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SIGNIFICANT DEVELOPMENTS IN THE LAW OF FEDERAL TAXATION, 1941-1947: II*

Paul G. Kauper†

II

TOPICAL SURVEY

C. Federal Income Taxes

2. Taxes on Corporate Income

(a) The basic (normal and surtax) rate structure (I.R.C., §§ 13, 14 and 15). The 1941 Revenue Act carried forward the rather complex normal tax structure prescribed by the 1940 Revenue Act and in

* The first installment of this article appeared in the April, 1947 issue at p. 659. The following outline indicates the sequence of material under Topical Survey in this and the preceding installment:

A. The Federal Estate Tax
   1. The Rate Structure
   2. Gross Estate Inclusions
   3. Deductions and Credits
   4. Burden of the Tax

B. The Federal Gift Tax
   1. The Rate Structure
   2. Taxable Transfers
   3. Exclusions from Value—Exceptions

C. Federal Income Taxes
   1. Taxes on Income of Individuals
      (a) The rate structure
      (b) Withholding and collection of tax at the source
      (c) Declaration and payment of estimated tax
      (d) Tax simplification
   2. Taxes on Corporate Income
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      (b) The excess profits tax
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   7. Corporate Distributions and Reorganizations
   8. Taxable Persons
      (a) Corporations
      (b) Husband—wife
      (c) Trusts

D. The Role of the United States Tax Court.

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112 No reference is made in the text to the surtax imposed under I.R.C., § 102 on corporations improperly accumulating surplus. This section was not substantially
addition introduced a corporate surtax rate schedule. The normal tax rates were increased to absorb the 10% defense tax previously imposed as a separate tax and also a very slight increase in the rates applicable to corporations with a normal-tax net income of less than $38,461.54. As so altered the normal tax amounted to 24% in the case of corporations having normal-tax net income over $38,461.54, and in the case of corporations having no more than this amount of normal-tax net income the applicable rate was determined by use of a bracket system that ranged from 15% on the first $5,000 to 37% on the excess over $25,000. The new surtax imposed by the 1941 act was levied at the rate of 6% on the first $25,000 of surtax net income and 7% on the remainder.

The basic scheme of the normal tax as well as the new surtax was carried forward by the 1942 Revenue Act. However, the dividing line for normal tax purposes was changed from $38,461.54 to $50,000 and the highest bracket rate on corporations having a normal-tax net income in excess of $50,000 was reduced to 31%. Otherwise the normal tax rates were not disturbed. Surtax rates were increased so as to range from 10% upon surtax net income not over $25,000 to 16% upon the surtax net income of corporations having such income over $50,000. Under this act the maximum aggregate normal and surtax was 40%, as contrasted with 31% under the preceding law.

No further changes were made in the basic corporate tax structure until the Revenue Act of 1945 reduced the surtax rates. Under this
act the surtax rates now range from 6% upon surtax net income not over $25,000 to 14% upon the surtax net income of corporations having such income in excess of $50,000. The maximum aggregate normal and surtax is now 38% as contrasted with 31% under the 1941 act and 40% under the 1942 act.

(b) The excess profits tax. The stimulation of industrial enterprise that resulted from the government’s demand for production of war materiel as part of its program for strengthening the country’s military position led to a demand for special taxation of “war profits” even before the United States entered the war. The Excess Profits Tax of World War II appeared in its embryonic form in the Second Revenue Act of 1940 which by its Title II added subchapter E, officially designated as the “Excess Profits Tax Act of 1940,” to chapter 2 of the Internal Revenue Code. This legislation was the product of hasty action, and it was generally recognized at the time that further legislation would be required to remedy its inadequacies. The legislation known as the “Excess Profits Tax Amendments of 1941” resulted in some clarifying changes. Even more substantial alterations were incorporated in Title II of the subsequently enacted Revenue Act of 1941. However, it was reserved for the Revenue Act of 1942 in its Title II, to give the excess profits tax law its definitive form.

The law in its earlier versions featured a progressively graduated rate schedule. Under the Second Revenue Act of 1940 the rates ranged from 25% on the first $20,000 of adjusted excess profits net income to 50% on such income in excess of $500,000. The Revenue Act of 1941 stepped up the rates from a minimum of 35% to a maximum of 60%. The progressively graduated rate feature was

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117 Sec. 121(a), amending I.R.C., § 15(b).
119 Comprising I.R.C., §§ 710 through 752.
120 Act of March 7, 1941, 55 Stat. L. 17, c. 10.
121 The code sections that will be referred to in connection with the discussion of the excess profits tax law are the sections that were included in subchapter E of chapter 2 as it stood prior to enactment of the Revenue Act of 1945 which by its § 122(a) repealed the excess profits tax law with respect to taxable years beginning after December 31, 1945. Technically the excess profits tax provisions are not included in the current code.
122 Sec. 201, adding to chapter 2 of the code subchapter E, comprising code §§ 710 through 752. Sec. 710 of the code as thus added imposed the tax and stated the rate schedule.
123 Sec. 201(a), amending I.R.C., § 710(a).
abandoned in the Revenue Act of 1942\(^{124}\) which fixed the tax at a flat rate of 90%. A further change was made in the Revenue Act of 1943\(^{125}\) which pushed the flat rate up to 95%. The severity of the flat rate was mitigated by two features of the law first introduced by the 1942 Revenue Act: provision was made for a post-war refund of 10% of the excess profits tax\(^{126}\) and an overall 80% rate ceiling was established with respect to the combined excess profits tax and the ordinary normal and surtaxes imposed on corporate income.\(^{127}\)

The specific excess profits tax exemption, designed to benefit small corporations, was originally limited under the 1940 Second Revenue Act\(^{128}\) to $5,000. This was increased to $10,000 by the Revenue Act of 1943.\(^{129}\) Under the Tax Adjustment Act of 1945,\(^{130}\) the exemption was further increased to $25,000, effective for tax years beginning after December 31, 1945 or ending in 1946. In view of the repeal of the excess profits tax by the Revenue Act of 1945, this increase lost its significance.

The excess profits tax law, in the definitive form it attained under the Revenue Act of 1942, was a complex piece of legislation. The most that can be attempted in the course of this review is to indicate the general pattern of the law and the principal problems engendered by it.\(^{131}\)

\(^{124}\) Sec. 202, amending I.R.C., § 710(a)(1).

\(^{125}\) Sec. 202, amending I.R.C., § 710(a)(1)(A).

\(^{126}\) Revenue Act of 1942, § 250, amending subchapter E of chapter 2 of the code to insert at the end thereof a new Part III, comprising I.R.C., §§ 780 through 783.

\(^{127}\) Revenue Act of 1942, § 202, amending I.R.C., § 710(a)(1).

\(^{128}\) Sec. 204(a), amending I.R.C., § 710(b)(1).

\(^{129}\) Sec. 2(a), amending I.R.C., § 710(b)(1).

At the risk of possible oversimplification, it may be said that the legislative object was to levy a special income tax on that portion of corporate profits attributable to the war effort. The choice of a measure to be applied to a corporation’s earnings for the purpose of determining how much thereof was in excess of normal peacetime earnings presented obvious difficulties and it was to be expected that the selection of any such yardstick would be somewhat arbitrary. In the end Congress chose alternative standards and gave the taxpayer the benefit of the standard that resulted in the lower tax. The alternative yardsticks chosen were “average base period net income”$^{132}$ and income measured by a statutory percentage (ranging on a graduated basis from 8% to 5%) of “invested capital.”$^{133}$

Stated in simple terms, the base period net income method rested on the theory that the portion of corporate income during each of the war years, beginning with 1940, which was in excess of the annualized average income during the four base period years, 1936-1939, should be earmarked as excessive earnings attributable to the war effort, or, conversely, that the portion thereof not in excess of such average base period net income should be equated with normal earnings not attributable to the war effort and therefore taxable in the usual way under the ordinary normal and surtax schedules. Similarly the invested capital method incorporated the idea that the portion of corporate income in a war year in excess of the recognized percentage taken on invested capital was abnormal, war-begotten gain, or, conversely, that the income in the amount measured by the recognized percentage of invested capital was the kind of fair return on investment which the corporation had a right to expect even in peacetime.

The statute prescribed in detail the methods to be used in computing both “average base period net income”$^{134}$ and “invested capital.”$^{135}$ In general the average base period net income was the income averaged out on an annual basis of the corporation’s net income during the four base years, 1936-1939, presumably selected because they were typical peacetime earnings years. Obviously many younger corpora-
tions had not attained the peak level of earning capacity during this four year period. In cases of that kind the statute permitted, through application of the so-called "growth formula," an adjustment upwards, where the average earnings of the last two years of the base period were in excess of the average earnings during the initial two-year period.

Invested capital as defined by statute included two classifications—equity invested capital and borrowed invested capital. Generally, equity invested capital included cash paid, property paid in and accumulated earnings and profits, with adjustment required for distributions. Borrowed capital as defined was included in invested capital only to the extent of 50% thereof. Invested capital was required to be reduced by the amount of so-called "inadmissible assets" which were defined to include stock in other corporations and tax-exempt securities.

Brief mention may be made of the mechanics of computation. The excess profits tax was imposed on "adjusted excess profits net income." This amount was arrived at by taking as the initial figure the corporate normal-tax net income, a familiar category. By application of a series of adjustments, corporate normal-tax net income was converted into "excess profits net income." This figure in turn was reduced by applying against it a series of statutory credits, including the exemption referred to above, the excess profits credit determined by reference to either average base period net income or statutory percentage of invested capital as briefly outlined above, and the unused excess profits credit for other years in accordance with the carry-back and carry-forward privileges explained below. The net figure thus arrived at constituted the "adjusted excess profits net income."

An important feature of the excess profits tax law was the provision authorizing a two-year carry-back and a two-year carry-forward of unused excess profits credit so that in effect a final determination of excess profits tax liability for any single year took into account a five

186 I.R.C., 713(f).
187 I.R.C., § 718.
188 I.R.C., § 719.
189 I.R.C., § 720.
190 I.R.C., § 710(a)(1).
191 I.R.C., § 711.
192 I.R.C., § 710(b).
year earnings perspective. This privilege of applying one year's deficiency to another year's excess with the effect of cancelling or reducing tax liability had important implications for corporations that found their earnings drastically reduced during the post-war reconversion period, a matter that will be touched upon later.

Despite the staggering task of adjusting the law to the equities of individual corporate taxpayers Congress took steps in this direction. The adjustments required for translating normal-tax net income into excess profits net income included adjustments by reference to abnormal deduction as well as abnormal income items during the base period years. The statute also took account of abnormalities in income during the excess profits tax years. A corporation that had a record of steady increase in earnings during the base period years was given the benefit of the "growth formula," by means of which it was permitted to reconstruct its actual base period net income into a larger figure by reference to a record of increased earnings during the last two years of the base period.

