounts are readily analogous to "deposits" properly recognized in Consolidated Edison as a neutral factor in the timing of an accrual. In addition, the Court in Schlude held that amounts not actually received for services to be performed in the future, if due and payable, were "likewise includable in gross income." Thus both the "all events" items (due and payable) and the "claim of right" items were currently taxable even though substantial performance remained to be completed under outstanding contracts. In light of that startling conclusion, and in view of the great number and variety of early-pay agreements currently being used, a heavy burden is placed on the self-assessment process by Supreme Court-made accounting theory. Indeed, Treasury understandably is in the process of modifying Schlude and related cases.\textsuperscript{343} Accrual basis taxpayers may defer (within prescribed limits) payments received for future services to be performed not later than the year following the year of receipt\textsuperscript{344} and proposed regulations would permit accrual basis taxpayers to defer certain prepayments for goods to be sold in the future.\textsuperscript{345}

In Commissioner v. Hansen,\textsuperscript{346} valuation problems were again disregarded, as they had been in American National. In Hansen sales by automobile and house trailer dealers were made on credit (one to five years) secured by the respective vehicles sold. Installment paper obtained by the dealer from a purchaser, usually guaranteed by the dealer, was discounted under an agreement whereby a percentage (5\% to 10\%) of the discount price was retained by the finance company or bank to secure dealer performance. The Court, ignoring problems of valuation, held that the full amount of the discount price must be included in the gross income of an accrual basis dealer in the year the installment paper was discounted,\textsuperscript{347} even though (1) it must have been apparent that a stated amount payable in the future ordinarily does not have the value of an immediate payment of the same amount\textsuperscript{348} and (2) the generally accepted rule requires that property received in a taxable exchange must be reported as income on the basis of fair market value. That rule

for goods to be sold in the future, at least the cost of goods sold, representing capital, should be excluded from current taxable income). See notes 343, 344 and 345 infra.

\textsuperscript{344}Proposed Treas. Reg. § 1.451-5. See also note 342 supra.
\textsuperscript{345}860 U.S. 446 (1959).
\textsuperscript{346}Transitional relief was afforded dealers by the Dealer Reserve Income Act of 1960. Pub. L. No. 86-459, 74 Stat. 124.
\textsuperscript{347}Note 258 supra.
is applied without question to the receipt of negotiable notes and should, a fortiori, be applied to non-negotiable obligations.

Cases such as American National and Hansen therefore, amply illustrate the need for the use of valuation procedures in the solution of tax accounting problems heretofore decided by the Court on an all-or-nothing basis. Recent lower court decisions emphasize the importance of that need. For example, in Mooney Aircraft, Inc. v. United States the taxpayer, with each aircraft manufactured and sold, issued a "Mooney Bond," representing an unconditional obligation to pay bearer $1000 upon the retirement of the aircraft from service. The taxpayer sought to exclude or deduct the principal amount of the bond from gross income in the year issued. Although the obligation was in effect a reduction in the sales price of the airplane the Commissioner disallowed the deduction, contending that it was allowable only in the year in which the aircraft was in fact retired. In sustaining the Commissioner the Court of Appeals relied heavily upon the Commissioner's statutory authority to require a taxpayer to use a method of accounting which clearly reflected income. Although the full amount of the deduction claimed by the taxpayer was properly disallowed, the case ought to have been remanded to the trial court for determination of the market value, if any, of the "Mooney Bond." To the extent that the taxpayer can establish the present market value, that amount should either be excluded from sales revenue or deducted from gross income and the difference between the present market value and the principal amount of the bond should be deducted ratably over the estimated life of the aircraft.

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340 See, e.g., note 340 supra.
341 Note 233 supra.
342 Note 349 supra.
352 420 F.2d 400 (5th Cir. 1969).
353 Or, alternatively, the taxpayer sold an airplane and a bond and the amount received (or receivable) should be allocated between the two.
354 See also Lukens Steel Company, 52 T.C. 764 (1969). That case involved the accrual (on the basis of current payroll hours) of unemployment benefits expense to be paid (pursuant to the requirements of a collective bargaining agreement) in the indefinite future, the accrual formula having been devised by "a group of experts on economics and statistics selected by the steel companies and the union." Id. at 778. The liability was unconditional, and the amount was readily determinable by use of the formula and the expense, in large part at least, was clearly attributable to current operations. Unemployment benefits were an immediate cost of producing steel, not a future cost of non-production. Required by the Union contract, the present value of the hourly incurred liability was as much a current cost of labor as take-home pay. To the extent that the accrual did not exceed the cost of acquiring from independent underwriters insurance providing equivalent future...
The Court in *Mitchell Brothers*, decided after the early depletion cases, recognized congressional intent to tax on the basis of "gain or increase." Nevertheless, when faced with valuation problems necessary to the determination of "gain or increase," the Court has been reluctant to consider matters of degree. Profitless accruals were fully taxable in *Spring City*. Depletion costs were disallowed in *Stratton's Independence* and related cases. Deferred receipts were fully taxable in *Hansen*, as were the returnable receipts in *Brown*. If the Court does continue to insist on the immediate tax accrual of the full amount of a receivable which is not to be collected until the distant future, as suggested by *Hansen*, it should find it difficult to justify the complete disallowance of a business expense, unconditional and fixed in amount, although payable in the distant future.\(^3\)

