The volume of tax work done by the United States Supreme Court at the last term remained at the peak characteristic of recent years. The range of decision, however, was unusually narrow. Federal taxes claimed the major share of the Court's attention. More than two-thirds of the cases decided at the 1940 Term fell into this category. Of these, thirty-three involved the federal income tax; six, the federal gift tax; three, the federal estate tax; and two processing taxes. The remaining cases dealt with state taxes. Eight decisions involved the commerce clause, of which three also raised problems of jurisdiction to tax. There were eight cases on jurisdiction to tax, counting the three involving the commerce clause. There was one case on the immunity of the United States from state taxes, one relating to the contracts clause of the Federal Constitution, and four bankruptcy cases, which to some extent involved state taxes.

There were no changes in personnel at the 1940 Term. Mr. Justice McReynolds retired, but his place was not filled until the work of the term was over. At the end of the term Chief Justice Hughes retired, and Mr. Justice Stone was elevated to his place. At the same time Senator Byrnes of South Carolina, and the Attorney General,
Robert H. Jackson, were named associate justices. This means, of course, that with the solitary exception of Mr. Justice Roberts, all of the present members of the Court owe their positions to the present administration and the current political philosophy.

From the point of view of taxation, the quality of the present Court is painfully clear. Opinions differ as to whether it is a genuinely liberal court. The cold facts of the record leave no room for argument, however, that it is an extremely governmental-minded court. This was emphasized by the tax cases at the last term. The taxpayer's chances of prevailing before the Supreme Court were approximately ten per cent. Of the sixty-three cases decided, the taxpayer won in seven. Only once did the Court find a tax unconstitutional. In but six cases could it be persuaded to dissent from the construction placed upon tax laws by the administrative agencies charged with their enforcement.

A review of a group of decisions as diverse as the tax cases decided by the Supreme Court at a given term presents baffling problems of classification and emphasis. The desire for some degree of dramatic unity inclines one to relegate federal taxation to the status of a sub-topic under the general heading taxation. With this initial bias, it is easy to take the next step of unduly magnifying the state tax cases, because they involve constitutional issues, while gliding swiftly, almost contemptuously, over federal cases, which present mere problems of construction. Analytically, this may be defensible. From a practical point of view, however, it has less to commend it. Federal taxation has easily achieved the stature of an independent subject, complete in itself. Its points of contact with the state tax cases are relatively limited and accidental. The tax decisions of the Supreme Court divide naturally into those dealing with federal taxes and those involving state taxes. At the last term not only quantitatively, but qualitatively, the more important part of the Court's tax work was in the field of federal taxation. Without consciously slighting the state tax cases, several of which are of first-rate importance, the bulk of this paper will be devoted to an analysis of the federal cases as a separate topic, and in the approximate detail their significance merits.

I. Federal Taxes

A. The Federal Income Tax

1. Income

Because of the fact that the income tax is a progressive tax, the possessor of a large income who can divide it into several smaller incomes, achieves a substantial tax saving. One method of doing this,
which has, however, been rather effectively discouraged by specific provisions of the Revenue Acts, as well as judicial legislation, is to divert a portion of one's income to a legal alter ego, like a corporation or a trust. Another method is to make an assignment of income or income-producing property. Although not specifically covered by legislation, the effectiveness of this device has been considerably impaired by recent judicial definitions of taxable income.

In *Helvering v. Horst,* for example, Horst owned certain coupon bonds. Shortly before the coupons fell due, he detached them from the bonds and gave them to his son, who proceeded to collect them in the same tax year as that in which the gifts were made. The Supreme Court held that the income from the coupons was taxable to the father, the assignor, rather than to the son, the assignee. Mr. Justice Stone, who spoke for the majority, said that the owner of a bond has rights to receive both principal and interest. When he gives away the coupons he exercises his right to interest and experiences an economic satisfaction which results in the realization of taxable income. In the Justice's own words, "Even though he never receives the money, he derives money's worth from the disposition of the coupons which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth. . . . The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment, and hence the realization, of the income by him who exercises it." 4

Mr. Justice McReynolds could not assent to Mr. Justice Stone's reasoning. He declared that the coupons were "independent negotiable instruments, complete in themselves. Through the gift they became at once the absolute property of the donee, free from the donor's control and in no way dependent upon ownership of the bonds." 5 Since "no question of actual fraud or purpose to defraud the revenue" was "presented," 6 he concluded that there was no basis for taxing the receipts from the coupons to the donor. The Chief Justice and Mr. Justice Roberts joined in Mr. Justice McReynolds' dissent.

There are several points worth noting in connection with Mr. Justice Stone's opinion. It is familiar doctrine that income may be realized through the discharge of an obligation as well as the actual

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3. 311 U. S. 112 (1940), (1941) 89 U. of PA. L. REV. 532.
5. *Id.* at 121.
receipt of a tangible benefit. Moreover, as far as the Sixteenth Amendment is concerned income may be realized by the discharge of a moral or social, as well as a strictly legal, obligation. In support of his position that the assignor realized income in the *Horst* case, Mr. Justice Stone cited the cases where income has been held to be realized through the discharge of an obligation. He also declared that “although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself, he has nevertheless, by his act, procured payment of the interest as a valuable gift to a member of his family.” It might seem from this portion of his opinion that the basis of taxing the assignor in the *Horst* case was that the assigned income was used to discharge a family obligation, or was at least kept under the assignor’s dominion in his family, so that it was still his income in line with the reasoning in *Helvering v. Clifford*. From the opinion as a whole, however, it seems clear that the purpose for which the coupons were assigned, or the person to whom they were assigned, was immaterial. The assignor realized income, not because he discharged a family obligation or made a gift to a member of his family, but because he made a gift of income, while still retaining the right to the principal which produced the income.

From an analytical point of view it is a little difficult to see why a man should realize income where he gives away the right to income and retains the ownership of the principal which produces the income, and yet fail to do so, where he gives away both the rights to income and principal. If, for example, the assignor in the *Horst* case had given not only the coupons, but the bonds as well, he would not have realized any income when the coupons were collected by his son. It is obvious, however, that he has exercised the “power to procure the payment of income to another,” which Mr. Justice Stone said resulted in a realization of income. The fact that he also exercised a power to procure the payment of principal to another can scarcely negative this.

Another peculiarity about Mr. Justice Stone’s opinion is chronological. Presumably the point at which the assignor in the *Horst* case experienced the satisfaction which resulted in his realizing income was when he gave away the coupons. Yet, according to Mr. Justice Stone, the assignor realized income, not when he gave away the coupons, but when they were collected. It is true that the precise time when income was realized in the *Horst* case was not critical since the coupons were given away and collected in the same tax year. In later cases, however,

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10. 309 U. S. 331 (1940).
where the gifts of income and collection by the donee did not coincide, it was held that income was realized by the donor when the assigned income was collected, rather than when the assignment took place.11

*Helvering v. Eubank* 12 involved the same type of problem as *Helvering v. Horst*. Eubank had been an insurance agent. After his agency terminated he was still entitled to certain commissions on policies which he had sold. He made irrevocable assignments of these commissions and the question arose whether, when they were collected, they were taxable to him or to his assignee. The Court, again speaking through Mr. Justice Stone, held upon the authority of *Helvering v. Horst*, that the commissions were taxable to the assignor. Mr. Justice Stone was content to rest upon the authority of that decision without further amplification of principle. Mr. Justice McReynolds, however, once more set forth, in terms which merit repetition, his reasons for disagreeing with the majority. "The assignment in question," he said, "denuded the assignor of all right to commissions thereafter to accrue under the contract with the insurance company. He could do nothing further with respect to them; they were entirely beyond his control. In no proper sense were they something either earned or received by him during the taxable year. The right to collect them became the absolute property of the assignee without relation to future action by the assignor. A mere right to collect future payments for services already performed is not presently taxable as 'income derived' from such services. It is property which may be assigned. Whatever the assignor receives as consideration may be his income; but the statute does not undertake to impose liability upon him because of payments to another under a contract which he has transferred in good faith, under circumstances like those here disclosed." 18 Again the Chief Justice and Mr. Justice Roberts concurred in Mr. Justice McReynolds' dissent.