But even the growth formula did not take into account a great many other factors which served in a wide variety of ways to make actual base period net income an inadequate measure of normal earnings. To attempt to anticipate all such situations and provide a specific legislative rule to take care of them was beyond the realm of possibility. The only alternative was an authorization of relief by reference to broadly stated standards to be interpreted and applied by the Commissioner and the United States Tax Court. This was the course Congress pursued in enacting the relief provisions found in the now famous section 722 of the Internal Revenue Code.

"Section 722 relief," as it is popularly known, is probably the

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144 I.R.C., § 710(c).
145 I.R.C., § 711(b).
146 I.R.C., § 721.
147 I.R.C., § 713(f).
148 Sec. 222 of the Revenue Act of 1942 gave code § 722 its definitive form.
most interesting feature of the excess profits tax law, if for no other
reason than because of the extremely broad terms in which it is stated. 
This section offers to a corporate taxpayer the opportunity of using 
a “constructive average base period net income” (emphasis added) in 
any case in which the taxpayer (1) establishes that the excess profits 
tax, as otherwise computed, results in “an excessive and discriminatory 
tax,” and (2) establishes what would be “a fair and just amount repre-
senting normal earnings to be used as a constructive average base 
period net income. . . .” The language of subsection (a) stating the 
general rule reads as follows:

“In any case in which the taxpayer establishes that the tax 
computed under this subchapter (without the benefit of this sec-
tion) results in an excessive and discriminatory tax and establishes 
what would be a fair and just amount representing normal earn-
ings to be used as a constructive average base period net income 
for the purposes of an excess profits tax based upon a comparison 
of normal earnings and earnings during an excess profits tax 
period, the tax shall be determined by using such constructive 
average base period net income in lieu of the average base period 
et income otherwise determined under this subchapter.”

Two principal problems are faced by a corporate taxpayer in at-
tempts to make out a case for relief under section 722. First, it 
must demonstrate that the tax as otherwise computed is excessive and 
discriminatory by reference to the broad economic and financial stan-
dards enumerated in the statute. Secondly, it must establish by con-
struction a hypothetical fair and just amount representing normal 
earnings to be used as a substitute for average base period net income. 
Simply to mention these two problems is to give some indication of 

Section 722,” 24 TAXES 579 (1946); Groseclose, “Expanding Business and the Ex-
cess Profits Tax,” 23 TAXES 879 (1945); Houghton, “When Tax Relief is Not Re-
722 Relief,” 22 TAXES 308 (1944); Maloney and Wood, “The Treasury Depart-
ment’s Bulletin on Section 722,” 23 TAXES 43 (1944); Mann, “A Commentary 
on Relief Provisions,” 24 TAXES 659 (1946); Miller, “Another Year of Section 722,” 
2 TAX L. REV. 417 (1947); Polk, “Excess Profits Tax Relief,” 21 TAXES 434 
(1943); Seidman, “The Treasury’s Bulletin on Section 722 Relief,” 23 TAXES 194 
(1945); Simons and Segher, “Relief From Excess Profits Tax Burdens, With Special 
Reference to Section 722,” 21 TAXES 67 (1943); Tarleau, “Section 722: Safety Valve 
of the Excess Profits Tax,” 10 LAW AND CONTEM. PROB. 43 (1943); Tarleau, “Cur-
rently Controversial Aspects of Section 722,” 1 TAX L. REV. 197 (1945-1946); 45 
MICH. L. REV. 763 (1947).

150 I.R.C., § 722(a).
the wide scope of the inquiry and the magnitude of the undertaking. Economic data and statistics, a study of business trends generally, the taxpayer's financial history and a chronicle of its earnings records, plus a lively sense of imagination in the trending of economic probabilities all enter into the picture.

On its face section 722 opened up wide vistas for excess profits tax relief. But it is not an easy or simple matter to secure this relief. After filing its excess profits tax return for a given year, a taxpayer that believes itself entitled to section 722 relief is required to make application to the commissioner on a form prescribed by him. The burden is on the taxpayer to support its application by stating sufficient grounds and presenting adequate evidence in support thereof. The part played by the bureau in its processing of relief claims is a very important one. Its regulations and its interpretative bulletin on section 722 relief, implementing the broad standards incorporated in the statute and furnishing more concrete guides to their construction, carry considerable weight.

In view of the very large number of relief applications filed by taxpayers it was not surprising that the bureau at the outset adopted a strict position which seemed to preclude relief except in the more extreme cases. In response to public protest that the bureau was not administering section 722 in accordance with Congressional intent, a protest which culminated in the Hearings before the Congressional Joint Committee on Internal Revenue Taxation, the bureau on July 10, 1946, set up the Excess Profits Tax Council which is now the agency within the bureau vested with final authority over section 722 relief applications. There is reason to believe that the creation of the council marked the beginning of a more liberal bureau policy in dealing with relief applications.

The bureau's determination in disallowing a taxpayer's relief application, in whole or in part, is subject to review by the United States Tax Court. The proceeding on review is similar to the ordinary deficiency proceeding. However, the Tax Court's determinations with

151 I.R.C., § 722(d).
152 Treas. Reg. 112, §§ 35.722-1 et seq.
155 I.R.C., § 732(a).
respect to section 722 matters is final and not subject to judicial re-
view.156 In one of the first section 722 cases that came before it the
Tax Court made clear that it would not review the bureau's determi-
nation unless the taxpayer had adequately stated its grounds for relief
before the bureau in the first instance.157 However, the more recently
decided *East Texas Motor Freight Lines* case158 indicates that the Tax
Court will permit a taxpayer to present before the court new and addi-
tional evidence to supplement evidence previously presented before
the bureau and in furtherance of grounds advanced in the original
application for relief.

To date the Tax Court has handed down only a handful of deci-
sions under section 722,159 and it is too early to draw any general con-
clusions with respect to this tribunal's general attitude toward relief
dispensation. However, the decisions granting relief in the *East Texas
Motor Freight Lines*160 and the *7-Up Fort Worth Co., Inc.*161 cases
indicate a reasonable liberality in effectuating the purpose and policy
of Congress—a liberality in contrast with the strict policy followed by
the bureau prior to the setting up of the Excess Profits Tax Council.

It is safe to suppose that in the end only a small percentage of the
large number of relief applications will be allowed. Difficulties in
substantiating claims will undoubtedly stand in the way of effective
prosecution of the larger part of them. However, the claims now be-
ning processed are numerically large enough to keep section 722 ques-
tions fresh in the minds of accountants, lawyers, economists, business
executives, the bureau and the Tax Court for some time to come.

The Revenue Act of 1945162 repealed the excess profits tax for tax

156 I.R.C., § 732 (c).
158 7 T.C. 579 (1946).
159 Uni-Term Stevedoring Co., Inc., 3 T.C. 917 (1944); Blum Folding Paper
Box Co., Inc., 4 T.C. 795 (1945); Fezandie and Sperrle, Inc., 5 T.C. 1185 (1945);
Monarch Cap Screw and Mfg. Co., 5 T.C. 1220 (1945); East Texas Motor Freight
Lines, 7 T.C. 579 (1946); Stimson Mill Co., 7 T.C. 1065 (1946); The Homer
Laughlin China Co., 7 T.C. 1325 (1946); 7-Up Fort Worth Co., Inc., 8 T.C. 52
(1947); The Fish Net and Twine Co., 8 T.C. 96 (1947).

160 7 T.C. 579 (1946). See Landman, "The Taxpayer's First Tax Court Vic-
161 8 T.C. 52 (1947).
162 Sec. 122(a), repealing subchapter E of chapter 2 of the code.
years beginning after December 31, 1945. But in repealing the tax Congress made an important concession by continuing the unused excess profits credit carry-back for one year after repeal of the tax itself. This means that a corporate taxpayer has the privilege of impressing the excess profits tax pattern upon its 1946 earnings for the purpose of measuring these earnings against the credit allowed under the excess profits tax law by reference to the alternative income and invested capital yardsticks. Any unused credit as thus determined may then be carried back against the taxpayer's 1945 and 1946 earnings in order to reduce the excess profits taxes for these years and thus establish the taxpayer's right to a refund. Apparently Congress thought this concession was necessary on the theory that the failure to earn normal earnings in 1946 was to be regarded as part of the cost of reconversion from war to peace-time production and hence was to be considered in a final accounting for taxes on war profits. This allowance of the carry-back privilege, after termination of liability for the excess profits tax itself, was criticized in some quarters as unnecessary in view of the concessions already made in the form of the 10% post-war refund, the accelerated amortization allowed for emergency plant facilities, and the possibilities of section 722 relief and on the further ground that the carry-back privilege offered a premium on corporate idleness or lack of production in 1946. A passage in the Senate Finance Committee's report indicates that it was not unmindful of possible abuse of the unused 1946 credit carry-back privilege and suggests that the last word on this matter may not yet have been written.

Before leaving this subject reference may be made to a problem of excess profits tax avoidance which led to specific legislation. The use of a credit derived from base period income or from invested capital suggested a scheme whereby corporate taxpayers might acquire inactive corporations for the purpose of exploiting their excess profits credits. To strengthen the commissioner's hand in dealing with practices of this kind Congress included in the Revenue Act of 1943 a

168 Revenue Act of 1945, § 122(b) and (c). Sec. 122(c) served to amend I.R.C., § 710(c)(2).
171 Sec. 128.
provision amending the code by adding thereto section 129 entitled, “Acquisitions Made to Evade or Avoid Income or Excess Profits Tax.” Under this section which is relevant for purposes of other income taxes as well as the excess profits tax the commissioner is authorized to disregard an acquisition and to disallow deductions, credits or allowances based thereon when the principal purpose of the acquisition was to evade or to avoid federal income or excess profits tax.\(^\text{167}\)

3. Gross Income—Inclusions and Exclusions

(a) Gain on bargain purchase [I.R.C., § 22(a)]

*Commissioner v. Smith*\(^\text{168}\)—employee whose corporate employer gave to him as compensation for services an option to purchase stock of another corporation held taxable when he later exercised option, on gain measured by difference between option price and market value of stock.\(^\text{169}\)

(b) Compromise payments [I.R.C., § 22(a)]

*Hort v. Commissioner*\(^\text{170}\)—taxpayer who had received a lump sum in cancellation of a lease held taxable on entire amount as income in year of receipt since the lump sum was in lieu of future rental payments.\(^\text{171}\)

(c) Gain on involuntary conversion [I.R.C., § 22(a)]

*Helvering v. William Flaccus Oak Leather Co.*\(^\text{172}\)—payment received from insurance company as compensation for loss of property

\(^{167}\) See Rudick, “Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code,” 58 Harv. L. Rev. 196 (1944).


