LEGISLATION

Book Profits as Taxable Income—The determination of what constitutes taxable income within the meaning of the Sixteenth Amendment and the Internal Revenue Acts is a question which has been before the federal courts on numerous occasions. Partly because of the length and complexity of the income tax laws and also because the question involves the consideration of somewhat technical accounting principles and practices, the answers to it have not always been entirely consistent. Paradoxically, one of the best settled rules—that the income to be taxable must be *realized* within the taxable year—has served to complicate one of the most troublesome problems, the taxation of "book profits" made by discharging a debt at less than its face value.

Book profit, as used herein, results from the employment of the accrual method of accounting.[1] This method requires that when assets have been received which are to be paid for in the future the amount of the obligation shall be entered as a liability at its face value. If thereafter the liability is discharged at less than face value, the taxpayer has made a gain as to the difference. No new assets have been added, but his financial position has been improved. This gain or improvement is designated for convenience as book profit.[2] Whether it should be taxed is the present problem.

The first case to reach the Supreme Court involving this problem was *Bowers v. Kerbaugh-Empire Co.*[3] There the corporation, prior to the World War, borrowed funds and gave as security its own notes payable in marks. The funds were used entirely by a subsidiary which lost them in its operations over a period of five years, the losses being allowed as deductions in the subsidiary's income tax returns for those years. In 1921, the corporation paid off the notes through the Alien Property Custodian at a large saving. The Commissioner sought to tax the resultant book profit as income received in 1921, but the Supreme Court held that because of the shrinkage in assets there had been no taxable gain realized, since the transactions, when considered as a whole, had resulted in a loss.

This decision, although subjected to criticism,[4] served as the basis for a series of subsequent lower court holdings to the effect that no taxable gain was realized either upon the discharge of bonds at less than face value, *absent* any proof that the whole transaction had resulted in a loss,[5] or upon a composition with creditors.[6] *United States v. Kirby Lumber Co.*[7] reversed the former group of decisions, but distinguished *Bowers v. Kerbaugh-Empire Co.*

---

[1] See *infra* note 27.

[2] In Note (1931) 45 Harv. L. Rev. 1072 the writer uses the term negative income. This, it has been pointed out, is a combination of terms mutually exclusive of each other.

[3] 271 U. S. 170, 46 Sup. Ct. 449 (1926), (1925) 34 Yale L. J. 334, (1925) 25 Col. L. Rev. 110. See Montgomery, Income Tax Procedure (1927) 327, 328.

[4] See articles cited *supra* note 3.

[5] Independent Brewing Co., 4 B. T. A. 870 (1926); Kirby Lumber Co., 19 B. T. A. 1046 (1930); Consolidated Gas Co. of Pittsburg, 24 B. T. A. 331 (1931).

[6] Simmons Gin Co. v. Commissioner, 16 B. T. A. 793 (1929), *aff'd*, 43 F. (2d) 327 (C. C. A. 10th, 1930); Burnet v. John F. Campbell Co., 15 B. T. A. 458 (1929), *aff'd*, 50 F. (2d) 487 (Ct. of App. D. C. 1931).

[7] 284 U. S. 1, 52 Sup. Ct. 4 (1931), Note (1931) 40 Yale L. J. 960, Note (1932) 20 Calif. L. Rev. 441, (1932) 45 Harv. L. Rev. 744. The court upheld U. S. Treas. Reg. 69, art. 545 (1) (1926) as a correct statement of the law. It provides:

"(a) If bonds are issued by a corporation at their face value the corporation realizes no gain or loss.

In the *Kirby* case the Supreme Court was presented with a far simpler factual situation than in the *Kerbaugh* decision. The book profit had been realized in the same taxable year in which the bonds were issued and there was no proof that any of the borrowed funds had been lost. It was clear that there had been an accession to income. Almost immediately the rule of the *Kirby* case was extended by the Board of Tax Appeals.[8] That body, in holding taxable book profit realized in a year *subsequent* to that in which the bonds had been issued, placed considerable reliance on *Burnet v. Sanford & Brooks Co.*,[9] a case of real significance.

While working on a specific contract, the Sanford & Brooks Co. incurred losses over a period of years. It kept its books on a cash basis and each year as loss occurred it was deducted from that year's gross income, thereby reducing the company's net taxable income for that year. Finally the losses on the contract were recovered from the other party. The Commissioner included the funds so realized in arriving at net taxable income and the Supreme Court upheld him.

