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CORPORATE EARNINGS AS "GAINS, PROFITS AND INCOME" AS DEPENDING UPON THE TIME OF THEIR ACCRUAL.

THE discussion here has to do with the earnings of corporations as taxable income, whether such earnings remain in the hands of the corporation accumulating them, or are distributed to the stockholders as dividends, the inquiry being limited, however, to the question of the time of their accrual as affecting their taxability.

A number of late cases in the Federal Courts arising under the INCOME TAX ACT of October 3rd, 1913, have dealt with this subject. In all of these cases the specific point in issue was this: Are earnings of a corporation which accrued prior to the incidence of the income tax sought to be imposed, but paid to or received by another corporation or individual as dividends subsequent thereto, taxable as income? On this proposition the several Federal Courts that have passed upon it are in hopeless conflict. In the late case of *Lewellyn, Collector* v. *Gulf Oil Company,*[1] the United States Circuit Court of Appeals for the Third Circuit, in overruling the District Court, holds that such income is taxable; and to the same effect are the late cases of*Towne* v. *Eisner,* and *Southern Pacific* v. *Lowe.*[2]

The opposite, and as we believe, manifestly correct conclusion is arrived at in the recent cases of *Lynch* v. *Hornby,*[3] *Lynch* v. *Turrish,*[3] and in the *Gulf Oil Case, supra,* in the District Court; and the same general view is taken in a number of cases construing earlier revenue laws.[4]

As will be seen, the Act of September 8th, 1916, did much to clear up the confusion but it remained for Congress, by the amendments to that Act introduced into the WAR INCOME ACT of October 3rd, 1917, to fix definitely just what corporate assets are and are not taxable, (and if taxable to what extent), as income so far as their taxability is dependent upon the time of their accrual. The word "accrued" wherever used is to be taken in its usual and

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[1] Lewellyn, Collector, v. Gulf Oil Corp (1917), 245 Fed. 1.

[2] Towne v. Eisner (1917), 242 Fed. 702; Southern Pacific Company v. Lowe (1917), 238 Fed. 847.

[3] Lynch v. Turrish (1916), 236 Fed. 653; Lynch v. Hornby, 236 Fed. 661; Gulf Oil Corp. v. Lewellyn (1917), 242 Fed. 709.

[4] Gray v. Darlington (1872), 15 Wall. (U. S.) 63; Bailey, Collector v. Railroad Co. (1882), 106 U. S. 109; Mitchell Brothers Co. v. Doyle, Collector (1915), 225 Fed. 437; Cleveland C. C. & St. L. Ry. Co. v. United States (1917), 242 Fed. 18.

ordinary legal meaning, that is as synonymous with the words "earned" or "accumulated".

Under the express language of the law as it now is, we are unable to conceive how any court can again fall into the palpable error which we believe inheres in the *Lowe, Eisner* and *Gulf Oil Cases.* However, these cases and those in which an opposite conclusion was reached are significant as showing the necessity, in the interest of uniformity in the administration of the Income Tax Law, for the changes in the law, and as emphasizing the state of the law as it is under the instant Acts. Starting with the leading case of *Gray* v. *Darlington,* which is the first one dealing with the point, we shall attempt to trace the genesis and development of the law to the present time.

THE DOCTRINE OF GRAY v. DARLINGTON.

Gray v. *Darlington*[4] arose under the Civil War Income Tax Law. The facts were that the plaintiff purchased bonds prior to the enactment of the INCOME TAX ACT of 1861. The bonds gradually increased in value during a period of years and were sold subsequent to the passage of the Act at a material gain. The question was whether or not the profit represented by this gradual increase in value was taxable as income for the year in which the bonds were sold. It was held that it was not. The Court speaking by Mr. Justice FIELD at p 65, said:—

"The advance in the value of property during a series of years can, in no just sense, be considered the gains, profits, or income of any one particular year of the series, although the entire amount of the advance be at one time turned into money by a sale of the property. The statute looks, with some exceptions, for subjects of taxation only to annual gains, profits, and income.

* * * Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital.

"The rule adopted by the officers of the revenue in the present case would justify them in treating as gains of one year the increase in the value of property extending through any number of years, through even the entire century. The actual advance in value of property over its cost may, in fact, reach its height years before its sale; the value of the property may, in truth, be less at the time of the sale than at any previous period in ten years, yet, if the amount received exceed the actual cost of the property, the excess is to be treated, according to their views, as gains of the owner for the year in which the sale takes place. We are satisfied that no such result was intended by the statute".[5]

[5] Supra, note 4.

Taking the decision literally it would seem that even that portion of the gain in value accruing during the taxable year was held not to be taxable income. However, the principle of *Gray* v. *Darlington* has been restricted in later cases to this extent, *viz*: that that portion of the increase in value which accrued subsequent to the incidence of the tax, is to be considered as taxable income.[6] As thus confined the doctrine laid down in *Gray* v. *Darlington* has never been directly challenged but, as will later appear, the *Lowe, Eisner* and *Gulf Oil Cases* are in direct conflict with it.