The most revealing case in connection with assigned income was the last case decided by the Court upon this topic. In *Harrison v. Schaffner*, 14 the life beneficiary of a trust assigned specified amounts in dollars from the income of the trust for the succeeding year to her children. The Court, again speaking through Mr. Justice Stone, and on this occasion without dissent, held that the income collected by the children was taxable to their mother, the assignor. In distinguishing the *Blair case*, 15 where it had been held that a life beneficiary of a trust

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12. 311 U. S. 122 (1940), (1941) 89 U. of Pa. L. Rev. 532.
13. 311 U. S. 122, 127 (1940).
14. 312 U. S. 579 (1941).
was no longer taxable upon income from a trust which he had assigned to his children, Mr. Justice Stone drew a distinction between an assignment of income-producing property, which relieves the assignor from further income tax liability, and a gift of income, which does not. He did not purport, however, to treat this as a real distinction, resting upon crystallized conceptions of the law of property, but simply as a convenient rationalization of a result. The Court, said Mr. Justice Stone, is “not so much concerned with the refinements of title as with the actual command over the income which is taxed and the actual benefit for which the tax is paid.” 16 Where an assignment represents merely an effort to “camouflage the reality” 17 that the assignor is enjoying the benefit of the trust of which he continues to be the beneficiary, the income will be taxed to the assignor. “Nor,” added the Justice, “are we troubled by the logical difficulties of drawing the line between a gift of an equitable interest in property for life effected by a gift for life of a share of the income of the trust and the gift of the income or a part of it for the period of a year as in this case. ‘Drawing the line’ is a recurrent difficulty in those fields of law where differences of degree produce ultimate differences in kind. . . . It is enough that we find in the present case that the taxpayer, in point of substance, has parted with no substantial interest in property other than the specified payments of income which, like other gifts of income, are taxable to the donor. Unless in the meantime the difficulty be resolved by statute or treasury regulations, we leave it to future judicial decisions to determine precisely where the line shall be drawn between gifts of income-producing property and gifts of income from property of which the donor remains the owner, for all substantial and practical purposes.” 18

Harrison v. Schaffner, of course, makes it clear that the determining factor in these cases of assigned income is the practical problem of tax avoidance, rather than any subtle metaphysic of the exercise of the power to direct the payment of income. A taxpayer cannot retain the “substantial” ownership of property and escape a tax upon its fruits. By refusing to chart a bright line between assignments of income-producing property and assignments of income, the Court evidenced its awareness of the inherent difficulty of dealing with tax avoidance schemes upon any but a strictly ad hoc basis. This is a sound judicial tactic, despite the concomitant embarrassment to the practitioner who is called upon to advise his clients in disposing of their property.

16. 312 U. S. 579, 581 (1941).
17. Id. at 582.
18. Id. at 583, 584.
Obviously, the situation here closely parallels that in *Helvering v. Clifford*, upon which the Court relied in deciding the *Schaffner* case. In *Helvering v. Clifford*, the Court pointed out that the income from some short term trusts will be taxed to the settlors of the trusts, without committing itself to a definite specification of the factors leading to this result, beyond the general admonition that they are trusts where the settlor remains the substantial owner of the trust property. In *Harrison v. Schaffner* the Court took a similar line, pointing out that assigned income will be taxed to the assignor where the assignor remains the "substantial" owner of the income-producing property.

Although the Court did not attempt to specify definitely the situations in which assigned income will be taxed to the assignor, it seems clear that income from services and income from property are in separate categories. An assignment of income from services appears to be conclusively presumed to be a mere "camouflage" to avoid taxes, and the assigned income will be taxed to the assignor. The fact that the income is assigned irrevocably is immaterial. Nor is it material that the income is from services which have been fully completed before the assignment. The justice in this discrimination against earned income is not readily perceptible. If the taxpayer, for example, in *Helvering v. Eubank*, had devoted himself to planting an orchard, he could have given the orchard away and escaped any liability for income taxation upon its fruits. But where he consecrated his energies to selling insurance, there was no way in which he could retire and give away the future income from his past labors so as to escape a tax upon it. It would seem that if a person divests himself completely of control over future income, its taxability to him or his assignee should depend upon the purpose to which the income is applied, rather than upon whether it is derived from property or the personal exertions of the taxpayer. It is difficult to see any sound reason for taxing the income from past services to an assignor when the assignment is complete and irrevocable and is not used to discharge some legal, or possibly moral, obligation of the assignor. The assignment of income from future services, which was the situation in the famous case of *Lucas v. Earl*, stands, of course, upon a quite different footing. The assignor by refusing to perform the services can defeat the interest of the assignee. This is not an irrevocable assignment. Where, however, services have been fully performed, there is no reason for treating the right to com-

21. Ibid.
22. 281 U. S. III (1930).
pensation for the services any differently than a bond or an interest in
a trust, or any other kind of property.

There was another decision at the last term, which, although not
involving an assignment, raised the problem of the nature of taxable
income. In *Hort v. Commissioner*, the taxpayer's father, after leasing
part of a building to the Irving Trust Company, died, leaving the
leased premises to the taxpayer. The Irving Trust Company later
decided to cancel the lease and paid the taxpayer $140,000 for this privi-
lege. The question arose as to whether or not this payment constituted
taxable income. The Commissioner contended that it did. The tax-
payer contended that it did not, and indeed went further and claimed
a deductible loss in the sum of $21,494.75, the alleged difference be-
tween what the Irving Trust Company paid to be relieved under the
lease and what it would have paid in rent if the lease had not been
abrogated. Ultimately the case reached the Supreme Court upon these
two questions: (1) Did the receipt of the payment for cancelling the
lease constitute income? (2) Did the taxpayer sustain a deductible loss
from the cancellation of the lease? Mr. Justice Murphy, delivering
the opinion of a unanimous Court, ruled against the taxpayer upon
both points. He pointed out that the rent from the lease would have
been income in the hands of the son and the payment for cancelling the
lease was simply a commutation of the rent due under it. It followed
that the payment for cancelling the lease was taxable as income and the
taxpayer was not entitled to deduct anything because of that portion of
the rent which he never received, since this represented merely a failure
to realize anticipated profits, rather than a destruction of capital. It is
admittedly difficult to distinguish between capital and income. As a
practical matter, however, the Court's position that upon the death of
the father the right to receive the rent from the lease did not become
capitalized so that all future payments of rent would represent a return
of capital, rather than income, was the only tenable one. Otherwise,
whenever a decedent died and left income-producing property, it could
be argued that the income from the property was no longer taxable.

2. Exempt Income

The Federal Farm Loan Act of 1916 provided that bonds issued
by joint stock land banks under the authority of the Act should be ex-
empt from income tax. In *United States v. Stewart* the question
arose whether this exemption was limited to interest from such bonds

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23. 313 U. S. 28 (1941).
25. 311 U. S. 60 (1941).
or extended to capital gains realized from their sale. Stewart had purchased the bonds in question when the banks issuing them were in receivership, with a view to a later disposal of them at a profit. He subsequently sold part of the bonds with their coupons and surrendered the remainder to the receiver of the issuing bank, realizing a profit upon both transactions. Without attempting to allocate this profit between interest and selling profit, he treated the entire gain as exempt from the federal income tax under the terms of the Federal Farm Loan Act of 1916 exempting "income derived" from such bonds. Over the dissent of Mr. Justice Roberts, the Supreme Court rejected this contention. Mr. Justice Douglas, who delivered the opinion of the Court, said that "income derived" from the bonds meant interest, rather than capital gains, which were derived from transactions in the bonds, rather than the bonds themselves. He qualified this, however, by declaring that in some cases "income derived" from bonds might be construed more broadly depending upon the applicable context. In the circumstances of the immediate case, he found a congressional intent to limit the exemption to interest from the bonds.

The taxpayer in United States v. Stewart also urged that he was not taxable because he had relied in purchasing the bonds upon a circular distributed by the Farm Loan Board stating that they were completely exempt from income taxes. The Court said that this was immaterial, since the Farm Loan Board lacked power to rule upon the exemption, and no administrative agency could estop the United States by waiving a public right. The Court added that a casual statement of the Secretary of the Treasury in the course of the hearing upon the Revenue Act of 1918, to the effect that the exemption of these bonds was broader than that of liberty bonds, was not entitled to any weight, since it did not even purport to be a discriminating analysis of the problem.

3. Capital Gains and Losses

The general definition of a capital gain or loss under the federal income tax is a gain or loss derived from the "sale or exchange" of capital assets. 26 Although this is adequate for the ordinary case, there are some situations where it encounters difficulties.