Although the Court, here too, distinguished the *Kerbaugh* decision, a strong argument can be presented that *Burnet v. Sanford & Brooks Co.* and *United States v. Kirby Lumber Co.* overrule the earlier decision.[10] At the time that the *Kerbaugh* case was decided, the Supreme Court's definition of taxable income was:

> "The gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. . . . Nothing else answers the description." [11]

If the Supreme Court had wished to rely on this definition it might have held the book profit in the *Kerbaugh* case exempt from taxation on the ground that it was not derived from capital but was rather a gain accruing to capital.[12] Instead the Court based its conclusion on an examination of the net effect of the whole series of transactions, which had extended over a number of tax years.[13]

In *Burnet v. Sanford & Brooks Co.*, however, the Supreme Court adopted an entirely different approach by emphasizing the importance of the *taxable year*, and refusing to attach any significance to the net effect of the whole series of transactions. While it is true that in *Bowers v. Kerbaugh-Empire Co.* book profit was involved and in the *Burnet* case the actual receipt of money, the *Kirby* decision plainly indicates that this is of no significance. The distinction was brushed aside by Justice Holmes with the comment:

(b) If the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year.

(c) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value the excess of the issuing price or face value over the purchase price is gain or income for the taxable year."

The regulation is still in force as art. 68 (1) of U. S. Treas. Reg. 77 (1932).

[8] Consolidated Gas Co. of Pittsburg, 24 B. T. A. 901, 904 (1931).

[9] 282 U. S. 359, 51 Sup. Ct. 150 (1931), (1930) 43 HARV. L. REV. 962.

[10] See Altman, *Net Losses and the Taxable Year* (1933) 28 ILL. L. REV. 525, 529.

[11] Eisner v. Macomber, 252 U. S. 189, 207, 40 Sup. Ct. 189, 193 (1920). There was also a more general definition: "The commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution." Merchants Loan & Trust Co. v. Smietanka, 255 U. S. 509, 519, 41 Sup. Ct. 386, 389 (1921).

[12] This was the contention of the Circuit Court: "There was nothing severed from the capital that came into the taxpayer within the intent of the Supreme Court's holding in the Eisner case." Kerbaugh-Empire Co. v. Bowers, 300 Fed. 938, 942 (S. D. N. Y. 1925).

[13] The court showed its willingness to depart from a definitional concept of income, by adding the qualification that "In determining what constitutes income substance rather than form is to be given weight". Bowers v. Kerbaugh-Empire Co., *supra* note 3, at 174, 46 Sup. Ct. 451. For a further treatment of this see (1931) 45 HARV. L. REV. 744.

"We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income if we take words in their plain popular meaning as they should be taken here." [14]

It should be noted that the doctrine of this case closely approximates the economist's definition of income: "the money value of the net accretion to one's economic power between two points of time." [15] These two cases, the one adhering so closely to the taxable year, the other to a concept of income akin to that of the economist, therefore substantially overrule the earlier one.

Bowers v. Kerbaugh-Empire Co. can also be attacked from another angle which emphasizes the importance of the taxable year. The borrowed funds were so used that losses resulted. But the losses were deducted from gross income in the years in which they were incurred. By considering them again when the question of taxing the subsequent book profit arose the court was permitting the losses to have a double effect—a ruling plainly untenable.[16]

While the above reasoning is apparently a strong basis for the proposition that *Bowers v. Kerbaugh-Empire Co.* has been discredited, it is interesting to note that several recent decisions have refused to carry the implications of the *Kirby* and *Burnet* decisions to their logical conclusions. *Bowers v. Kerbaugh-Empire Co.* is still regarded as of importance. In *Commissioner v. Rail Joint Co.*,[17] the taxpayer reappraised certain assets and added the increase to surplus. It then declared and paid a dividend to shareholders in the form of bonds. Subsequently some of the bonds were discharged at less than face value. The resulting book profit was held not taxable because "neither the amount written up to surplus nor the bonds issued against it had ever been deducted from gross income for taxation purposes" in the year incurred. Consequently "the entries in the surplus account are only bookkeeping entries and do not reflect a realized taxable gain." [18]

In *Commissioner v. American Chicle Co.*,[19] the taxpayer assumed an issue of bonds upon its purchase of the assets of the *S* Company, which was primarily liable. Later a book profit was realized as to some of the bonds. The Board of Tax Appeals and the Circuit Court of Appeals both refused to allow the Commissioner to tax this, the former on the ground that only "when all of the bonds have been retired by the petitioner [the Chicle Co.] its obligations to the .... Company will have been satisfied in full, and whatever the total amount paid to retire the bonds, it will constitute a part of the cost to petitioner of the .... assets." [20] The Circuit Court argued that one buying property by an obligation in the form of a bond realizes no gain if the property remains in kind after the debt has been discharged at a book profit. "The cost has indeed been definitely settled, but that is only one term of the equation; as long as the other remains at large there is no 'realized' gain." [21] On appeal the United States Supreme Court failed to find on the record any facts indicating what had be-

[14] *Supra* note 7, at 3, 52 Sup. Ct. at 5.