\(^{170}\) 313 U.S. 28, 61 S. Ct. 757 (1941).

\(^{171}\) See the discussion of the case in Magill, Taxable Income, rev. ed., 200-201 (1945).

\(^{172}\) Cf. McAllister v. Commissioner, (C.C.A. 2d, 1946) 157 F. (2d) 235, holding that the taxpayer’s surrender, on payment of valuable consideration, of her life estate in a trust resulted in a capital loss, as contrasted with the commissioner’s contention that the transaction resulted in ordinary gain.

\(^{172}\) 313 U.S. 247, 61 S. Ct. 878 (1941).
which had been fully depreciated for income tax purposes held taxable as ordinary gain.

(d) **Illegal gain** [I.R.C., § 22(a)]

*Commissioner v. Wilcox*\(^{178}\)—taxpayer held not taxable on embezzled funds since he did not receive or hold the same under a bona fide claim of right. This case indicates a hitherto unsuspected limitation on the taxability of illegally derived gains.

(e) **Alimony** [I.R.C., § 22(k)]

The 1942 Revenue Act\(^{174}\) added subsection (k) to section 22 to require inclusion in gross income of periodic payments received pursuant to a decree of divorce or separate maintenance. This amendment marked a legislative reversal of the rule laid down in the early case of *Gould v. Gould*.\(^{175}\) The 1942 act\(^{176}\) simultaneously amended section 23 by adding subsection (u) thereto to permit a deduction to the husband for such payments.\(^{177}\)

(f) **Improvements by lessee of lessor’s property**

[I.R.C., § 22(b)(I)]

The 1942 Revenue Act\(^{178}\) added paragraph (I) to section 22(b) to exclude from gross income “income, other than rent, derived by a lessor of real property upon the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee.” Congress thereby repealed the rule of *Helvering v. Bruun*.\(^{179}\)

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\(^{174}\) Sec. 120(a).

\(^{175}\) 245 U.S. 151, 38 S. Ct. 53 (1917).

\(^{176}\) Sec. 120(b).


The 1942 Revenue Act [§ 120(c) amending code by adding § 171] also prescribed specific treatment of alimony trusts. See the references cited in note 335, infra.

\(^{178}\) Sec. 115(a).

(g) Tax-free interest [I.R.C., § 22(b)(4)]

Commissioner v. Shamberg's Estate\(^{180}\)—interest from bonds issued by Port of New York Authority held exempt under section 22(b)(4). This decision marked a defeat for the commissioner in his attempt to reopen the constitutional issue respecting the tax exempt status of state securities.\(^{181}\)

(h) Gifts payable out of income [I.R.C., § 22(b)(3)]

The 1942 Revenue Act\(^{182}\) amended section 22(b)(3) to provide that a gift or bequest of the income from property is taxable, to the extent of the income. Congress thereby overruled the doctrine of Burnet v. Whitehouse\(^{183}\) which had held annuities non-taxable in view of the gift exclusion.\(^{184}\) The 1942 act\(^{185}\) simultaneously amended section 162(b) to authorize a deduction to trustees for income distributed in payment of an annuity, thereby abrogating the rule followed in Helvering v. Pardee.\(^{186}\)

(i) Employees' annuities [I.R.C., § 22(b)(2)(B)]

The 1942 Revenue Act\(^{187}\) added a new subparagraph (B) to section 22(b)(2), to state the rule respecting taxability to an employee of payments made by an employer to purchase employees' annuities and to define the base for the purpose of determining, by reference to the 3% rule, the taxability to the employee of annuity payments received by him. This amendment, when correlated with the simultaneous

\(^{180}\) (C.C.A. 2d, 1944) 144 F. (2d) 998, cert. den., 323 U.S. 792, 65 S. Ct. 433 (1945).


\(^{182}\) Sec. 111(a), amending I.R.C., § 22(b)(3).


\(^{185}\) Sec. 111(b), amending I.R.C., § 162(b).

\(^{186}\) 290 U.S. 365, 54 S. Ct. 221 (1933).

\(^{187}\) Sec. 162(c), amending I.R.C., § 22(b)(2).
amendments\textsuperscript{188} of sections 165 and 23 (p) is seen to be part of a new and important legislative policy respecting pension trusts and annuity plans.\textsuperscript{189}

\textbf{(j) Income from discharge of indebtedness [I.R.C., § 22(b)(9)]}

The 1939 Revenue Act\textsuperscript{190} had added paragraph (9) to section 22(b) so as to grant a gross income exclusion in respect to income from discharge of indebtedness in the case of all corporate taxpayers "in an unsound financial condition." By its terms this amendment was not made applicable to any discharge of indebtedness occurring before the date of enactment of the 1939 act or in a taxable year beginning after December 31, 1942. The 1942 Revenue Act\textsuperscript{191} amended section 22(b)(9) to make the exclusion of income arising from discharge of indebtedness applicable generally to all corporations, whether or not financially sound. But the exclusion as thus broadened was made inapplicable to any discharge occurring in a taxable year beginning after December 31, 1945. Later legislation\textsuperscript{192} further extended the effective date to September 31, 1947.

\textit{Helvering v. American Dental Co.}\textsuperscript{193}—held that a creditor's cancellation of post-due interest and back rent was a \textit{gift} and therefore not taxable income to the debtor-taxpayer. Arising under the 1936 Revenue Act and therefore unaffected by the 1939 and 1941 amendments, this case indicates a sharp limitation on the general doctrine deducible from the earlier holding in the \textit{Kirby Lumber Co.} case.\textsuperscript{194}

\textsuperscript{188} Revenue Act of 1942, § 162(a) and (b).
\textsuperscript{189} See note 340, infra.
\textsuperscript{190} Sec. 215(a), amending I.R.C., § 22(b) by adding paragraph (9).
\textsuperscript{191} Sec. 114(a), amending I.R.C., § 22(b)(9).
\textsuperscript{192} Sec. 152 of 1945 Revenue Act, amending I.R.C., § 22(b)(9) and (10); Pub. L. 578, 79th Cong., 2d sess. (1946).
\textsuperscript{194} United States Kirby Lumber Co., 284 U.S. 1, 52 S. Ct. 4 (1931).

(k) Recovery exclusion—the "tax benefit" rule
[I.R.C., § 22(b)(12)]

Dobson v. Commissioner—taxpayer who had been induced to buy worthless securities on the strength of fraudulent representations and who had taken an income tax deduction for the loss on the same, thereafter recouped the purchase price; held, that the findings and determination of the Tax Court that recoupment gave rise to no taxable gain since earlier deduction had not resulted in a tax benefit were not to be disturbed on review since the Tax Court's treatment of what was viewed as an accounting question did not constitute a reviewable question of law.

Compare Douglas v. Commissioner and Virginian Hotel Co. v. Helvering on the question whether the tax benefit rule applies with respect to depletion and depreciation allowances.

The 1942 Revenue Act added to section 22(a) a new paragraph (12) providing for the exclusion from gross income of income attributable to the recovery during the taxable year of a bad debt, prior tax or delinquency amount to the extent that a prior deduction or credit taken with respect to such item did not give rise to a tax benefit.

The Dobson case did not arise under the 1942 amendment to the code. The Treasury has taken the position that the policy expressed in section 22(b)(12) applies equally well to recovery of items like those involved in the Dobson case but not expressly mentioned in the

195 320 U.S. 489, 64 S. Ct. 239 (1943).
197 322 U.S. 275, 64 S. Ct. 988 (1944). In this case the Supreme Court was evenly divided on the question whether upon cancellation of a mineral lease, pursuant to which the lessee had paid a minimum royalty even though no ore had been mined, the lessor was required to restore to gross income the depletion allowances for earlier years held properly taken into account in a subsequent adjustment resulted in a tax benefit.
198 319 U.S. 523, 63 S. Ct. 1260 (1943). Here excessive depreciation allowances for earlier years held properly taken into account in a subsequent adjustment of depreciation basis even though the excessive allowances had not resulted in a tax benefit.
199 Sec. 116(a), amending I.R.C., § 22(b) by adding paragraph (12).
200 See the articles by Plumb, cited in note 196, supra.
However, the Regulations preclude application of the tax benefit rule to depletion and depreciation items.

4. Deductions

(a) General authorization and limitations

(1) Ordinary and necessary trade or business expenses

[I.R.C., § 23(a)(1)]

(i) Trade or business

See Higgins v. Commissioner; City Bank Farmers Trust Co. v. Helvering; United States v. Pyne. The holding common to the three cases was that the managing of investments did not constitute a trade or business, consequently the expenses incident to such management were not deductible.

Interstate Transit Lines v. Commissioner—payments made by a parent corporation to a subsidiary corporation pursuant to contract whereby parent agreed to reimburse subsidiary for operating deficits, held disallowed as deductions since these expenses did not relate to parent's business.

Commissioner v. Flowers—attorney who maintained law office in Jackson, Mississippi, where he was domiciled and maintained his family residence, served as counsel for railroad with headquarters in Mobile, Alabama, and spent a substantial amount of his time there; held that expenses of travel to Mobile and of board and lodging there

See TREAS. REG. III, § 29.22(b)(12)-1, as amended by T.D. 5307 and T.D. 5454.


313 U.S. 121, 61 S. Ct. 896 (1943).

313 U.S. 127, 61 S. Ct. 893 (1943).

319 U.S. 590, 63 S. Ct. 1279 (1943) The lower court decision is noted in 43 COL. L. REV. 234 (1943).

were not deductible. The Tax Court had rested its determination on ground that expenses were not incurred away from "home," but chief ground of Supreme Court's affirmance was that expenses were not incurred pursuant to business.

(ii) Ordinary and necessary

*Textile Mills Security Corp. v. Commissioner*—Regulations sustained in denying a deduction to corporation for lobbying expenses incurred in promoting legislation.

*Commissioner v. Heininger*—litigation expenses incurred by dentist in mail order business in defending against fraud order issued by Post Master held ordinary and necessary, hence deductible, since fraud order if it had remained in effect would have destroyed taxpayer's business.

*MacDonald v. Commissioner*—taxpayer who had been appointed to a state court to complete an unexpired term, thereafter waged an unsuccessful campaign for election to the court upon expiration of the interim term; his campaign expenses, including substantial contributions to party "war-chest," held not deductible although Court conceded that under section 41 of code taxpayer's office as judge constituted "trade or business."

(2) Ordinary and necessary non-trade or non-business expenses

[I.R.C., § 23(a)(2)]

The 1942 Revenue Act added the very important paragraph (2) to section 23(a) to allow, in the case of an individual, "all the ordinary and necessary expenses paid or incurred during the taxable


210 320 U.S. 467, 64 S. Ct. 249 (1943), noted in 42 MICH. L. REV. 1143 (1944).