This was true in Helvering v. William Flaccus Oak Leather Co., 27 where the taxpayer's property, which had been fully depreciated for income tax purposes, was destroyed by fire and the question arose as to whether the insurance it received should be treated as ordinary income or a capital gain. At this time the 1934 Act was in force, which lim-

26. INT. REV. CODE, § 117 (a) (1939).
27. 313 U. S. 247 (1941).
ited the deduction of capital losses to the amount of capital gains plus $2,000. Since the taxpayer had large capital losses in the year in question, it treated the insurance money as a capital gain in order to utilize its losses. The Commissioner, however, determined a deficiency upon the theory that the insurance proceeds were ordinary income. His action was sustained by the Board of Tax Appeals, but the Circuit Court of Appeals reversed the Board’s decision. The Supreme Court, however, was unanimously of the opinion that the Commissioner had been correct, and that the insurance proceeds represented ordinary income, rather than a capital gain. In reversing the judgment of the Circuit Court of Appeals, Mr. Justice Murphy declared that the destruction of property and the receipt of insurance was not a sale or exchange. “Neither term,” said he, “is appropriate to characterize the demolition of the property and subsequent compensation for its loss by an insurance company. Plainly that pair of events was not a sale. Nor can they be regarded as an exchange, for ‘exchange’ as used in § 117 (d), implies reciprocal transfers of capital assets, not a single transfer to compensate for the destruction of the transferee’s asset.”

The taxpayer had based its case on the argument that the destruction of property which is compensated for by insurance is classified under the Act as an involuntary conversion and occurs in that portion of the statute dealing with sales and exchanges, and is, therefore, by implication a sale or exchange. Mr. Justice Murphy pointed out, however, that Congress had been careful to specify explicitly any transactions, apart from ordinary sales or exchanges, which it regarded as giving rise to capital gains or losses. The failure of Congress specifically to provide that an involuntary conversion was such a transaction overcame any inference to that effect from the juxtaposition of the section dealing with involuntary conversions.

Although the destruction of a capital asset by fire and the receipt of insurance to compensate for its loss is not a capital transaction giving rise to capital gain or loss, a loss due to the foreclosure of a lien or mortgage on a capital asset results in a capital loss to the lienor or mortgagor. This was the holding of the Supreme Court in two cases.

Mr. Justice Stone, who delivered both opinions, said that when the statute used the expression “sale” in defining capital gains or losses, it meant involuntary as well as voluntary sales, and therefore applied to sales in connection with foreclosure proceedings. The Court was unanimous, with the exception of Mr. Justice Roberts who dissented in both cases.

28. Id. at 249.
Prior to the 1934 Act, the federal income tax did not classify the redemption of corporate securities as a sale or exchange resulting in capital gain or loss.\textsuperscript{30} Section 117 (f) of the 1934 Act provided, however, that amounts received upon the "retirement" of bonds and other specified corporate securities should be treated "as amounts received in exchange therefor." In \textit{McClain v. Commissioner},\textsuperscript{31} and a companion case\textsuperscript{32} disposed of by the same opinion, the question arose as to the meaning of "retirement". In both cases the taxpayers held bonds of debtors who had gotten into difficulties. In the \textit{McClain} case, the taxpayer surrendered his bonds to the water district which had issued them for approximately 50\% of their face value. In the \textit{Thomson} case, the taxpayer surrendered debentures to the receiver of the issuer in return for $5 for each $1,000 debenture. In both cases the taxpayers deducted their full losses as bad debts. The Commissioner, however, contended that these were losses sustained upon the retirement of the securities and must under section 117 (f) be treated as capital losses. After conflicting Circuit Court of Appeals decisions, the contention of the Commissioner ultimately prevailed in the Supreme Court. Speaking for a unanimous bench, Mr. Justice Roberts held that the word "retirement" was broader than redemption and covered practically any surrender of securities to the issuer or its representative. To the plea by the taxpayer who received $5 for each $1,000 debenture that this treated him unfairly, since he could have refused to surrender his securities and deducted his loss in full as a bad debt, Mr. Justice Roberts replied, "The answer is that we must apply the statute as we find it, leaving to Congress the correction of asserted inconsistencies and inequalities in its operation."\textsuperscript{33} As a matter of fact, this is an inequality which Congress has undertaken to ameliorate, since the current law provides that all losses in connection with corporate securities shall be treated as capital losses.\textsuperscript{34}

4. Basis

The present provisions of the income tax provide that the basis of property acquired from a decedent shall be its fair market value at the date of "acquisition".\textsuperscript{35} Some of the earlier Acts, while adopting the date of acquisition as determinative in the case of realty received from a decedent and specific bequests of personalty, provided that the basis of other property received from a decedent should be its fair market

\begin{itemize}
\item \textsuperscript{30} Fairbanks \textit{v. United States}, 306 U. S. 436 (1939).
\item \textsuperscript{31} 311 U. S. 527 (1941).
\item \textsuperscript{32} Helvering \textit{v. Thomson}, 311 U. S. 527 (1941).
\item \textsuperscript{33} Id. at 530.
\item \textsuperscript{34} \textit{INT. REV. CODE}, § 23 (g) (2) (1939).
\item \textsuperscript{35} \textit{INT. REV. CODE}, § 113 (a) (5) (1939).
\end{itemize}
value at the time of "distribution". A group of cases at the last term undertook to allay the confusion which has arisen as to the precise meaning of "acquisition" and "distribution".

The first of these was *Maguire v. Commissioner.* A decedent died in 1903 leaving a will by which he created a trust of personal property for the taxpayer. In 1905 the executors under the will paid over the property to be held in trust to themselves as trustees. In 1923 they distributed to the taxpayer trust property which consisted partly of personal property belonging originally to the decedent and partly of personal property purchased by the trustees for the trust. The taxpayer sold property from both groups in 1930 and the question arose as to what bases he should use in computing gain or loss from the sales. At that time the 1928 Act was in force, section 113 (a) (5) of which, provided that the basis of property acquired by will or intestacy, other than realty and personalty specifically bequeathed, should be its fair market value at the "date of distribution to the taxpayer." Since the trust had not been created by a specific bequest, the question arose as to when the property had been distributed to the taxpayer. She contended that this was the date when it had been turned over to her by the trustees. The majority of the Court, however, rejected this contention. Mr. Justice Douglas, who wrote the majority opinion, drew a distinction between the property originally belonging to the decedent and that purchased by the trustees. With respect to the original property, he said that it was distributed to the taxpayer, not when it was actually paid over to her, but when it was paid over to the trustees to hold it in trust for her. With regard to the property purchased by the trustees, Mr. Justice Douglas said that its basis was not governed by section 113 (a) (5). Although the taxpayer's right to the property had its source in the provisions of a will, it was not acquired "by will or intestacy" within the purview of section 113 (a) (5). Consequently its basis was determined by the general rule of section 113 (a) and was the cost of the property to the trustees.

*Helvering v. Gambrill* also involved the construction of section 113 (a) (5) of the 1928 Act. In addition to the question of the proper basis of property received from a decedent, however, this case raised the problem of how the time such property is deemed to have been held is computed. The taxpayer was the remainderman under a trust created by the will of his grandmother, who died in 1897. Her executors handed over the trust property to themselves as trustees in 1898. In March, 1928, the life beneficiary died and on May 5, 1928,

36. 313 U. S. I (1941).
37. 313 U. S. II (1941).
the trustees paid over the trust property, which consisted partly of personality belonging originally to the creator of the trust and partly of personality purchased by the trustees, to the taxpayer. In 1930, in February, on May 6, and in June, the taxpayer sold property from both groups. The Board of Tax Appeals and the Circuit Court of Appeals held that the basis of both groups of properties was their fair market value on the date they were distributed to the taxpayer by the trustees. They also held that the time during which the taxpayer should be deemed to have held the property was to be computed from the date of such distribution, with the result that the property sold in February was not a capital asset under the 1928 Act, which required property to be held for more than two years to constitute a capital asset. The Supreme Court held that the lower tribunals erred on both points. Mr. Justice Douglas again delivered the opinion of the Court, while the Chief Justice and Mr. Justice Roberts dissented. The basis of the property, Mr. Justice Douglas said, was governed by the decision in Maguire v. Commissioner. Consequently, the basis of the property originally belonging to the decedent was its fair market value on the date it was handed over to the trustees by the executors. With respect to the property purchased by the trustees, its basis was the cost of the property to the trustees. The time during which the property was held, Mr. Justice Douglas said, should be computed from the date when the taxpayer acquired an interest in the property, which was the time of the decedent's death in the case of the property originally owned by the decedent, and the date of purchase, in the case of the property purchased by the trustees. With respect to the original property, moreover, it was immaterial that the taxpayer initially had only a remainder. "'Property held by the taxpayer' as used in § 101 (c) (8), embraces not only full ownership but also any interest whether vested, contingent, or conditional." As Mr. Justice Douglas pointed out, computing the time of holding the original property from the decedent's death means that the date which determines the time of holding differs from that which determines its basis. This, however, was also true in McFeely v. Commissioner, decided in 1935, which Mr. Justice Douglas cited as controlling in the Gambrill case.