[15] HAIG, THE FEDERAL INCOME TAX (1921) 7.

[16] Where affiliated corporations have presented consolidated income tax returns and the subsidiary sustains losses which have been deducted in those returns, the parent, on liquidation of its interest in the subsidiary cannot claim as a deductible loss the whole loss sustained on liquidation. The sum of the subsidiary's previous deductions must first be offset. Commissioner of Internal Revenue v. Apartment Corp., 67 F. (2d) 3 (C. C. A. 4th, 1933), (1934) 82 U. OF PA. L. REV. 292.

[17] 61 F. (2d) 751 (C. C. A. 2d, 1932).

[18] *Id.* at 752.

[19] U. S. L. W., March 6, 1934, at 568.

[20] 23 B. T. A. 221, 225 (1931).

[21] 65 F. (2d) 454, 455 (C. C. A. 2d, 1933); Note (1933) 11 N. Y. U. L. Q. 269.

come of the assets acquired by the taxpayer from the *S* corporation; whether they still existed or whether the taxpayer lost or gained by the whole transaction. It therefore reversed, holding that the doctrine of the *Kirby* case was controlling. Justice McReynolds distinguished *Bowers v. Kerbaugh-Empire Co.* on the ground that there

> "the final outcome of the dealings was revealed—the taxpayer suffered a loss. Here, for aught we know, there was a substantial profit—certainly, the record does not show the contrary. Doubtless respondent's books indicated a decrease of liabilities with a corresponding increase of net assets."

This decision of the Supreme Court avoided reaching a conclusion on the most interesting feature of the case, which is, of course, that raised by the Circuit Court. It is possible that the point may be raised again.[22] Meanwhile, however, the Supreme Court's *dicta* indicate that it still regards *Bowers v. Kerbaugh-Empire Co.* as good authority. The continued vitality of the decision is also indicated in two composition cases,[23] recently decided by the Board of Tax Appeals, holding the book profits involved not taxable. In each instance the Board relied on decisions antedating the *Kirby* case, and in one [24] utilized the earlier definition of income as "gain derived from capital", in order to reach the result.

All three of these situations, the bond dividend case, the *American Chicle Co.* case—assuming the missing fact that the property was still in the taxpayer's possession—and the composition cases, present difficult questions. In each there was clearly a book profit, yet it sounds quite plausible to say in the first situation that nothing was ever received and hence nothing could ever be realized; in the second, that because the property originally purchased was still held nothing had been realized; and in the third, that since the debtor was insolvent he realized nothing which is taxable.

At this point a supposititious case may throw some light on the subject. A taxpayer owning a piece of property for which he has issued a twenty year note or bond, writes off against the property each year the full amount of depreciation which the law allows. In twenty years the book value of the property has been more than cut in half by this process. He then discharges the note for half its face value. If, as was said by the Circuit Court in *Commissioner v. American Chicle Co.*, this act twenty years after purchase determines the cost of the property, then all the depreciation charges which have been deducted each year have been deducted on a false basis and the taxpayer has escaped taxation on the amount of the depreciation charges which the subsequent property-cost-determination indicates to have been erroneous.

In a recent case before the Board of Tax Appeals,[25] where the taxpayer was solvent and a book profit arose because certain machinery for which notes had been given proved defective and the notes were cancelled, the Board properly applied the rule of the *Kirby* decision, stating with considerable cogency:

> "The use of fixed accounting periods requires that the amount by which expenses once deducted because paid or accrued are reduced by later adjustments must be taken into income in the year of adjustment. Only

[22] U. S. L. W., March 6, 1934, at 579. The Official Journal of Proceedings of the Supreme Court states that the cause was remanded to the Circuit Court for further proceedings in conformity with the opinion of the Court. This hardly means that the Circuit Court is to seek to determine what became of the property.

[23] E. B. Higley & Co. v. Commissioner, 25 B. T. A. 127 (1932); Towers & Sullivan Mfg. Co. v. Commissioner, 25 B. T. A. 922 (1932).