213 Sec. 121(a), amending I.R.C., § 23(a).
year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.” Obviously designed to remedy the situation created by the disallowances under section 23(a)(1) of the expenses involved in the Higgins, City Bank Farmers Trust Co. and Pyne cases, referred to above, the language used in the amendment suggested an even broader reach. The two decisions noted below are must reading on the interpretation of this amendment.

MacDonald v. Commissioner—see reference to case above respecting deductibility of campaign expenses as ordinary and necessary trade or business expenses; the same expenses also disallowed under section 23(a)(2) on the ground that the 1942 amendment intended only to correct the result reached in the Higgins case et alia under section 23(a)(1) and not to liberalize the deductibility of expenses incident to trade or business. The forcible and persuasive dissenting opinion suggests a broader interpretation of the 1942 amendment on the theory that the legislative intent was to tax net income only.

Trust of Bingham v. Commissioner—taxpayer-trustee incurred legal expenses arising out of various transactions having to do with distributions to beneficiaries and legatees; these expenses held deductible under section 23(a)(2) as necessary and proper expenses incurred in the management of the trust. While proceeding on a theory that paragraph (2) of this section is to be construed in pari materia with paragraph (1), the case indicates a liberal interpretation of the 1942 amendment with respect to the deductibility of expenses incurred for the “management, conservation or maintenance of property held for the production of income.”


(3) Capital expenditures [I.R.C., § 24(a)]

Spreckles v. Commissioner — taxpayer, not a dealer in securities, disallowed a deduction for selling commissions paid to brokers since commissions are to be treated as an offset against sale price in the determination of gain or loss on later sale or exchange.

F. H. E. Oil Co. v. Commissioner — the circuit court's first opinion in this case, questioning the validity of the provision of the Regulations granting oil operators an option either to charge to expense or to capitalize so-called "intangible drilling and development expenditures," led to an expression of Congressional intent in support of the Regulation.

The 1942 Revenue Act added paragraph (7) to section 24(a) of the code to disallow taxes and carrying charges as expenses where in accordance with regulations the same are chargeable to capital account with respect to property, and taxpayer elects in accordance with regulation to treat such items as so chargeable.

(b) Optional standard deduction [I.R.C., § 23(aa)]

Reference has already been made to the provision of the Individual Income Tax Act of 1944 adding subsection (aa) to section 23 of the code to authorize the taking by individual taxpayers of an optional standard deduction in lieu of specific deductions authorized under section 23. In general it may be said that the optional standard deduction takes the place of all deductions other than expenses incurred in trade or business or expenses attributable to the earning of rents or royalties. The items not covered by the optional standard deduction become relevant in translating gross income into "adjusted gross income" under section 22(n) of the code.

(c) Specific deductions

(1) Alimony [I.R.C., § 23(u)]

The 1942 Revenue Act added subsection (u) to section 23 to allow a husband deductions for periodic payments pursuant to a decree of divorce or permanent maintenance.

219 (C.C.A. 5th, 1945) 147 F. (2d) 1002, reh. den., 149 F. (2d) 238.
220 TRES, REG. III, § 29.23(m)-16 (b)(1).
222 Sec. 120(b), amending I.R.C., § 23.
223 See note 110, supra.
224 Sec. 120(b), amending I.R.C., § 23.
(2) Extraordinary medical expenses [I.R.C., § 23(x)]

The 1942 Revenue Act\(^{226}\) added subsection (x) to section 23 to authorize a deduction for expenses of medical care of the taxpayer, his spouse and dependents. As further amended in 1944\(^{227}\) and 1945\(^{228}\) this subsection now authorizes a deduction for such expenses to the extent that they exceed 5% of the taxpayer's adjusted gross income.

(3) Interest on Indebtedness [I.R.C., § 23(b)]

The John Kelley Co. v. Commissioner and Talbot Mills v. Commissioner\(^{229}\)—held in these companion cases that Tax Court's findings on deductibility by corporation of payments on hybrid types of securities were not to be disturbed by reviewing courts. The opposite results reached by the Tax Court in these two cases indicated a narrow line of distinction.\(^{230}\)

The 1942 Revenue Act\(^{231}\) added paragraph (6) to section 24(a) to disallow deductions for amounts paid or accrued in indebtedness incurred or continued to purchased a single premium life insurance or endowment contract.

(4) Taxes [I.R.C., §§ 23(c) and (d)]\(^{232}\)

Wisconsin Gas & Electric Co. v. United States\(^{233}\)—tax imposed by Wisconsin Dividend Privilege Tax Act denied as deduction to corporation under section 23(c) since tax not imposed upon the corporation and also disallowed under section 23(d) since the corporation in

\(^{226}\) Sec. 127(a), amending I.R.C., § 23.

\(^{227}\) Individual Income Tax Act of 1944, § 8(c), amending I.R.C., § 23(x).

\(^{228}\) Revenue Act of 1945, § 102(b)(1), amending I.R.C., § 23(x).

\(^{229}\) 326 U.S. 521, 66 S. Ct. 299 (1946). See the comment on these cases in 44 Mich. L. Rev. 827 (1946).

\(^{230}\) On the general question see Winstead, “Can a Corporation Deduct From Gross Income Dividends on Preferred Stock?” 23 Tex. L. Rev. 39 (1944). On the various hybrid types of securities see GUTHMANN & DOUGALL, CORPORATE FINANCIAL POLICY 519 (1942); Berl, “The Vanishing Distinction Between Creditors and Stockholders,” 76 Univ. P. A. L. Rev. 814 (1928). For briefer treatments of the tax question see 40 Col. L. Rev. 1084 (1940); 55 Harv. L. Rev. 1189 (1942); 90 Univ. P. A. L. Rev. 730 (1942); 50 Yale L. J. 151 (1940).

\(^{231}\) Sec. 129, amending I.R.C., § 24(a).


\(^{233}\) 322 U.S. 526, 64 S. Ct. 1106 (1944).
charging the tax against the stockholder’s dividends was reimbursed for the same.

_Magruder v. Supplee_²²⁴—purchaser of real estate who agreed to assume payment of accrued property tax on the real estate disallowed deduction for same since tax not imposed upon him by law.

The 1942 Revenue Act²³⁵ amended section 23(c) to authorize a deduction for retail sales taxes imposed by local law where sales tax is stated separately as part of purchase price and purchaser-taxpayer actually pays the same.²³⁶

The 1943 Revenue Act²³⁷ further amended this section to disallow deductions for federal excise taxes. However, such excises are still deductible under section 23(a) as trade or business expenses.

(5) *Taxes and interest paid to cooperative apartment corporations* [I.R.C., § 23(z)]

The 1942 Revenue Act²³⁸ added subsection (z) to section 23 to place tenant-stockholders of cooperative apartment house corporation in the same position as house-owners respecting deductibility of amounts paid for taxes and interest.

(6) *Contributions to employees’ trust* [I.R.C., § 23(p)]

The 1942 Revenue Act²³⁹ completely revised subsection (p), respecting deductibility by employers of contributions to an employees’ trust or annuity plan and of compensation under a deferred-payment plan. This very significant amendment dovetailed into the important 1942 amendments²⁴⁰ of section 165 (dealing with pension trusts)²⁴¹ and of 22(b)(2) referred to above under gross income inclusions (“employees’ annuities”).

(7) *Foreign war losses* [I.R.C., § 127]

The 1942 Revenue Act²⁴² added the comprehensive and important

²³⁵ Sec. 122, amending I.R.C., § 23(c).
²³⁷ Sec. 111, amending I.R.C., § 23(c)(1).
²³⁸ Sec. 128, amending I.R.C., § 23.
²³⁹ Sec. 162(b), amending I.R.C., § 23(p).
²⁴⁰ Revenue Act of 1942, § 162(a) and (c).
²⁴¹ See note 340, infra.
²⁴² Sec. 156(a), amending I.R.C., to insert new § 127.
section 127 authorizing deduction for war losses and defining the limits thereon.

(8) Carry-back of net operating loss [I.R.C., § 122]

The 1942 Revenue Act amended section 122 to permit in addition to the two-year carry-over of net operating loss as authorized by earlier law a two-year carry back of net operating loss.

(9) Losses by individuals [I.R.C., § 23(g)]

Boehm v. Commissioner—worthlessness of stock for purposes of permitting loss deduction under section 23(e) of Revenue Act of 1936 held determined by an objective test based on “identifiable events” rather than by a subjective test based on the taxpayer’s reasonable and honest belief supported by his conduct, and deduction taken by taxpayer for year in question accordingly disallowed.

The 1938 Revenue Act withdrew losses based on worthlessness of stock from the section 23(e) categories of ordinary losses and placed them in the category of capital losses under section 23(g). As carried forward into the code this section provides that the loss sustained when stock becomes worthless shall be treated as a loss arising from the sale or exchange of a capital asset. The Boehm case is therefore not relevant under the present section 23(e) of the code.

(10) Bad debts [I.R.C., § 23(k)]

The 1942 Revenue Act amended section 23(k)(1) to eliminate, effective as to all taxable years beginning after December 31, 1938.
the requirements of ascertainment of worthlessness and charge-off as prerequisite to a bad debt deduction. Under the law as so amended bad debts are deductible in the year when they actually become worthless. Because the 1942 amendment had failed to take partially worthless debts into account and since doubt had arisen whether under the amendment a deduction could still be taken on a charge-off of partially worthless debt, the 1943 Revenue Act further amended paragraph (1) to reinstate the former wording permitting a deduction for a debt recoverable only in part "in an amount not in excess of the part charged off within the taxable year."

The 1942 Revenue Act further amended section 23(k) by adding paragraph (4) to restrict the deduction in the case of an individual for loss on "non-business bad debts" by requiring the same to be treated as a loss arising from the sale or exchange of a short-term capital asset.

(II) Depreciation [I.R.C., § 23(l)]

*Detroit Edison Co. v. Commissioner*—electric power company not entitled to deduction for depreciation in respect to cost of extension of its facilities, to extent such cost was borne by customers whose payments to the company therefor were neither refunded nor refundable.

*Virginian Hotel Co. v. Helvering*—excessive amounts claimed by taxpayer for depreciation in its tax returns for earlier years held properly deducted from cost in a later readjustment of the property's depreciation basis even though the excessive depreciation taken in the earlier years had not resulted in a tax benefit.