There was one more case involving the construction of section 113 (a) (5) of the 1928 Act. This was Helvering v. Campbell, which while posing the same problems as the Maguire and Gambrill cases, advanced another step by pointing out the application of the "first in, first out rule" to property acquired from a decedent. Helvering v.
Campbell was really one of three cases, all of which were disposed of by the same opinion. The taxpayers in the three cases were three children of a common parent who died in 1915 leaving a will by which he created separate trusts for each of them. One-fourth of his residuary estate was bequeathed to trustees for his daughter, Marjorie Campbell, with directions to apply so much of the income as should be needed for her support to that purpose, until she reached twenty-one, and to accumulate the residue. When Marjorie attained twenty-one she was to receive the income from the trust until she reached twenty-eight, when, in addition, she was to receive one-half of the principal. Upon attaining thirty-five, she was to receive the remaining half.

Another portion of the testator’s residuary estate was placed under a similar trust for another daughter, Dorothy Rogers, and a third trust created for a son, Seymour Knox. The terms of Seymour’s trust differed from those created for his sisters in that he was to receive $500,000 when he became twenty-five, one-half of the remainder of the corpus at thirty, and the balance at thirty-five.

Marjorie Campbell became twenty-eight on July 10, 1928, and the trustees paid over to her one-half of the principal of her trust, which consisted of securities her father had owned, securities purchased by her father’s executors, and securities purchased by the trustees. She sold and redeemed bonds from all three classes in 1933. In 1926 and 1927 she purchased F. W. Woolworth stock which, with dividends received in 1927, amounted to 1,000 shares. Under the 1928 distribution from the trustees, she received 15,000 additional shares of the same stock, which represented shares originally owned by her father, a subsequent tax-free stock split-up, stock dividends and purchases by the trustees. In 1929 she surrendered these 16,000 shares and received in return 40,000 new shares pursuant to a split-up of the stock. In 1933 she sold 10,000 of these shares. It was impossible to identify the shares which she sold with any particular shares surrendered in 1929.

Dorothy Rogers received part of the corpus of her trust in 1924 when she was twenty-eight, and part on August 6, 1931, when she was thirty-five. During 1933 she sold some of these securities; those sold included securities originally owned by her father, others purchased by her father’s executors, and still others purchased by the trustees.

Seymour Knox was thirty on September 1, 1928. On that date the trustees paid over to him half of the corpus of his trust, including 8,575 shares of Maine Share Corporation, of which 5,160 shares had been purchased by the trustees on August 3, 1927, and 3,415 shares had been purchased by them on August 20, 1928. Seymour later ex-

41. Helvering v. Knox and Helvering v. Rogers were the other two cases.
changed these shares in a non-taxable transaction and sold the shares received on the exchange on June 10, 1930.

The Board of Tax Appeals and the Circuit Court of Appeals held:

1. that the basis of the securities distributed to the various cestuis que trust was their market value at the date of distribution;
2. that the time during which Seymour held the Maine Share Corporation stock was to be computed from the date he received this stock from the trustees; and
3. that Marjorie in determining what shares of F. W. Woolworth stock she had sold should treat the shares she had purchased herself as having been sold prior to those received from the trustees under the rule of the "first in, first out."

The Supreme Court in reversing the judgment of the Circuit Court of Appeals, held that the lower tribunals had erred on all three points. Mr. Justice Douglas again delivered the opinion of the Court, while the Chief Justice and Mr. Justice Roberts continued to dissent. The basis of the property sold by the beneficiaries of the trusts in the case of that originally owned by the decedent was its fair market value at the time it was distributed to the trustees, and, in the case of the property purchased by the trustees, its fair market value at the date it was purchased by them. With regard to the securities purchased by the executors, Mr. Justice Douglas said that they were to be considered as property acquired by will under section 113(a)(5) and their basis was, therefore, their fair market value at the time when they were distributed to the trustees.

In the case of the stock in the Maine Corporation, which the trustees had purchased for Seymour's trust, Mr. Justice Douglas said that under Helvering v. Gambrill it must be deemed to have been held from the dates when the trustees purchased it, rather than from the time when they handed it over to Seymour.

With respect to the application of the "first in, first out" rule to Marjorie's Woolworth stock, Mr. Justice Douglas said that it is the date of acquisition which is controlling. Therefore, since she acquired the stock distributed to her by the trustees at the date of her father's death, this stock must be deemed to have been sold before that which she herself purchased.

In these cases Mr. Justice Douglas stressed the point which was developed more fully in a later decision, that the basis of property received from a testamentary trust is not affected by whether the interest of the beneficiary is vested or contingent. On this point, for example, he said in Helvering v. Campbell: "We are not concerned here with the question as to when the transfers took effect for purposes of the estate tax. As we indicated in Maguire v. Commissioner, supra, we are deal-
ing only with a point of reference and a standard of value for determination of gains or losses realized on subsequent sales of property acquired by bequest, devise or inheritance. For that purpose distinctions between vested and contingent remainders or between absolute and conditional property interests have no relevancy." 42

The final case in this group, Helvering v. Reynolds, 43 further emphasized the fact that the basis of property acquired from a decedent is not affected by whether the taxpayer's interest is vested or contingent. Helvering v. Reynolds differed from its predecessors in that it involved section 113 (a) (5) of the 1934 Act, rather than section 113 (a) (5) of the 1928 Act. Under the 1934 Act, as under the current law, the basis of property received from a decedent is its fair market value at the date of acquisition, regardless of whether the property is realty or personalty, or is or is not specifically bequeathed. The question then in Helvering v. Reynolds was not when the property was distributed to the taxpayer, but when it was acquired by him. In this case the taxpayer's father at his death in 1918 had created a testamentary trust under which the taxpayer took a contingent interest. On April 4, 1934, the trustees distributed securities from the trust to the taxpayer. Some of these had originally belonged to the decedent, and some had been purchased by the trustees. The taxpayer sold securities from both groups in 1934, taking as his basis their fair market value when he received them from the trustees. The Commissioner determined a deficiency contending that as far as the securities which had originally belonged to the decedent were concerned, they had been acquired by the taxpayer at his father's death, and their proper basis was, therefore, their market value at that date. With respect to the securities purchased by the trustees, the Commissioner claimed that their basis was the cost of the securities to the trustees. The Board of Tax Appeals sustained the Commissioner. The Circuit Court of Appeals on the other hand agreed with the taxpayer and reversed the Board's decision. The Supreme Court felt that the Board had decided the case correctly and reversed the judgment of the Circuit Court of Appeals. Mr. Justice Douglas delivered the opinion of the Court. He said that the securities which had originally belonged to the taxpayer's father were acquired by the taxpayer when his father died, despite the fact that the taxpayer took only a contingent interest. The term "acquisition" in the context of section 113 (a) (5) was sufficiently ambiguous to admit of administrative interpretation and might properly be construed, as the

42. 313 U. S. 15, 21, 22 (1941).
43. 313 U. S. 48 (1941). Cary v. Comm'r, 313 U. S. 441 (1941), raised the same problem as Helvering v. Reynolds and was decided in the same way on the authority of that decision.
Commissioner had construed it, to cover a situation where a taxpayer acquired only a contingent interest "which ultimately ripened into complete ownership." As far as the basis of the property purchased by the trustees was concerned, Mr. Justice Douglas held, in line with the earlier cases, that this was not governed by section 113 (a) (5) since that section related only to property "acquired by bequest, devise, or inheritance." The basis of such property was, therefore, governed by the general rule, and was its cost to the trustees.

Mr. Justice Roberts, who with the Chief Justice dissented diligently throughout this series of cases, took occasion in Helvering v. Reynolds to express the reasons for his lack of concurrence more fully. He declared that when the statute referred to the date of acquisition of property, it meant the date when the taxpayer became the "owner of the property; when he became able to enjoy it and dispose of it at his will," and not the time when he acquired merely a contingent interest.