As emphasized in *Anderson*, accrual accounting is based on the premise that income earned during the taxable year must be charged with expenses incurred in producing that income. The process of matching revenue and expense should not be distorted by the frequently ac-

benefits, such cost was properly allowed by the Tax Court in the year accrued by the taxpayer. In addition to the increased hourly cost for current wages, the agreement with the Union also required the taxpayer to assume unconditionally the amount of contingent unemployment benefit liability which had accumulated under an earlier wage agreement. Subject to similar discount adjustments, if any, applicable to the current unemployment benefit costs, the expense so incurred was also properly deducted in the year the liability became unconditional. Although applicable to past services, the amount was not allowable for the year the work was performed, in view of *Ox Fibre* and *Sanford & Brooks*. Any excess amount accrued (assuming the reasonableness of the benefits, an assumption readily made, in view of the bargaining which gave rise to the obligation) should be deferred and written off in some appropriate manner.

*Washington Post Co. v. United States*, 405 F.2d 1279 (Ct. Cl. 1969), presented a somewhat different situation. In that case the taxpayer accrued irrevocable obligations to pay its independent circulation dealers under specified conditions at determinable but uncertain future dates the amounts so accrued, a purpose of the plan being "to maintain a continuing relationship" between the taxpayer and the dealers "over a period of years." 405 F.2d at 1281. The allocation of the accrued cost of the "continuing relationship" to appropriate years was not necessary, because Section 173 of the current Internal Revenue Code provided that "expenditures...to establish, maintain, or increase the circulation of a newspaper...shall be allowed as a deduction." And the Regulations helpfully provided (1) that the deduction "shall be allowed only for the taxable year in which such expenditures are paid or incurred," Section 1.173-1(a)(3), and (2) that under the accrual method of accounting "an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy." Section 1.461-1(a)(2). The fact and amount of liability being clear, questions of valuation and of matching expense with related revenue were not considered. The Code and Regulations made those questions irrelevant.

\(^3\)See notes 332 and 355 supra.
cidental timing of the cash flow or by requiring the technical ripening of unconditional claims and liabilities. And preliminary to that matching is the valuation of the items under consideration, a matter of estimate measured by experience and reasonable judgment.

Unfortunately, the attainment of needed correction under a government of separation of powers is slow and uncertain. The formulation of a concept of business income which will operate fairly when applied to widely diversified activity, as a practical matter rather than a theoretical matter, is an enormously difficult task. Conflicting points of view and uncoordinated decisions of the legislative, executive and judicial branches of government, compounded by taxpayer demands for preferred consideration have produced illogical rules which, if actually followed, could and frequently do result in determinations of income widely at variance with the official records of the corporate taxpayer and with generally accepted concepts of income.

Basically the responsibility for raising revenue is legislative and executive rather than judicial. While obviously necessary and desirable as a means of settling non-accounting disputes between the taxpayer and the tax collector, the Supreme Court does not have the facilities for and should not be charged with the duty of defining a general concept of business income and should not have been permitted, by default, to establish basic (tax) accounting rules to be followed in computing the income so defined. The initial failure of Congress to enact a workable income tax law together with the consequent preemption by the Supreme Court of the responsibility for formulating principles of accrual, and the harmful effect of remedial legislation enacted to modify those principles by affording special relief to limited groups of favored taxpayers is responsible for much of the complexity and most of the unfairness of the present Internal Revenue Code provisions dealing with the determination of annual taxable income.

\[\text{Treasury took an encouraging step forward in § 3.09 of Technical Release No. 1040, note 344 supra, dealing with prepaid income received for the performance of the future services when it required that}
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The amount of any advance payment includible in the taxable year of receipt under the foregoing rules shall be no less than the amount of such payment included for purposes of all reports (including consolidated financial statements) to shareholders, partners, other proprietors, beneficiaries, and for credit purposes.

Congress earlier had taken a similar position with respect to the use of the "lifo" method of inventorying goods. See Int. Rev. Code of 1954, § 472(c). Hopefully, the requirement will be extended to other and more important areas.