250 Sec. 113(a), amending I.R.C., § 23(k)(1).

251 Sec. 124(a), amending I.R.C., § 23(k).


253 319 U.S. 523, 63 S. Ct. 1260 (1943). See note 197, supra, in connection with the reference in the text at that point to the "tax benefit" rule.
(12) Amortization of emergency facilities
[I.R.C., §§ 23(t) and 124]

This very important deduction authorization, first added to the code by the Second Revenue Act of 1940 and thereafter amended by the Revenue Act of 1942, was one of the most significant tax concessions granted by Congress as an incentive to the construction and acquisition by private capital of facilities necessary to the successful prosecution of the war effort. Congress was faced with practical considerations in dealing with an urgent problem. Taxpayers in devoting private capital to special war facilities faced the risk of finding these facilities worthless when the war ended. Profits from the operation of these facilities were subject to the special war-time excess profits tax. But profits determined by reference to ordinary depreciation rates based on the physical life of the facilities and not taking into account the potential functional uselessness of the facilities at the war's end would give a distorted picture of income attributable to the war effort. Tax-wise this presented a picture calculated to discourage the use of private capital in financing new war industry. To meet this situation Congress authorized the amortization deduction for which detailed treatment is specified in section 124. Under this section a taxpayer was permitted to amortize his capital investment in emergency facilities over a sixty-month period, in lieu of taking the ordinary depreciation allowance. The sixty-month period began with the month following the month in which the facility was completed or acquired. A very important feature of the law permitted accelerated amortization over a period shorter than the sixty-months in case the war was declared terminated before the sixty-months expired. This meant that many taxpayers recouped tax-wise over a period substantially shorter than five years their entire investment in emergency facilities which in many instances continued useful after the war for peacetime industrial use.

255 Sec. 155, amending various subsections of I.R.C., § 124.
Kirby Petroleum Co. v. Commissioner; Commissioner v. Crawford[^258^]—taxpayer leased land to companies for production of oil and other minerals in consideration of a cash bonus, a royalty in the usual form, and an agreement that taxpayer-lessee should receive a percentage of the net money profits realized by lessees from their operations under the lease; held that taxpayer was entitled to deduct depletion in respect to the percentage of net income since, applying the test of *Palmer v. Bender*, it had an "economic interest" in the oil in place.

*Burton-Sutton Oil Co., Inc. v. Commissioner[^259^]—taxpayer, assignee of a contract relating to oil land pursuant to which grantee agreed to pay grantor 50% of net profits from operations, held entitled to deduct the 50% payments from its gross income on theory that they represented rents or royalties and not capital expenditures. This case indicates that the right to net profit payments, standing by itself, constitutes an economic interest, with the result that the net profits payments can be characterized as depletable income.

The 1942 Revenue Act[^260^] amended section 114(b)(4) to extend the percentage depletion allowance privilege to additional designated minerals and to abrogate the election requirement.[^261^] Accordingly the...
depletion allowance may now be computed either on a percentage or cost basis, whichever yields the larger deduction.

The 1943 Revenue Act extended the percentage depletion allowance privilege to additional designated minerals.

The 1942 Revenue Act amended the code to authorize a deduction for amortizable bond premium as defined in the new section. This new section covers the matter in a detailed and comprehensive way.

5. Accounting

(a) Taxable periods

(i) Annual accounting

(ii) Carry-back of net operating loss [I.R.C., § 122]. See discussion of same under “Deductions” above. The effect of the two-year carry-back and carry-forward of net operating losses is to establish a five-year accounting period in setting-off operating losses against gains.

(ii) Recovery exclusion—the tax benefit rule [I.R.C., § 22(b)(12)]. See discussion under “Gross Income—Inclusions and Exclusions,” above. The effect of the tax benefit rule as codified by the 1942 Revenue Act and as recognized judicially in the Dobson case is to set some limit on the general doctrine that each year’s tax accounting must stand on its own feet.

(2) Accruals on death of taxpayer [I.R.C., §§ 42(a) and 126]

Helvering v. Estate of Enright—section 42 of 1934 Revenue Act interpreted to require in the case of a cash basis deceased taxpayer inclusion in his income for the period terminated by his death of all items accrued to date of death.

Putnam’s Estate v. Commissioner—dividend declared prior to
date of death of cash receipts taxpayer but payable to stockholders of record on date after his death, held not accrued within meaning of section 42 of 1938 Revenue Act and hence not includible in deceased taxpayer's income. The Enright case was distinguished on the ground that there the accrual related to income attributable to a partner's services.

The 1942 Revenue Act amended section 42 and added the new section 126 to state the general rule that income which is not includible in a deceased taxpayer's gross income for the taxable period terminating with his death under the accounting method customarily employed by him is taxable, when received, to the person who actually receives it.

(b) **Accounting methods—cash receipts versus accrual**

(i) **Noninterest-bearing obligations issued at discount**

The 1942 Revenue Act amended section 42 and added the new section 126 to state the general rule that income which is not includible in a deceased taxpayer's gross income for the taxable period terminating with his death under the accounting method customarily employed by him is taxable, when received, to the person who actually receives it.

| 1941 Revenue Act amended section 42 by adding subsection (b) authorizing cash receipts taxpayers to account for increase in re- |

1941 Revenue Act amended section 42 by adding subsection (b) authorizing cash receipts taxpayers to account for increase in re-

- 269 Sec. 134(a) and (e), amending I.R.C., § 42(a) and adding I.R.C., § 126, respectively. Sec. 134(b) of the 1942 act, amending I.R.C., § 43, similarly changed the rule with respect to deductions and credits.


- 272 Sec. 114, amending I.R.C., § 42.
demption price either as it accrues or on a cash receipts basis when the obligation is redeemed or sold. This same act added subsection (c) to require income by way of discount on noninterest-bearing short term obligations issued on a discount basis to be accounted for when such obligations are redeemed or sold.

(2) Compensation for services rendered for period of thirty-six months or more and back pay (I.R.C., § 107)

The 1942 Revenue Act amended section 107 (which had been added by the 1939 Revenue Act to mitigate the harshness of cash receipts accounting for deferred compensation for services rendered during a period of five years or more by substituting in effect an accrual accounting for the same) to reduce the period to thirty-six months or more, and also added subsection (b) to extend the same relief to artists, writers, and inventors.

The 1943 Revenue Act added subsection (d) to permit in effect an accounting on an accrual basis for “back pay” when the amount of such pay received by an individual during the taxable year exceeds 15% of the individual's gross income for such year.

(3) Accrual deduction for contingent obligation (I.R.C., § 43)

Dixie Pine Products Corp. v. Commissioner—accrual deduction disallowed for taxes contested by taxpayer and never paid by it, since contingent liability may not be accrued.

Security Flour Mills v. Commissioner—facts essentially the same as in the Dixie Pine Products Corp. case and same result reached. A noteworthy aspect of the case was the Court's rejection of the taxpayer's argument that section 43 of the code authorizes the substitution of “a hybrid system, partly annual and partly transactional,” for that of annual accounting periods.

272 Sec. 115(a), amending I.R.C., § 42.
274 Sec. 139(a), amending I.R.C., § 107.
275 Sec. 119(a), amending I.R.C., § 107.
277 320 U.S. 516, 64 S. Ct. 364 (1944).
279 321 U.S. 281, 64 S. Ct. 596 (1944).
280 See Edelmann, “Time for Accrual and Deduction of Taxes,” 23 TAXES 110 (1945), also Jones' article, cited note 278, supra. For earlier discussions, see the articles by Brown, Ellis and Gray cited in note 232, supra.
6. Sales and Exchanges

(a) Transactions distinguished from sales and exchanges of property

_Hort v. Commissioner_—see reference to case under “Gross Income—Inclusions and Exclusions,” above; taxpayer who had received a lump sum in cancellation of a lease having several years to run did not report it as income but instead reported as a loss an amount representing the difference between the present value of the unmatured rental payments and the fair rental value of the premises for the remainder of the lease; the entire amount received was held taxable as ordinary income in year of receipt and no deduction allowed on a loss theory.

_Heilvering v. William Flaccus Oak Leather Co._—see reference to case under “Gross Income—Inclusions and Exclusions,” above; involuntary conversion of property through loss by fire held not a sale or exchange of property and gain resulting from insurance payments therefore held taxable as ordinary gain.

_Choate v. Commissioner._—taxpayer who transferred an oil lease and equipment for cash and a royalty interest; held entitled to allowance for unrecovered cost of physical equipment. With respect to this equipment, the transaction was viewed as a sale of property and not as a sublease.

(b) Cost basis [I.R.C., § 113(a)]

_Heilvering v. Reynolds_—where taxpayer, pursuant to father’s will, acquired contingent remainder interest in securities, the value for purpose of determining cost basis of same in connection with sale thereof by taxpayer, was value at time of father’s death since this was the time of “acquisition” within the meaning of paragraph (5) of section 113(a).

The 1942 Revenue Act amended paragraph (5) to relate cost basis valuation in the case of property transmitted at death to the applicable valuation date for estate tax purposes in the event the executor exercises the optional valuation privilege under section 811(j) of the code.

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282 For references in connection with the case, see note 171, supra.
283 313 U.S. 247, 61 S. Ct. 878 (1941).
284 324 U.S. 1, 65 S. Ct. 469 (1945).
286 Sec. 144(a), amending I.R.C., § 113(a)(5).
The 1942 Revenue Act also amended paragraph (3) of section 113(a) to make clear that gifts in trust are subject to the cost basis provisions applicable generally under paragraph (2) to property acquired by gift.

(c) Capital gains and losses

(1) The basic pattern (I.R.C., § 117). The 1942 Revenue Act substantially modified section 117. The section as so amended recognizes two classes of capital assets: (a) short term—held for not more than six months; (b) long term—held for more than six months.

In the case of individual taxpayers 100% of gain or loss is taken into account on the sale or exchange of short-term capital assets and 50% on long-term capital assets; a net capital loss is deductible against ordinary income only to the extent of $1000; however unused net capital loss may be carried forward to be applied against net capital gains and against $1000 of ordinary income in each of the succeeding five years; the use of an alternative tax separately computed in case of a net long-term capital gain has the effect of limiting the tax to 25% of the total gain on long-term transactions.

In the case of corporate taxpayers the full amount of gain or loss is taken into account on the sale and exchange of either short-term or long-term capital assets; capital losses are deductible only against capital gain but a five-year carry-over is allowed for net capital loss. The use of an alternative tax with respect to net long-term capital gain limits the effective tax rate to 25% of the total gain on long-term transactions.

(2) Definition of "capital assets" [I.R.C., § 117 (a)(1)]. The 1942 Revenue Act amended subsection (a) to exclude from the capital asset category "real property used in the trade or business of the taxpayer."