5. Undistributed Profits Tax

One of the objections urged against the undistributed profits tax was that it penalized corporations with an impaired capital which were not allowed to distribute their current profits under local state laws, and which could not, therefore, avail themselves of the dividend paid credit provided for in the tax. A possible answer to this objection was that such a corporation could claim that its earnings were retained under a written contract restricting it from distributing dividends and that it was, consequently, entitled to a credit on that score. The obvious difficulty with such a solution was to find the necessary written contract. The Treasury took the position that a corporation was not entitled to any credit under such circumstances. In several cases decided at the last Term the Supreme Court has finally ruled that the Treasury's position was correct and the tax as unfair as its critics contended.

In Helvering v. Northwest Steel Rolling Mills, Inc., a corporation organized under the laws of the State of Washington was prohibited by the laws of that state from distributing current earnings because its capital was impaired. It did not, therefore, distribute any

44. 313 U. S. 428, 433 (1941).
45. Id. at 436.
47. Id. § 27.
48. Id. § 26 (c) (1).
51. 311 U. S. 46 (1940), cited note 50 supra.
dividends, but claimed that it was entitled to a credit against the undistributed profits tax on the ground that it was unable to distribute its earnings, because of a written contract forbidding their distribution. The corporate charter contained a provision to the effect that the corporation would abide by the laws of Washington. This in conjunction with the state laws forbidding the distribution of earnings was alleged to constitute the written contract restraining the distribution of dividends. The corporation also claimed that if it were denied such a credit the undistributed profits tax, insofar as it applied to it, was unconstitutional. The Supreme Court, however, was of the unanimous opinion that the corporation was not entitled to a credit, and that the denial of the credit was not unconstitutional. Mr. Justice Black said that the corporate charter was not a written contract forbidding the payment of dividends in the sense in which this term was used in the undistributed profits tax. "It is true, as respondent contends," he said, "that a charter has been judicially considered to be a contract insofar as it grants rights, properties, privileges and franchises. To this extent it has been said that an Act of Incorporation is a contract between the state and the stockholders. But it does not follow that Congress intended to include corporate charters and related state laws in the cautiously limited area permissible for tax credits and deductions under this section. . . . Respondent's chief reliance is upon that charter provision which required that it conform to existing and future laws of Washington. But that provision is not a grant and is not a contract. . . . It is clear, therefore, that what prohibited respondent from distributing dividends was not the provision of an executed written contract expressly dealing with the payment of dividends. On the contrary, what prohibited respondent from paying dividends was a valid law of the State of Washington." 52

As far as the constitutionality of denying the credit was concerned, the taxpayer had urged that this violated the Fifth, Sixteenth and Tenth Amendments. Mr. Justice Black, however, swiftly disposed of these objections. He dismissed the argument that there was an unconstitutional discrimination forbidden by the Fifth Amendment in allowing a credit to a corporation restrained by a written contract from paying dividends and denying it to corporations similarly restricted by oral contracts or state laws with the terse observation that it was "without merit". "It is not necessary," he added, "to point out the many obvious reasons which might underlie the distinction here drawn in granting special deductions from a generally imposed tax." 53

52. Id. at 50, 51, 52.
53. Id. at 52.
In connection with the Sixteenth Amendment the taxpayer argued that since its capital was impaired taxing its undistributed earnings was a tax on capital rather than income, and was not, therefore, authorized by the amendment. Stressing the fact that the tax was on "profits earned during a definite period—a tax year" regardless of the state of the corporation's capital, Mr. Justice Black pointed out that the tax was really upon income and the objection on the score of the Sixteenth Amendment was without merit.

Finally the taxpayer contended that the tax violated the Tenth Amendment, since it interfered with the authority of the state to prescribe the powers of corporations and the conditions under which these powers might be exercised. Mr. Justice Black retorted that the tax did not in any way interfere with the powers of a corporation, but simply "imposes a tax as authorized by the Sixteenth Amendment." 56

6. Deductions

Although the federal income tax imposes a tax upon income regardless of whether or not it is derived from a business, it will not allow an expense connected with the production of income to be deducted, unless it is a business expense. 56 This unhappy limitation is not only unfair; it is difficult to administer in the absence of any clear criterion as to what constitutes a business or a business expense. Prior to the recent decision in Higgins v. Commissioner, 57 it was generally assumed that quantitative factors like the continuity of his conduct, the extent of his activities and the time he devoted to them, determined whether a taxpayer engaged in a profit-making venture was or was not carrying on a business. The Higgins case, however, injects a new element into the picture—a qualitative requirement that the taxpayer must be engaged in the right kind of profit-making activity. The facts of the case were striking.

The taxpayer had extensive investments in real estate, stocks and bonds. In order to manage his property he maintained offices in New York and Paris with a staff of hired assistants. These offices conducted his financial affairs under his detailed personal instructions. They kept records of his investments, received securities, interest and dividend checks, made deposits and forwarded weekly and annual reports, and undertook generally the care of his investments under his directions. For more than thirty years the taxpayer had handled his affairs in this way. Prior to 1932

54. Id. at 53.
55. Ibid.
57. 312 U. S. 212 (1941).
the Government had made no objection to his deducting the salaries and expenses incident to maintaining his offices. For the tax years 1932 and 1933, however, the Commissioner refused to allow the deductions on the ground that "mere personal investment activities never constitute carrying on a trade or business, no matter how much of one's time or of one's employees' time they may occupy." The taxpayer appealed to the Board of Tax Appeals. Before the Board, the Commissioner conceded that the portions of the taxpayer's expenses referable to handling his real estate were business expenses; but, he contended, and with success, that the portions of the expenses allocable to handling the stocks and bonds were not business expenses. The Circuit Court of Appeals affirmed the decision of the Board and the Supreme Court affirmed the judgment of the Circuit Court of Appeals. Writing on behalf of the unanimous Court, Mr. Justice Reed said that what constitutes carrying on a business requires an examination of the facts in each case. The Commissioner and the Board had decided a debatable question of fact, which it was beyond the province of the Court to contest. "The Commissioner and the Board," said Mr. Justice Reed, "appraised the evidence here as insufficient to establish petitioner's activities as those of carrying on a business. . . . No matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board." Although from a strictly legal point of view the Court did not hold as a matter of law in the *Higgins* case that investing one's funds in stocks and bonds cannot constitute a business, from a practical point of view, there is no other sensible construction to put upon the decision. This is obvious from the later decisions of *United States v. Pyne* and *City Bank Farmers Trust Co. v. Helvering*. In the *Pyne* case, the executors of a large estate sought to deduct the fees paid to an attorney for assisting them in the legal and financial aspects of the administration of the estate, on the ground that the affairs of the estate were of such magnitude that this was a necessary business expense. The Commissioner disallowed the deduction and determined a deficiency which the executors paid under protest and for which they later sued in the Court of Claims. The Court of Claims found that the executors were entitled to a refund. The Supreme Court, however, vacated the judgment in favor of the executors on the ground that the lower court's legal con-

58. *Id.* at 215.
59. *Id.* at 218.
60. 313 U. S. 127 (1941).
61. 313 U. S. 121 (1941).
clusion was not sustained by proper findings of fact. Mr. Justice Black pointed out that what constitutes carrying on a business is a question of fact to be decided upon the evidence of each individual case. The Court of Claims had not, however, found that the executors were engaged in carrying on a business. They had simply found that the decedent had been a financier and the executors were carrying on his affairs as he would have done if he had lived. From this conclusion of fact, which, Mr. Justice Black said, was not a conclusion that the executors were carrying on a business, the Court of Claims had drawn the erroneous legal conclusion that they were engaged in a business. Mr. Justice Black added that the reason the Court of Claims failed to make a specific finding of fact that the executors were not carrying on a business was "the result of the court's adoption of criteria of 'carrying on . . . business' inconsistent with our holding in the Higgins case." 62 With due deference to the legal subtleties of Mr. Justice Black's opinion, the practical result seems to be that taxpayers will not be able to deduct expenses incident to investing their funds as business expenses. The Supreme Court may characterize this as a question of fact. From the taxpayer's point of view, however, it might apparently be just as well a rule of law.