[24] Towers & Sullivan Mfg. Co. v. Commissioner, *supra* note 23.

[25] B. F. Avery & Sons v. Commissioner, 26 B. T. A. 1393 (1932).

in this way can the amount of the taxpayer's reported income be made to agree with its actual income." [26]

This statement brings out the crux of the matter. It is accrual accounting and the taxable year which are responsible for the rule of *United States v. Kirby Lumber Co.* The whole purpose of accrual accounting is to present as accurate a balance sheet picture as possible of the financial position of the taxpayer between two points of time.[27] Its advantages are so great that nearly all modern business organizations keep their books on this basis.[28] It presents an accurate picture, however, only if two requirements are met. All accruals must be taken into consideration at their then known value in the year of accrual, and all subsequent changes in those values must be considered at the time of such change. It is not feasible when the amount of change is ascertained to go back and alter the original entries. They are past history. This was emphasized in *Burnet v. Sanford & Brooks Co.*[29] Consideration by the courts of the "entire transaction" ignores this fundamental accounting principle. Furthermore, in actual practice no general liability, once incurred, is set off against a specific asset. General liabilities constitute a general claim on all assets. The discharge of any one liability below book value does not affect any one asset; rather it affects net worth. This leads to the conclusion that once property is received by the taxpayer and is entered on his books as an asset, it should be divorced from any further connection with an offsetting liability, so far as subsequent determination of income is concerned.

Applying this conclusion to the recent cases just discussed would, in the dividend case,[30] make the book profit taxable. And it is submitted that this result is entirely fair. If the corporation had paid the dividend in cash its assets would have been diminished to the full amount of the payment. Instead, it set up against all of its assets an obligation in the form of bonds. Their subsequent discharge with a smaller amount of assets than anticipated clearly benefited the corporation. In the *American Chicle Co.*[31] case the book profit would be taxable even though the original property were still held. The composition cases, however, present some further difficulty.

Logically, there is little difference between the book profit derived in the composition cases from that in the bond situation. It is true that there is no real release of assets [32] because the debtor is usually insolvent. There is, however, an improvement in the taxpayer's financial position which is an "accretion to one's economic power." [33] And, under the interpretation of the *Kirby* case, which has been urged here, such an improvement should logically be taxed. But there is a strong feeling that to tax such a book profit would be an injustice. Furthermore, even in bankruptcy cases it could be urged that there was a book profit effected by the discharge from bankruptcy. This is mentioned to show that the very purpose of the bankruptcy acts—to clear away

[26] *Ibid.* at 1400.

[27] It accomplishes this by including on the balance sheet as deferred assets: (1) All expenses not yet incurred, but nevertheless paid for, (2) All income earned but not yet received; and as deferred liabilities: (1) All expenses incurred but not yet paid for, (2) All income received but not yet earned.

[28] There is no other way of giving a proper value to inventories and other items. See LECTURES ON TAXATION, *Accounting and the Concept of Income* (1932) 43-48.

[29] *Supra* note 9 and text.

[30] *Supra* note 17 and text.

[31] *Supra* note 19 and text.

[32] In the Kirby decision and several subsequent cases the courts have stressed the fact that the net effect of the book profit has been to release assets formerly subject to the claims of creditors.

[33] *Supra* note 15 and text.

all of the debtor's obligations and give him a new start—is defeated if the discharge leaves him with a large income tax. From the standpoint of the creditor who is forced to participate in a composition because he realizes it is the only feasible means of saving a portion of his claim, the amount of loss is deductible from his gross income in the year in which the composition takes place. It would therefore seem logical to say that the converse should follow and the debtor be taxed on his gain. It is apparent, however, that the only basis for not taxing in these cases is found in policy considerations. Either the courts should acknowledge this as the true basis, or else the *Internal Revenue Act* should itself make an express exception.

In conclusion, it should be noted that the application of the rule that specific assets and liabilities should be divorced from each other in determining income would lessen appreciably the importance of the realization rule, since it would not be applicable in cases involving book profits. However, since the purpose of the realization rule is to confine taxation to actual gain,[34] and accrual accounting demonstrates that there has been an actual gain in the book profit cases, this is not a serious difficulty.

R. L. L.

[34] In Eisner v. Macomber, *supra* note 11, at 207, 40 Sup. Ct. at 193, the Court stressed the necessity of realization: "Here we have the essential matter. Not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital, however invested or employed, and coming in, being 'derived', that is, received or drawn by the recipient for his separate use, benefit and disposal;—that is income derived from property."