(3) Gains and losses from the sale or exchange of certain property used in the trade or business and from the involuntary conversion of such property and of capital assets [I.R.C., § 117(j)]. The 1942 Revenue Act added subsection (j) to provide that if the recognized

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287 Sec. 143(b), amending I.R.C., § 113(a)(3).
289 Sec. 150, amending various parts of I.R.C., § 117.
290 Sec. 151(a), amending I.R.C., § 117(a)(1).
291 Sec. 151(b), amending I.R.C., § 117.
gains from such transactions (where property held for more than six months) exceed the losses, they are to be treated as long term capital gains and losses so that the net gain is given the benefit of the alternative tax applicable to net long-term capital gains. On the other hand, any net loss by reference to these transactions is made deductible as an ordinary loss. This amendment marks an important concession to taxpayers by giving them with respect to certain transactions the benefit of the limited tax rate in the case of a gain and the benefit of an ordinary deduction in case of loss. It will be noted that one of the results of this amendment is to overcome the effect of the Supreme Court’s decision in *Helvering v. William Flaccus Oak Leather Co.*292 which had held that an involuntary conversion was not a sale or exchange and that gain thereon was taxable as ordinary gain.

(4) Gain or loss upon the cutting of timber [I.R.C., § 117(k)]. The 1943 Revenue Act293 amended this section by adding subsection (k) which authorizes a taxpayer to elect to treat the cutting of timber (for sale or for use in his trade or business) as a sale or exchange of such timber cut during the taxable year.

7. Corporate Distributions and Reorganizations294

(a) Stock dividends [I.R.C., § 115(f)(1)]

*Helvering v. Griffiths*295—taxpayer held not taxable on value of common stock received by him as dividend on his common stock holding. The majority based its decision on the intent of Congress and found no occasion to reconsider *Eisner v. Macomber.*296

293 Sec. 127(a), amending I.R.C., § 117.
Helvering v. Sprouse—taxpayer who owned voting common stock in a corporation which had only voting and non-voting common stock outstanding held not taxable on a dividend of non-voting common stock which was issued to holders of both classes of stock; dividends found not to disturb the relationship previously existing amongst all the stockholders.

Strassburger v. Commissioner—taxpayer who was sole stockholder of corporation held not taxable on a dividend in non-voting preferred; distribution resulted in no change in stockholder’s net interest in corporation.

(b) Tax-free corporate reorganizations [I.R.C., § 112(g)]

See the following decisions which involved “creditors’ reorganizations” and which arose under the law prior to the 1942 amendment referred to below: Helvering v. Alabama Asphaltic Limestone Co.; Marlborough Investment Co. v. Commissioner; Palm Springs Holding Corp. v. Commissioner; Helvering v. Southwest Consolidated Corp.; Helvering v. Cement Investors, Inc.

298 See the articles by Altman and Rottschaefer, cited note 296, supra.
300 See the articles by Altman and Rottschaefer, cited note 296, supra.

The 1943 Revenue Act added paragraph (10) to section 112(b) to provide for the non-recognition of gain or loss on transfers pursuant to court orders in certain receivership and bankruptcy proceedings.

(c) Distributions pursuant to tax-free reorganization having effect of taxable dividend [I.R.C., § 112(c)]

Commissioner v. Estate of Bedford—cash distributed pursuant to a plan of recapitalization that came within the statutory definition of reorganization held taxable as ordinary income and not as capital gain since such distributions had "the effect of the distribution of a taxable dividend."

8. Taxable Persons

(a) Corporations

(i) Recognition of corporate entity

Moline Properties, Inc. v. United States—gain on sale of real property owned by corporation taxable to it and not to its sole stockholder; corporation regarded as separate taxable entity.

Commissioner v. Court Holding Co.—corporation held taxable on gain from sale of corporate assets where corporation entered into initial negotiations with respect to sale but thereafter distributed assets in liquidation to stockholders who then completed the sale.


(2) **Consolidated returns by affiliated corporations** (I.R.C., § 141)

The 1942 Revenue Act extensively amended section 141 to restore to affiliated corporations the privilege of filing consolidated returns for the purposes of the corporate normal and surtaxes as well as the excess profits tax.

(b) **Husband-wife**

(i) **Family partnership. Commissioner v. Tower** and Lusthaus v. Commissioner—facts in these companion cases essentially the same; majority sustained Tax Court’s determination that husband taxable on all of partnership earnings despite wife’s capital interest in partnership, where husband controlled the business, wife took no part in management or operation and her capital share therein was derived by way of gift from husband.

(ii) **Community income. Commissioner v. Harmon**—notwithstanding that taxpayer and his wife elected to come under Oklahoma optional community property law, taxpayer held taxable on all the

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816 Sec. 159(a), amending I.R.C., § 141.

817 On the taxation of family trusts, see the treatment of trusts below.


818 327 U.S. 280, 66 S. Ct. 532 (1946).

819 327 U.S. 293, 66 S. Ct. 539 (1946).


income derived from his earnings and from his separate property. In reaching this result the majority distinguished *Poe v. Seaborn* on ground that in the latter case the community status was created by law and was not derived from agreement of the parties.822

(c) *Trusts* 823

(1) The basic statutory pattern (I.R.C., §§ 161-163). The 1942 Revenue Act824 amended section 162 to require distributions out of other than income to be treated as income distributions under certain circumstances. This act further amended this section to insure tax-

822 After this decision the Oklahoma law was revised so as to eliminate the elective feature. H.B. 218 was approved April 28, 1945 and became effective July 26, 1945. In I.T. 3782, INT. REv. BuLL. 1946-4-12239, the bureau ruled that community property interests under the new statute would be recognized for tax purposes. For a discussion of the earlier statute, see Daggett, "The Oklahoma Community Property Act—A Comparative Study," 2 La. L. Rev. 575 (1940).


824 Sec. 111(c), amending I.R.C., § 162.
tion to beneficiaries of distribution of trust income not currently distributable during the taxable year of the estate or trust; this amendment was designed to end practice of avoiding tax on beneficiary by making trust income distributable shortly after close of taxable year of trust.\(^2\)

\((2)\) Deductions for contributions to charities [I.R.C., § 162(a)]. *Merchants National Bank of Boston v. Commissioner*\(^2\)\(\_\)—trustee not allowed charitable deduction against capital where charity’s interest in corpus of trust was subject to trustee’s power to invade for benefit of life tenant and hence the gain was not “permanently set aside” for charitable use. See reference to same case under “Estate Tax-Deductions,” above.

\((3)\) Taxation of trust income to settlor on ownership or control theory\(^2\)\(\_\) [I.R.C., § 166, 22(a)]. In the celebrated case of *Helvering v. Clifford*\(^2\)\(\_\) the Supreme Court held that income from a short-term (five-year) irrevocable trust was taxable to the settlor-taxpayer under section 22(a) of the code, where the taxpayer’s wife was named as beneficiary, the taxpayer named himself as trustee and in his capacity as trustee had discretionary power either to distribute the income currently or to accumulate the same, as well as very wide powers of management over the trust property.\(^2\)\(\_\) The case presented an extraordinary instance of statutory construction in that it pointed to a much more inclusive taxation of trust income to the settlor under the “shotgun” language of section 22(a) than Congress had indicated in the specific and restricted language of section 166 which covers cases where the settlor has power at any time, either alone or in conjunction


Reference was made earlier in the text to the 1942 amendment which requires the beneficiary of an annuity trust to treat amounts received from such a trust as income to the extent that they are actually paid out of income of the trust. See the references cited in notes 182-184, supra.

\(^2\) 320 U.S. 256, 64 S. Ct. 108 (1943).

\(^2\) On the use generally of the trust as a tax avoidance device, see the articles cited in note 323, supra.

\(^2\) 309 U.S. 331, 60 S. Ct. 554 (1940).

with any person not having a substantial adverse interest, to revest in himself title to the trust corpus.

The ramifications of the Clifford doctrine have constituted a major aspect of income tax litigation during the period under review. The elasticity of the "substantial ownership" idea and its unsuspected reaches are revealed in the host of decisions that claim a Clifford ancestry. Viewed as a whole the progeny spawned by the Clifford case reveal the following major trends:

(a) The three factors that have emerged as the significant criteria of "substantial ownership" are the following: (1) reversion to the settlor at the end of a relatively short term; (2) retention by the settlor, in whatever capacity, of a power to control the distribution of the income or the corpus; (3) retention by the settlor, in whatever capacity, of a large measure of administrative control over the trust property.

(b) Any one of the significant factors pointing to substantial ownership is sufficient to warrant taxation of the settlor, i.e., it is not necessary to show a combination of all the significant factors.

The large areas of doubt and uncertainty respecting the application of the Clifford rule led the Treasury to issue on December 29, 1945, its highly important Treasury Decision 5488 which had the effect of amending Regulations 111 by adding section 29.22(a)-21 thereto. Purporting to state an authoritative interpretation of the Clifford doctrine, this amendment in the way it details the treatment of the subject and posits specific rules and tests can scarcely be distinguished from an act of Congress amending the code. In general it

INT. REV. BULL. 1946-2-12210.

may be said that this amendment of the Regulations capitalizes upon the previously mentioned trends evident in the judicial decisions that followed in the wake of the *Clifford* case and bottoms the settlor's liability on one or more of the three factors of substantial ownership referred to above, i.e., reversion after a relatively short term, control over distribution of corpus or income, or administrative control. A trust with reversion to the settlor *within ten years* is considered a short term trust and the income thereof made taxable to the settlor regardless of any other element of control. But even a *fifteen year* trust is taxable to the settlor if certain specified elements of administrative control are retained. On the other hand retention of administrative control which is exercisable primarily for the benefit of the settlor rather than the beneficiaries is sufficient to make the income taxable to the settlor regardless of the term of the trust. Likewise the power in the settlor to determine or control beneficial enjoyment of income or corpus makes the trust income taxable to him, regardless of the term of the trust. These illustrative cases are cited simply to give some indication of both the scope and detail of Treasury Decision 5488 and to emphasize the necessity of a careful examination of the same.

Whether the amended Regulations will stand up under judicial scrutiny remains to be seen. The general theory of Treasury Decision 5488 as well as its specific treatment of some types of cases are well authenticated by decisions interpreting the *Clifford* case. The validity of some of the detailed treatment and specific standards stated therein is open to question and will undoubtedly be the subject of considerable litigation.

(4) *Taxation of trust income to settlor on a benefit theory*

See the articles cited in note 333, supra.

Sec. 29.22 (a)-21 of Regulations 11 as amended by T.D. 5567, approved June 30, 1947. In conformity with the Federal Administrative Procedure Act notice of the proposed further amendment was given in the Federal Register, January 28, 1947. For the text of this section of the regulations as most recently amended see 1947-2 P.H. FED. TAX SERV., § 15,312. The general effect of T.D. 5567 is to liberalize the rules stated in T.D. 5488.