City Bank Farmers Trust Company v. Helvering followed the same line. The trustees of several large trusts sought to deduct their commissions from the trust income as business expenses. The Commissioner and the Board of Tax Appeals refused to allow this. The decision of the Board of Tax Appeals was affirmed by the Circuit Court of Appeals and the judgment of the Circuit Court of Appeals affirmed by the Supreme Court. Mr. Justice Black again delivered the opinion of a unanimous Court. Again he was careful to point out that the Court was simply affirming a finding of fact by the Board of Tax Appeals which was supported by evidence. He seems to admit, however, that there are certain legal conceptions involved in this finding of fact which look like rules of law. Quoting from the Higgins case he said: "The conclusion of the Board of Tax Appeals 'is adequately supported by this record and rests upon a conception of carrying on business similar to that expressed by the Court for an antecedent section.'" 63

A word of caution may not be amiss in connection with the Higgins case. It has been widely assumed in view of that decision that if a taxpayer's activities take the form of investing in real estate, his expenses in this connection are business expenses which are deductible. It should be noted, however, that this question was not before the Court.

62. 313 U. S. 127, 131 (1941).
63. 313 U. S. 121, 126 (1941).
Before the Board of Tax Appeals the Commissioner conceded that that part of the taxpayer's expenses referable to his real estate holdings were deductible as business expenses. The concession was not litigated and was not in issue when the case reached the Supreme Court. There may be valid reasons for holding that expenses incurred in connection with stocks and bonds are not business expenses, while those incurred in connection with real estate are. In view of the Court's emphatic warnings, however, that what constitutes carrying on a business is a question of fact and that the decision of the Board of Tax Appeals is not to be reversed as long as it is sustained by evidence, it would appear to be unwise to assume that the Court will surely hold that expenses connected with real estate are business expenses, or reverse a possible ruling by the Board or the Commissioner to the effect that they are not.

The other cases in connection with deductions were notable chiefly because the Court decided them in favor of the taxpayers. Since 1921 the federal income tax has allowed life insurance companies to deduct a certain percentage "of the mean reserve funds required by law." In Helvering v. Oregon Mutual Life Insurance Co., and a companion case, Helvering v. Pan-American Life Insurance Co., the question arose in connection with the 1932 and 1934 Acts, as to whether this was limited to a percentage of reserves set aside to pay death benefits, or also included reserves, which life insurance companies were required by law to maintain to cover disability in connection with combined policies of life, health and disability insurance. Without dissent the Court held that the companies were entitled to deduct the statutory percentage of both kinds of reserves. Mr. Justice Black pointed out that the deduction not only fell within the literal wording of the statute, but that the settled administrative practice from 1921 to 1934 had been to allow the deduction of both kinds of reserves. Consequently, he said that by the 1932 and 1934 Acts "Congress has granted life insurance companies a deduction for disability reserves which only Congress can take away" and the Regulations interpreting these statutes to the contrary were void.

7. Returns

The joint return of a husband and wife has bothered both the Government and taxpayers for a long time, because it has not been clear, and conflicting administrative interpretations have failed to make it

64. INT. REV. CODE, §203 (a) (2) (1939).
65. 311 U. S. 267 (1940).
66. 311 U. S. 272 (1940).
69. 311 U. S. 267, 272 (1940).
clear, whether the income of the spouses should be treated as the income of separate taxpayers or that of a single taxpayer. From this failure to clarify the basic conception underlying such returns have arisen such questions as whether the losses of one spouse may be offset against the gains of the other; whether the fifteen per cent. limitation upon the deduction of charitable contributions is to be measured by the aggregate income of both spouses or by the separate income of the contributing spouse; and, whether the earned income credit is to be computed according to the individual incomes of each spouse or the aggregate income of both. The Supreme Court in a series of cases decided at the last term seems to have put these questions at rest by definitely favoring the single taxpayer, aggregate income concept.

Thus, for example, in *Helvering v. Janney* and *Gaines v. Helvering* Chief Justice Hughes, speaking for a unanimous court, held that upon a joint return the capital losses of one spouse might be offset against the capital gains of the other. "We are of the opinion," the Chief Justice said, "that under the provisions of the Act of 1934 as to joint returns of husband and wife, which embodied a policy set forth in substantially the same terms for many years, Congress intended to provide for a tax on the aggregate net income and that the losses of one spouse might be deducted from the gains of the other; and that this applied as well to deductions for capital losses as to other deductions.”

In *Taft v. Helvering* the Court took the same position. Husband and wife filed a joint return in which the deduction for charitable contributions of the wife was based upon fifteen per cent. of their combined income. The Commissioner contended that this was erroneous and that the deduction for the wife’s contributions should be reduced to fifteen per cent. of her separate income. The Supreme Court, however, once more in complete accord and speaking through the Chief Justice, upheld the taxpayer. The federal income tax, said Chief Justice Hughes, “provides specifically for the inclusion of the income of each spouse ‘in a single joint return’ and in that case that ‘the tax shall be computed upon the aggregate income.’ The principle that a joint return is to be treated as the return of a ‘taxable unit’ and as though it were made by a ‘single individual’ would be violated if in making a joint return each spouse were compelled to calculate his or her charitable contributions as if he or she were making a separate return. The prin-

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70. 311 U. S. 189 (1940).
71. Ibid.
72. Mr. Justice Roberts did not, however, participate in these cases.
73. 311 U. S. 189, 194 (1940).
74. 311 U. S. 195 (1940).
ciple of a joint return permitted aggregation of income and deductions and thus overrode the limitations incident to separate returns." 75

Although in these cases the "principle that a joint return is to be treated as the return of a taxable unit and as though it were made by a single individual" worked to the advantage of the taxpayers, it will not always do so. For example, in the past, when computing the earned income credit of taxpayers filing a joint return, husband and wife have been treated as separate taxpayers, with the result that where one of the spouses had an unearned income he or she was allowed to treat it as earned up to $3,000, regardless of the income of the other spouse. This is no longer permissible under the prevailing concept that a joint return is the single return of a single taxpayer. 76

Other interesting permutations of this problem may be easily imagined. Suppose, for example, that a husband sells a thousand shares of XYZ stock at a loss. The next day his wife buys a thousand shares of XYZ stock. If they file a joint return may the husband deduct the loss from the sale of his stock, or will this be treated as a wash sale? 77

Again suppose that a husband and wife each own $10,000 principal amount of United States Treasury Bonds. They file a joint return. Are they entitled to exclude the income from $10,000 worth of these bonds, or only that from $5,000?

There was another case at the last term involving returns, which raised the problem of the proper definition of a "first return" in connection with a statutory privilege to elect percentage depletion. Although the case was decided by a unanimous court it seems needlessly harsh and severe. The J. E. Riley Investment Company was engaged in mining gold at Flat, Alaska. Because the winter mail service to that point was so slow and uncertain, the company used the preceding year's forms in filing its federal income tax returns. On January 2, 1935, it executed its return for 1934 on a 1933 form, which had been forwarded to it by the collector for that purpose. At that time the company was unaware of a provision of the 1934 Act 78 under which it could have elected to claim percentage depletion, and it had not been notified by the collector of this ability to make election when he forwarded the 1933 form. If the company had been aware of it, it would have elected percentage depletion, since it had exhausted its depletion allowance on the basis of cost. The return executed on January 2, 1935, reached the

75. Id. at 198.
77. This was not treated as a wash sale by the Board of Tax Appeals prior to the decisions in Helvering v. Janney, 311 U. S. 189 (1940), cited note 70 supra, and Helvering v. Taft, 311 U. S. 195 (1940), cited note 74 supra. Frank B. Gummey, 26 B. T. A. 894 (1932); see W. E. Brochon, 30 B. T. A. 404 (1934).
78. REVENUE ACT OF 1934, § 114 (b) (4), 48 STAT. 710 (1934).
collector at Tacoma on January 29, 1935. In August, 1935, the taxpayer learned for the first time of the provision in the 1934 Act authorizing percentage depletion. In consequence, on March 3, 1936, it filed an amended return for 1934 claiming percentage depletion and asking for a refund. The Commissioner denied the refund on the ground that the taxpayer had failed to elect percentage depletion in its "first return" filed under the 1934 Act, as required by that Act. In J. E. Riley Investment Co. v. Commissioner,79 the Supreme Court unanimously upheld the position of the Commissioner. Mr. Justice Douglas said that by a first return Congress meant an original return or an amended return filed within the time for filing an original return. In support of this conclusion he declared that if any other construction were placed upon the law "taxpayers with the benefit of hindsight could shift from one basis of depletion to another in light of developments subsequent to their original choice." 80 This does not follow. There was no question of any "original choice" by the taxpayer in this case. The Court admitted that if the taxpayer had known that it could claim percentage depletion when it filed its return in January, 1935, it would have done so. To the taxpayer's argument that it had been treated harshly and that "equitable considerations should govern" in the construction of the law, Mr. Justice Douglas coldly replied: "That may be the basis for an appeal to Congress in amelioration of the strictness of that section. But it is not ground for relief by the courts from the rigors of the statutory choice which Congress has provided." 81 Surely, the Court could have construed "first return" to mean the first return filed after the taxpayer had had a reasonable opportunity to acquaint himself with the provisions of the law. The Court has certainly been willing enough to give an "equitable" construction to tax statutes when such a construction favored the Government.82 There is no obvious reason for weighting the scales against the taxpayer.

8. Taxation of Partnerships

After the debacle in 1929 the revenue from the federal income tax suffered considerably by reason of the fact that taxpayers sold their deflated securities and realized huge tax losses. To cope with this situation Congress provided in the 1932 Act that losses from the sale of securities, which did not constitute capital assets, could not be deducted generally from gross income, but could be used merely as an offset

79. 311 U. S. 55 (1940).
80. Id. at 59.
81. Ibid.
82. E. g., Helvering v. Clifford, 309 U. S. 331 (1940).
against gains from the sale of similar securities.\footnote{83} In \textit{Neuberger v. Commissioner} \footnote{84} the question arose as to whether this privilege of offsetting losses from the sale of noncapital securities extended to a partner's share of the partnership's gains from the sale of such securities, or was limited to his individual gains. Neuberger had sold some of his individual securities, which were not capital assets, at a loss. His distributive share of the income of a partnership included gains realized by the partnership from the sale of similar securities. Under the present law it is explicitly provided that capital gains and losses of a partnership are to be treated as the gains and losses of the individual partners.\footnote{85} Moreover, there is no requirement that property be held for more than two years in order to be a capital asset. Consequently, under the current version of the income tax, there is no question but that a partner may offset individual losses against partnership gains. The 1932 Act was not, however, explicit upon this point. Under the 1932 Act it was simply provided that a partnership should make an income tax return upon which the partnership income should be computed like that of an individual, and that the individual partners should return their distributive shares of the partnership income in their individual returns.\footnote{86} The Commissioner contended, therefore, that under the 1932 Act noncapital losses of the partnership were to be offset against its noncapital gains on the partnership return, and the individual partner could not utilize the partnership gains again on his individual return as an offset against his individual losses. Although three of the Justices agreed with the Commissioner, the majority of the Court rejected this construction and held that he had misinterpreted the 1932 law. Mr. Justice Murphy, who delivered the majority opinion, declared that in limiting the deduction of noncapital losses, Congress merely intended to protect the tax on ordinary income and did not intend to tax noncapital security gains unless they exceeded noncapital losses. Although Congress under the 1932 Act recognized partnerships as business units to the extent of requiring them to file informational returns, it also treated them as associations of individuals by taxing the income from the partnerships to the individual partners. Mr. Justice Murphy concluded, therefore, that it was the intent of the law to allow individual losses to be offset against partnership gains, a result eminently fair and sensible.\footnote{87}

There was another decision on the taxation of partnerships at the last term, which unlike the \textit{Neuberger} case, is of practical significance

\footnotesize{\begin{itemize}
\item \footnote{83} \textit{Revenue Act of 1932}, § 23 (r) (1), 47 Stat. 169, 183 (1932).
\item \footnote{84} 311 U. S. 83 (1940).
\item \footnote{85} \textit{Int. Rev. Code}, § 182 (1939).
\item \footnote{86} \textit{Revenue Act of 1932}, §§ 181-189, 47 Stat. 160, 222, 223 (1932).
\item \footnote{87} Mosbacher \textit{v. United States}, 311 U. S. 619 (1940), a memorandum decision raised the same problem as \textit{Neuberger v. Comm'r}, 311 U. S. 83 (1940), cited note 84 supra, and was decided the same way upon the authority of that case.}

under the current law. This was *Helvering v. Enright,* Enright at the time of his death was a partner in a law firm. Both he and the firm returned their income upon a calendar year and a cash receipts and disbursements basis. The articles of partnership provided that upon the termination of the partnership by the death of a partner, his estate should be entitled to a partner's percentage of the "net monies in the treasury of the firm plus his like percentage in the outstanding accounts and the earned proportion of the estimated receipts from unfinished business." Under this provision Enright's interest in the uncollected accounts of the firm was valued at $2,055.55 and his interest in the firm's unfinished business, at $40,855.77. His executors included these sums in Enright's estate tax return; but they did not include them in the income tax return filed for him; nor, when they were collected were these sums returned as part of the income of his estate. The Commissioner, consequently, determined an income tax deficiency on the basis of section 42 of the 1934 Act, which requires income accrued at the death of a taxpayer to be included in the income tax return filed for him, even though he be on a cash basis. The Board of Tax Appeals sustained the deficiency. The Circuit Court of Appeals, however, reversed the Board, taking the view that section 42 simply requires accrued income of a deceased partner to be included in his return, and since Enright at the time of his death was not entitled to receive anything from the partnership except his proportionate share of the cash receipts of the firm, this was all that accrued to him at his death. In other words, the Circuit Court of Appeals said that section 42 requires accrued income of a deceased partner to be included in his return, but it does not require the accrued income of the partnership to be included in the partner's return, when the partnership is on a cash basis. The Supreme Court of the United States unanimously reversed the judgment of the Circuit Court of Appeals. Mr. Justice Reed said that the purpose of section 42 is to prevent the escape of any income from the income tax upon the death of a taxpayer. Consequently, he held that upon the death of a partner not only must the income which has accrued to him be included in his income tax return, but also his proportionate share of the income which has accrued to the partnership. This brought him to the problem of whether or not the disputed items in the instant case could be properly said to have accrued to the partnership. Ordinarily an item is held to accrue when the right to receive it becomes clear and fixed. Under ordinary conceptions of accrual there was no difficulty, therefore, in holding that the uncollected accounts of the partnership had accrued. A more perplexing problem faced Mr. Justice Reed when he

88. 312 U. S. 636 (1941).
undertook to show that anything accrued to the partnership with respect to its unfinished business. Starting from the premise that "accrue" has not yet become a "word of art with a definite connotation when employed in describing items of gross income" he said that it would be necessary to determine its meaning in connection with section 42 in view of the purpose behind that section. This purpose was to make sure that income of decedents earned during their lives would be included in their income tax returns, regardless of whether they reported their incomes on a cash or accrual basis. Consequently, in connection with section 42 an item should be deemed to accrue when it was fairly susceptible of valuation. "Accrued income under § 42 for uncompleted operations," said Mr. Justice Reed, "includes the value of the services rendered by the decedent, capable of approximate valuation, whether based on the agreed compensation or on quantum meruit. The requirement of valuation comprehends the elements of collectibility. The items here meet these tests and are subject to accrual." 90

9. Administration and Procedure

An appellate court will not ordinarily consider an issue which has not been raised in the court below. This is not, however, according to the Supreme Court, an inflexible practice. "There may always be exceptional cases or particular circumstances which will prompt a reviewing or appellate court, where injustice might otherwise result, to consider questions of law which were neither pressed nor passed upon by the court or administrative agency below." 91 Several cases in this category occurred at the last term.

In Hormel v. Helvering 92 the petitioner created three trusts under which the petitioner himself, and his wife as guardian for one of his sons, were beneficiaries. Each trust was for a different son. Other than this, however, their terms seem to have been identical. The subject matter of each trust consisted of stock in the Geo. A. Hormel Co., of which the petitioner was an officer. The trustees were the petitioner and another named by the petitioner. The petitioner retained the power to remove the co-trustee at any time, with the consent of his wife. The terms of the trusts provided that the trustees should pay the income from each of the trusts to the petitioner's wife, as guardian, up to $2,000 a year, and any income in excess of this amount to the petitioner.