Prior to the 1942 amendments the husband-settlor of a trust was held taxable, on a benefit theory under § 22(a), on the income used to discharge an obligation to pay alimony to a divorced wife where, under local law, the transfer in trust did not mark a final discharge of the obligation of support. See Cahn, "Local Law in Federal Taxation," 52 YALE L. J. 799 (1943); Cardozo, "Federal Taxes and the Radiating Potencies of State Court Decisions," 51 YALE L. J. 783 (1942); Paul, "Five Years with Douglas v. Willcuts," 53 HARV. L. REV. 1 (1939); Tye, "Federal
Helvering v. Stuart—settlor held taxable on income of trust to extent that such income, in the discretion of persons not having an interest substantially adverse to settlor, could be applied to discharge his obligation to maintain and support his legal dependents.

In failing to limit the settlor's tax liability in the case of such a discretionary trust to the income actually used for his benefit through the discharge of his family obligations, the Stuart case seemed to go further than was required by a reasonable regard for the prevention of tax avoidance. Accordingly Congress in the 1943 Revenue Act amended section 167 of the code by adding thereto subsection (c) which provides that in the case of a discretionary trust for support and maintenance the income therefrom shall not be taxed to the settlor on a benefit theory except to the extent that the income is applied or distributed for the support or maintenance of the settlor's dependents. This amendment appears to make clear that the maintenance and support trust is now controlled by section 167 rather than by the general definition of income under section 22(a).

(5) Employee's trusts (I.R.C., § 165). The 1942 Revenue Act extensively amended this section in order to state with much greater precision the conditions necessary to establish the tax-exempt status of a trust forming part of a stock bonus, pension or profit-sharing plan. Seen in broad perspective the purpose of the amendment was to make

Taxation of Alimony Trusts, 19 Taxes 19 (1941); comments in 35 Ill. L. Rev. 332 (1940); 38 Mich. L. Rev. 1285 (1940); 19 N.C. L. Rev. 94 (1940). Under the 1942 act [§ 120(c), amending supplement E of chapter I by adding I.R.C., § 171] income from an alimony trust is now taxable to the wife, and the husband-settlor is relieved from liability for tax on the same. See Gornick, "Alimony and the Income Tax: Background and Effect of the Provisions in the Revenue Act of 1942," 29 Cornell L. Q. 28 (1943). This amendment conforms to the other 1942 amendments taxing periodic alimony or separate maintenance payments to the wife and giving the husband a deduction for such payments. See the references cited in notes 175-177, supra.


338 Sec. 134(a), amending I.R.C., § 167.

339 Sec. 162(a), amending I.R.C., § 165.
clear that the tax-immunity privilege in the case of a trust of this kind rests on a policy of favoring plans which are designed to benefit employees as a whole as distinguished from plans granting preferred privileges by way of deferred compensation to small classes of employees in the higher-salary groups. Stated in another way, Congress in adopting the 1942 amendment employed the income tax law as a vehicle for inducing employers to conform to federal standards in the establishment of employee-benefit plans. Mention has previously been made under other headings of the related 1942 amendments having to do with inclusions in the employee's gross income of contributions paid by an employer to employee-benefit plans and with deductions by employers for such contributions. A common element of legislative policy gives a pattern of unity and consistency to these related amendments.

(D) The Role of the United States Tax Court

Under the 1942 Revenue Act the tax tribunal formerly known as the United States Board of Tax Appeals was redesignated as the United States Tax Court. This was a formal change unaccompanied by any revision of the statutory scheme relating to the tribunal's jurisdiction.

A much more significant event in the elevation of this tax tribunal's status was the decision in the celebrated case of Dobson v. Commissioner, where the Supreme Court took occasion to delineate the role of the Tax Court in the system of federal tax administration and to announce a policy that pointed to a drastically curtailed judicial review of the Tax Court's determinations. Since 1926 the statute defining the jurisdiction of the former Board of Tax Appeals and its successor, the present Tax Court, has authorized review by the circuit courts of appeals and in turn by the Supreme Court, for errors of law.


841 See the references cited in notes 187 and 239, supra.

842 Sec. 504(a), amending I.R.C., § 1100.

843 320 U.S. 489, 64 S. Ct. 239 (1943).

in the tax tribunal's determinations. What was new in the *Dobson* opinion was the articulation by the Supreme Court of its intention to limit the "question of law" concept and thereby constrict the scope of judicial review to a narrower area than was recognized in the pre-*Dobson* era.

The specific question in the *Dobson* case was whether the Tax Court had erred in applying the so-called "tax benefit rule" with respect to recoupment by a taxpayer of a loss item which had previously served as the basis of an income tax deduction. Without committing itself on the merits of the tax benefit rule, the Supreme Court held that the rule involved essentially a matter of income tax accounting, that such a matter of accounting was not strictly a question of law, that the Tax Court was competent to adopt the tax benefit rule and that the reviewing courts were precluded from substituting their own conclusions on the soundness of the tax benefit theory.\(^{345}\)

That the *Dobson* case was not a "fly-by-night" decision and that the Supreme Court has taken upon itself in a serious way the task of delimiting judicial review of the Tax Court's determinations is evident from its subsequent decisions.\(^{346}\) It is also evident that the Supreme Court's attitude has made a distinct impression upon the circuit courts of appeals.\(^{347}\)

For a compilation and analysis of the cases dealing with the application of the *Dobson* doctrine the reader is referred to a comment recently appearing in this *Review*.\(^{348}\) For the purpose at hand it is sufficient to call attention to the following Supreme Court decisions chosen for their significance as follow-ups to the *Dobson* case: Commissioner v. Heininger;\(^{349}\) Commissioner v. Scottish American Invest-

\(^{345}\) See Paul's article, cited in note 344, supra.


\(^{347}\) "The *Dobson* decision was handed down in 1943. Since that time the Supreme Court applied the rule of the *Dobson* case once again in 1943, six times in 1944, once in 1945 and six times in 1946 to date. More informative is the application of the rule by the circuit courts of appeals. There it was applied in forty-four instances in 1943, in twenty-four cases in 1944, and in twenty-five cases in 1946 to date." 45 Mich. L. Rev. 192 at 193 (1946).


\(^{349}\) 320 U.S. 467, 64 S. Ct. 249 (1943).
A study of these cases makes clear that the recent developments have not clarified but rather obscured the distinction between questions of law and questions of fact, that questions of statutory construction normally regarded as questions of law have been assimilated into the question of fact category for purposes of judicial review, that there is a good deal of confusion and uncertainty within the Supreme Court itself on the proper application of the Dobson idea and that the results tend to confirm the conclusion of competent observers that the appellate courts will probably review those determinations of the Tax Court which they wish to review. A further word on this matter appears in the final part of this review.

III

Bibliographical Note

The writer's purpose in this part is to call attention to some major bibliographical items as well as to refer the reader to sources on some phases of federal taxation not dealt with in the preceding part.

Randolph Paul's Federal Estate and Gift Taxation, published in two volumes in 1942, marked a major contribution to the body of tax literature. This superlative work has now been brought up to date with the publication of the 1946 Supplement which measures up...
to the high standard set by the first two volumes and includes excellent treatments of the important changes made by the 1942 Revenue Act.

Roswell Magill's *Taxable Income*, first published in 1936, appeared in a revised and expanded edition in 1945. The revision has enhanced the very fine reputation the book gained for itself in its earlier edition. No student of the subject can afford to do without this gem of a text.

Mertens' *Law of Federal Income Taxation* which appeared in a revised and expanded edition in 1942 (12 volumes), and which is kept up-to-date through the use of cumulative pocket supplement parts, continues to be the definitive work on the subject. This text combines comprehensive coverage, thorough scholarship and careful analysis.


Two excellent series of monographs have been prepared and published by the Practicing Law Institute in conjunction with the Taxation Section of the American Bar Association. The first series (published in 1943-1944) is entitled "Fundamentals of Federal Taxation," and is particularly useful both as an introduction to the subject and for general "refresher" purposes. The second series, "Current Problems in Federal Taxation" (1944-1945) represents a more highly specialized treatment of specific questions.

The period under review gave birth to a new journal devoted exclusively to tax matters. The first number of the *Tax Law Review*, published by the New York University School of Law, appeared in 1945. This scholarly publication is a welcome addition both to the family of law reviews and to the specialized body of tax literature.

Another contribution by New York University is the publication by it of the Proceedings of the Annual Institute on Federal Taxation conducted under its auspices and first inaugurated in 1942. These published proceedings are chock-full of helpful expert discussions of fed-

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861 The Ronald Press Company, Publisher.
862 Callaghan & Co., Publisher.
863 The Ronald Press Company, Publisher.
864 The Ronald Press Company, Publisher.
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general tax problems of all kinds. The Proceedings of the 1946 Institute cover approximately sixty subjects and total 958 pages.

The number of texts and articles devoted to the subject of estate planning and conservation, with emphasis on the matter of tax economies, bear witness to the importance of this phase of the lawyer's job in serving his clients.\(^66\)

The larger fiscal, economic and administrative phases of federal taxation have been the subject of renewed interest and attention. A good deal of critical and constructive thinking is being devoted to the general subject of basic tax policy and to the matter of post-war reform of the tax system in order to stimulate economic enterprise, improve tax administration and remedy the treatment of some specific problems. The matter of altering the present system of corporate taxa-

tion in order to eliminate or mitigate the discriminatory multiple taxation of corporate earnings is seen to be an important part of any post-war tax program. For excellent treatments of these broader aspects of federal taxation, see Roswell Magill’s *The Impact of Federal Taxes* \(^{866}\) published in 1943, and Randolph Paul’s *Taxation for Prosperity* \(^{867}\) which at the time of this writing is just off the press. Other useful discussions of this general character are referred to in the note below. \(^{868}\)

IV

**General Summary**

The revenue legislation enacted by Congress during the period under review may be broken down into two parts, namely, (a) the provisions peculiarly attributable to the war emergency and (b) the more or less permanent changes made in the basic tax law. In the first category may be placed the extraordinary increases in income tax rates, the enactment of the excess profits tax law, the provisions for amortization or accelerated depreciation of war plants and the deductions authorized for war losses. The advent of the post-war era has already resulted in some reduction of income tax rates, and it is not unlikely that further reductions will soon be made.\(^{868a}\) The excess profits tax law is no longer effective, although the problems generated by it will con-

\(^{866}\) Columbia University Press.


\(^{868}\) Groves, Production, Jobs and Taxes (1944); Groves, Post-War Taxation and Economic Problems (1946); Rumil and Sonne, Fiscal and Monetary Policy, Planning Pamphlet No. 35, Natl. Planning Assn. (1944); Postwar Federal Tax Plan for High Employment, prepared by the Research Committee of the Committee for Economic Development; The Twin Cities Plan, Postwar Taxes, Twin Cities Research Bureau, Inc. (1944); The Postwar Corporation Tax Structure, a study published by the Division of Tax Research of the U.S. Treasury Dept. (1946).