89. Id. at 643.
90. Id. at 645. Pfaff v. Comm'r, 312 U. S. 646 (1941), presented the same problem as Helvering v. Enright, 312 U. S. 636 (1941), cited note 88 supra, and was decided in the same way upon the authority of that case.
92. Ibid.
The trustees had power to appoint proxies to exercise the voting rights connected with stock held in trust and they were also empowered to sell the securities deposited with them and substitute others. It was further provided that no trust estate should vest in the petitioner’s wife, as guardian, or in the named sons, that the wife and sons should have no power to alienate or incumber their interests, and that the trustees should be liable only for wilful and deliberate violation of their duties. The trusts were to terminate in three years, or upon the prior death of the petitioner, or of the son named under the trust. Upon the termination of any trust, the trust property was to be paid over to the petitioner or his representatives. In 1934 and 1935 the income from the trusts was paid to the petitioner’s wife as guardian and the petitioner did not include it in his income tax returns. The Commissioner consequently determined a deficiency against the petitioner on the theory that the trusts were “revocable” trusts and under section 166 of the 1934 Act he was properly taxable upon the income from them. The petitioner appealed to the Board of Tax Appeals, where the Commissioner broadened his argument, contending not only that the income from the trusts was taxable to the petitioner under section 166, but also under section 167 of the 1934 Act, which imposes a tax upon the creator of a trust where the income of the trust may be accumulated for or distributed to him in his discretion or in the discretion of one who lacks a substantial adverse interest in the trust. The Board ruled in favor of the taxpayer that the income from the trusts was not taxable to him under either section 166 or section 167. The Commissioner appealed to the Circuit Court of Appeals. Before the Circuit Court of Appeals he abandoned his reliance upon section 166, conceding that the trust was not a revocable trust. He contended, however, that the Board erred in holding that the petitioner was not taxable under section 167. He also introduced for the first time a new argument that irrespective of sections 166 and 167, the petitioner was taxable under section 22 (a), the section defining income generally. In other words, the Commissioner suited his argument to and based it upon the decision in Helvering v. Clifford which the Supreme Court had handed down by the time the Commissioner reached the Circuit Court of Appeals. The Circuit Court of Appeals agreed with the Board of Tax Appeals that the petitioner was not taxable under sections 166 and 167. However, they allowed the Commissioner to introduce his new argument and held that the taxpayer was taxable upon the income from the trusts under section 22 (a). The taxpayer sought certiorari on the ground that the Circuit Court of Appeals had erred in deciding the case on the basis of section 22 (a),

93. 309 U. S. 331 (1940).
since this had not been raised by the Commissioner before the Board of Tax Appeals. The Supreme Court, however, in a unanimous opinion delivered by Mr. Justice Black, declared that the decision of the Circuit Court of Appeals was correct and that this was one of the extraordinary cases where an appellate court could properly decide a case upon an issue not raised in the lower court. "Rules of practice and procedure," said Mr. Justice Black, "are devised to promote the ends of justice, not to defeat them. A rigid and undeviating judicially declared practice under which courts of review would invariably and under all circumstances decline to consider all questions which had not previously been specifically urged would be out of harmony with this policy. Orderly rules of procedure do not require sacrifice of the rules of fundamental justice."  

Mr. Justice Black did not undertake a judicial blueprint of the situations where "the fundamental rules of justice" require an appellate court to make an exception to the "orderly rules of procedure," by considering an issue which was not raised below. Presumably the exceptional character of the exception precluded it. It seems, however, that this is not a matter resting in the uncontrolled discretion of the appellate body. Thus, for example, in Helvering v. Richter, another short-term family trust case, the Circuit Court of Appeals had refused to allow the Commissioner who based his case before the Board of Tax Appeals on sections 166 and 167 to shift his position and ground his argument on Helvering v. Clifford. The Supreme Court reversed the judgment of the Circuit Court of Appeals declaring that it should have considered the case upon this basis.

There were two more cases involving the income tax which dealt with procedural problems. In United States v. A. S. Kreider Co., the Supreme Court held that the statute of limitations governing a suit initiated in a district court for the refund of income taxes, was the five year limitation of section 1113(a) of the 1926 Act, rather than the six year period allowed by section 24(20) of the Judicial Code. In this case the taxpayer in 1921 paid an income tax for the year 1920 of $52,481.07. Prior to June 15, 1926, it executed a waiver extending the time for audit and assessment of additional taxes until December 31, 1926. On July 26, 1926, the taxpayer paid a deficiency assessment of $1,362.50. On March 3, 1929, however, it filed a claim for a refund of $53,844.47, the entire amount of the taxes paid with respect to 1920. The Commissioner found that the taxpayer had overpaid its 1920 tax

94. 312 U. S. 552, 557 (1941).
95. 312 U. S. 561 (1941).
96. 309 U. S. 554 (1940).
97. 313 U. S. 443 (1941).
in the sum of $14,833.68 and in October, 1929, he sent it a certificate of over-assessment for this amount. Upon the certificate there was, however, a notation to the effect that $13,471.18 of the overpaid taxes were barred by the statute of limitations, and the check accompanying the certificate, which the taxpayer apparently accepted, was simply for the residue, $1,362.50. On March 2, 1932, the taxpayer sued in a district court to recover the sum withheld by the Commissioner. The question arose whether the suit was timely. The District Court held that the action was barred by section 1113 (a) of the 1926 Act, which prescribes the period in which suits for refunds of income taxes must be brought. The Circuit Court of Appeals disagreed with the District Court and held that the action was timely, since it was governed by section 24 (20) of the Judicial Code, which allows six years in which to bring suit in a district court. The Supreme Court, in a unanimous decision, held that the conclusion of the District Court was correct and reversed the judgment of the Circuit Court of Appeals. Mr. Justice Murphy pointed out that section 24 (20) of the Judicial Code was simply an outside limitation on bringing suits for refunds in the district courts, which was controlled by the specific provisions of section 1113 (a) of the 1926 Act relating to refunds. He also said that the taxpayer could not avoid the limitation imposed by section 1113 (a) on the ground that the transactions with the Commissioner in 1929 amounted to an account stated, since the refusal of the Commissioner to refund part of the overpaid taxes imported no promise to pay them, which is the basis of an account stated.

In the last income tax case the Supreme Court agreed that a collector cannot release a surety from liability on a bond to pay an income tax deficiency and interest on the deficiency. They could not agree, however, where a collector had attempted to waive the interest provided for in such a bond, upon the rules governing the allowance of interest upon this sum. In *Royal Indemnity Co. v. United States, 98* the Commissioner in 1920 assessed a taxpayer for $29,128 for additional 1917 income taxes. The taxpayer filed a claim for abatement of the assessment and, to secure suspension of the collection of the tax, executed a bond for $38,000 conditioned upon payment of the deficiency and interest on May 2, 1923. The Commissioner allowed the claim in abatement except for principal of $8,233.38 and interest of $4,169.07. On demand by the collector, the Royal Indemnity Company, surety on the bond, paid only the principal amount and not the interest. Payment was made by draft, which recited that it was in full payment of the tax and all liability upon the bond. Although the collector accepted the

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98. 313 U. S. 289 (1941).
draft and surrendered the bond, the United States later brought suit in a district court to recover the interest which had not been paid. The District Court allowed the recovery of $4,169.07, the interest provided for in the bond, but refused to allow interest on this sum. The Circuit Court of Appeals ruled that interest should have been allowed on the interest provided for in the bond at 6 per cent., the rate fixed by section 370 of the New York General Business Law, the state where the suit was brought. The Supreme Court affirmed the judgment of the Circuit Court of Appeals. Mr. Justice Stone, speaking for the majority, said that the collector had no power to release a tax obligation owing to the government, since only the Commissioner can compromise such claims. The Circuit Court of Appeals acted properly, moreover, in allowing interest upon the interest stipulated for in the bond. This was not interest upon interest, but interest upon a sum which the defendant was under a contractual duty to pay. As to the rate of interest which should have been allowed, this, said Mr. Justice Stone, is a question for the federal courts to decide, rather than a matter of state law. However, in the absence of a federal rule, the Circuit Court of Appeals acted properly in adopting the rate prescribed by the New York General Business Law.

Mr. Justice Black agreed with the majority of the Court that a collector has no power to waive a tax obligation owing to the government and that it was, therefore, entitled to recover the interest due on the deficiency assessed by the Commissioner. He doubted, however, whether it was proper to allow interest upon this sum. Moreover, he felt that if interest were to be allowed, the federal courts should set their own rule and prescribe a uniform rate of interest, so that all taxpayers would be treated equally. Mr. Justice Douglas and Mr. Justice Murphy concurred in Mr. Justice Black's views.

(To be concluded.)