Attention may also be called at this point to the highly informative and very useful report, “Federal, State and Local Government Fiscal Relations,” submitted to the Secretary of the Treasury by a special committee designated to conduct a study in intergovernmental fiscal relations in the United States. This report which appeared in 1943 was published as S. Doc. No. 69, 78th Cong., 1st sess.

\(^{868a}\) The two attempts to date of the 80th Congress to reduce individual income tax rates have proved abortive. H.R. 1 (80th Cong., 1st sess.), known as Individual Income Tax Reduction Bill of 1947, was vetoed by the President on June 16, 1947, and the vote in the House of Representatives on June 17 sustained the veto. H.R. 3050 (80th Cong., 1st sess.), bearing the same title, was vetoed by the President on July 18, 1947; the House overrode the veto the same day, but the Senate vote a few days later was not sufficient to override.
tinue to be with us for some time to come. As a matter of drafting skill and technique the complex excess profits tax law constituted a major legislative achievement. Questions both as to the general fairness of the law in its impact upon corporate taxpayers and as to the fiscal worth of the excess profits tax to the government cannot be adequately answered until the processing of refund claims based on accelerated amortization, general relief and carry-back of the 1946 unused excess profits credit is completed. It may in the end appear that Congress was more liberal than the equities of the case required.

The more or less enduring legislative achievements for the period under review represent on the whole solid improvements in the federal tax law. Inauguration of a large scale system of collection of income tax at the source by the withholding method, the placing of taxpayers on a pay-as-you-go basis, and the introduction of simplified tax tables and of the optional standard deduction all marked commendable revisions in the mechanics of tax collection and computation. Congress may also be complimented on many of the revisions of the basic substantive law. The rewriting of the powers and insurance subsections of the estate tax law was long overdue. The community property amendments to the estate and gift tax laws were a desirable step forward in reducing the preferred position of the community property states under the federal tax system. Changes in the income tax law having to do with gross income inclusions and exclusions, such as those relating to alimony payments, annuity trusts, and improvements by lessees and the tax-benefit rule reflected on the whole a legislative intention to deal sensibly and fairly with taxpayers. The same may be said of the code revisions relating to deductions, such as the amendments authorizing deductions for non-trade or non-business expenses, for extraordinary medical expenses, for retail sales tax regardless of the technical legal incidence of the tax. Similarly the amendment repealing the code provision requiring income accruals to date of death upon the decease of a taxpayer and the amendments authorizing a carry-back of net operating losses and liberalizing the rule with respect to tax accounting for deferred compensation, were concessions to taxpayers by way of relief from rigid accounting requirements. Although it is not to be expected that any scheme for taxation of capital gains will ever be completely satisfactory, the treatment of capital gains and losses introduced in 1942 has probably occasioned less dissatisfaction than the various plans previously tried by Congress.

Some of the code amendments were clearly intended to put an end
to abuses that had resulted in tax losses to the Treasury. This was true of the extensive revisions relating to pension trusts which had too often been used both as a means of favoring small groups of executive employees and a flexible device for controlling the employer's income tax liability. The same purpose may be ascribed to the amendments dealing with trust income generally and designed to end a system that had placed a premium on the timing of income distributions. But in general, the revisions of the code during the period under review achieved the purpose of clarifying the law, correcting judicial errors and mitigating the harshness of the law's impact upon taxpayers.

The developments by way of judicial interpretation confirmed trends already evident before the war period began. Characteristic of this trend were freedom and elasticity of interpretation, disregard for technicalities, an eye to the revenue needs of the government and scant sympathy for the ways of the tax-dodger. Impatience with the technical concepts of property and contract law is evident in the decisions interpreting the estate and gift tax provisions of the code. The treatment of income assignments, short term trusts, family partnerships and the Oklahoma optional community property statute all indicate a readiness to brush form aside and to look to substance in the handling of income deflection schemes. But judicial impressionism and free interpretation are not always conducive to sound tax administration and to the sense of certainty and predictability that may reasonably be expected with respect to a matter of such practical importance as taxation. Attention may be called, for instance, to the confusion now evident in regard to application of the Hallock and Clifford doctrines. Moreover, respect for the Treasury's interest in the revenues, if used as a general guide to interpretation of the code, may furnish an occasion for the development and use of artificial canons of construction. In recent years the Supreme Court has stressed two general ideas in the construction of the income tax law: (a) that Congress has manifested its intention of exercising to the full its constitutional power to tax income; (b) that deductions must be strictly construed against the taxpayer since they are a matter of legislative grace. Questions may be raised as to the validity of these premises. In any event the use of such shibboleths, founded on general presuppositions as to an overall policy of Congress, often tends to obscure the real issue, namely, the

869 See Dean Griswold's protest in his comment, "An Argument Against the Doctrine that Deductions Should be Narrowly Construed as a Matter of Legislative Grace," 56 Harv. L. Rev. 1142 (1943).
intention and policy of Congress with respect to the specific question under consideration and may lead to results which, measured by standards of ordinary fairness and good judgment, do injustice to the legislative purpose. A review of recent legislation creates the impression that in numerous instances Congress was led to amend the code in order to correct interpretations established by judicial decisions which were seen to bear too harshly upon taxpayers. A conspicuous example was the 1942 amendment authorizing deductions for non-trade or non-business expenses. The McDonald case suggests that even this liberalizing amendment is to be construed with unwarranted narrowness. Fortunately, the dissenting opinion in that case offers the hope of a more liberal construction based on the premise that Congress has evidenced an intention of taxing only net income, a premise which carries more weight than the notion that all deductions must be narrowly construed.

In expressing the above criticism the writer has reference to general trends in judicial theory and decision. He does not mean to suggest that every taxpayer who is successful in getting his case before the Supreme Court must expect an adverse decision from this tribunal. Any such suggestion is refuted by the recent income tax decisions involving debt forgiveness, stock dividends, embezzled funds, litigation expense deductions and depletion allowances as well as the decision finding that the relinquishment of a power in consummation of an earlier bona fide inter vivos transfer was not a transfer in contemplation of death for purposes of the estate tax law. The writer does mean to suggest that the Supreme Court has committed itself to certain presuppositions and canons of construction which may tend to obscure the merits of the taxpayer’s case and to make his position unnecessarily difficult.

In concluding this review attention may be called to some problems and questions in need of urgent attention. Space does not permit of the detailing of proposals for extensive code revision to correct or clarify the treatment of many specific items.\(^{870}\) However, the problems generated by the decisions in the Hallock and Clifford cases may be singled out for special attention. It is doubtful whether the Treasury Decisions purporting to state an authoritative interpretation of the doctrine of these cases constitute a final or satisfactory answer. Pro-

\(^{870}\) See “Proposed Amendments to the Federal Income, Estate and Gift Tax Laws,” A Report by the Committee on Taxation of the Association of the Bar of New York City (1946). Mr. Roswell Magill was Chairman of this Committee.
posals for legislative treatment of these specific matters seem meritorious and deserve consideration by Congress.

Some larger questions also call for attention. The preferred status under the income tax law of citizens of community property states should not continue to be tolerated by Congress. Surely it should be possible to have this inequity corrected without the necessity of having the other states resort to the clumsy and unsatisfactory expedient of substituting an exotic system of property law for systems well rooted in their common law and statutory traditions. 371

The matter of integration of the estate and gift taxes and of correlation of these transfer taxes with the income tax continues to be a pressing one. The decision in the Shaughnessy case marked abandonment by the Supreme Court of any attempt to correlate estate and gift taxes in terms of mutual exclusiveness. On the other hand, a studied effort pointing toward correlation of these two taxes is evident from the decision in the Fahs case. At present there is neither rhyme nor reason in the inconsistent theories underlying estate, gift and income taxation of trusts. 372 Questions may be raised as to the feasibility of attempting a complete correlation of all three taxes. 373 But a careful study by Congress of the whole matter might well lead to code revision pointing to greater order and consistency within the code. 374

The tumultuous disorder which runs through the whole system of federal tax administration begs for attention. Indeed to characterize the present arrangement as a system is to indulge in an euphemism. The Dobson case, in stating a new policy in favor of curtailed review of the Tax Court's determinations, is best described as a bold maneuver

372 For an excellent review of these inconsistencies, see Judge Magruder's opinion in Higgins v. Commissioner, (C.C.A. 1st, 1942) 129 F. (2d) 237.
by the Supreme Court to reduce the burden of tax litigation in the federal courts. Enlargement of the "question of fact" category was seized upon as the device for attaching finality to determinations seen to lie within the Tax Court's expert technical competence. Apart from the uncertainty in the application of the Dobson doctrine and apart from the question whether this development distorts the system of judicial review contemplated by the statute, the question may well be raised as a matter of policy whether the Dobson case points in the right direction in a program of bringing greater order into federal tax administration. In his "iconoclastic observations" on the subject, Mr. Eisenstein takes the position that the preferred solution to the problem is to accord greater weight and conclusiveness to the commissioner's regulations. Randolph Paul's thinking runs in the same direction. Dean Griswold urges the creation of a court of tax appeals to replace the present appellate review by the circuit courts of appeals as the means of securing an expert and uniform interpretation of the tax law. Whatever the best solution may be, it is clear that the problem of tax administration is one that calls for careful consideration.

Finally, the advent of the post-war era forces upon us the necessity of rethinking our basic conceptions of tax policy and objectives, of appraising realistically the impact of taxation upon the nation's whole economic structure and process, and of looking upon the taxing power not simply as a source of necessary revenues but also as a means of promoting national prosperity and well-being. On this point we are well reminded by Randolph Paul:

"Taxes are no exception to the general rule that we live intelligently only by looking ahead to the long-range results of what we presently do. A piecemeal, tinkering method of tax revision can yield only jumbled results. There is a peculiar need in

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376 PAUL, TAXATION FOR PROSPERITY 393-400 (1947).
378 See MAGILL, THE IMPACT OF FEDERAL TAXES (1943) and PAUL, TAXATION FOR PROSPERITY (1947); also the references cited in note 368, supra.

On June 10, 1947, Chairman Knutson of the House Ways and Means Committee announced the appointment of a special Tax Study Committee to counsel with the Ways and Means Committee on a complete revision of the Internal Revenue Code. Mr. Roswell Magill was named chairman of the special committee. For the text of the press release, see 5 P-H FED. TAX SERV., § 76, 190 (1947).
taxation for seasoned judgment and mature perspective which can appraise all changes in the light of a complete pattern of Federal taxation. No less comprehensive approach will suffice, for taxes at the rates necessary to meet present-day government expenditures must have a profound effect upon our daily lives. To impose them only for immediate revenue without consideration for what they will do to our economy and without regard for their social consequences would be the most costly mistake we could make at this critical period of American history."

379 Taxation for Prosperity 417-418 (1947).