Bailey, Collector v. *Railroad Co.*, also arose under the Civil War Income Tax Law and was a suit by the Railroad Company against Bailey, Collector of Internal Revenue, to recover moneys which it claimed had been illegally exacted as income tax within the meaning of the law. The Act provided that certain corporations should be subject to and pay a tax on the amount of interest, etc., and upon "any dividend in scrip or money due or payable to its stockholders as part of the earnings, profits, income or gain of such company, and all profits of such company carried to the account of any fund or used for construction." The Company in 1868 declared a scrip dividend out of earnings accruing through the period from 1853 to 1868. The Supreme Court of the United States held that there was no authority for the imposition of the tax upon so much of the earnings as accrued prior to 1862, the date from which the tax took effect.[6a] The Court speaking by Mr. Justice MATTHEWS, at p. 114, said:— "It should be borne in mind, in the first place, that the tax provided for in this section is an annual income tax, and its subject is the interest paid and profits earned by the company for each year, and year by year; and that both by the express letter of the law, and its necessary implications, the tax is not laid on any of these funds which came into being before the time prescribed in the act. And in the ordinary execution of the law, it was contemplated that the funds to be taxed, and the tax imposed upon them, would be concurrent, as to each fiscal year; the scheme of the statute being to levy the tax upon the income for the year ending on the 31st of December next preceding the assessment; and while it would be altogether admissible to go back, for the purpose of assessing a tax upon a proper fund which had accrued during a previous year and escaped taxation, nevertheless the tax imposed would be for the omitted year. But no tax, in contemplation of the law, accrues upon the fund, except for the year in which the fund itself accrued."

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[6] Cleveland C. C. & St. L. Ry. Co. v. United States, Supra, note 4 at p. 19.
[6a] Supra, note 4.

CASES ARISING UNDER CORPORATION EXCISE TAX LAW OF 1909.

Mitchell Bros. Company v. *Doyle, Collector,* was a case in which the property of a corporation consisted chiefly of timber lands and a saw mill, and its business, the manufacture and sale of lumber. Held, that for the purpose of its return under the CORPORATION EXCISE TAX ACT it was entitled to deduct from its gross receipts as capital assets a sum at least equal to the market value, at the time the Act went into effect, of the standing timber from which the lumber sold during the year was manufactured, although such timber was bought years before at a smaller price; and it was also entitled to deduct as capital assets any amount received from the sale of cut-over or other lands sold during the year, not exceeding their market value at the time the law went into effect. The Court in arriving at this conclusion speaking by SESSIONS, J., at p. 440 said:—"Can the government, at least in the absence of specific legislative declaration to that effect, reach back years before the enactment of its revenue statute for a controlling factor in determining the net income of a corporation? Can it ignore a substantial increase in value of property, which has occurred and accrued prior to the taking effect of the tax law, and thereby convert into income that which is not income within any meaning of the term? To state these questions is to answer them".[7]

In *Cleveland C. C. & St. L. Ry. Co.* v. *United States,* the Railway Company purchased stock in another company prior to January 1st, 1909, and sold such stock at a profit subsequent to January 1st, 1909. Held, that such profit was not "income" within the meaning of the corporation Excise Act of 1909, except to the extent that the selling price exceeded the market value on January 1, 1909, but to that extent, the selling price constituted income, it appearing that the stock had a regular fixed stock market value. The court in this case follows the case of *Gray* v. *Darlington* modifying it, however, to the extent of holding that the increase in value of the stock which accrued subsequent to January 1, 1909, the date when the law became effective, was taxable income.[8]

CASES ARISING UNDER THE ACT OF OCTOBER 3, 1913.

In *Lynch, Collector* v. *Turrish, supra,* a corporation acquired certain property in 1903 which gradually increased in value for a period of years and was finally sold in 1914 at a large profit and the entire proceeds distributed as dividends to the stockholders in 1914. The facts in the case showed that no increase in value had accrued

[7] Supra, note 4.
[8] Supra, note 4.

after March 1st, 1913. It was held that the dividends so declared were not "income, gains or profits" within the meaning of the Act and, therefore, not taxable for the year 1914 because no income, gains or profits *accrued* to the stockholder during the year 1914 or after March 1, 1913 (the date of the incidence of the tax).

The conclusion of the court is well stated in the syllabus in the following language:—"The enhanced value of property of a corporation, which accrues from the gradual increase in its value during a series of years prior to the effective date of an income tax law, although divided or distributed by dividend, or otherwise, subsequent to that date, does not become 'income, gains, or profits' taxable under such an act, but is rather an 'increase of capital assets' ".[9]

In this case the court discusses the underlying principles involved in its decision in an intelligent and comprehensive way. The doctrine there laid down is undoubtedly the correct one to be applied in determining the taxability or non-taxability of profits from sales of property, or of dividends, with reference to the time of their accrual. To the same effect is *Lynch* v. *Hornby, supra.*

It should be observed that in *Lynch* v. *Turrish* and in *Lynch* v. *Hornby,* there was actually a distribution as dividends to the stockholders of capital assets but this does not weaken the authority of the case as a precedent in support of the principle for which we are contending. The real point of the decision is that the increase in value of the property all accrued prior to March 1st, 1913. Had any part of such increase accrued subsequent to March 1st, 1913, then manifestly the court would have held such increase taxable. Suppose again that the property had been purchased subsequently to March 1st, 1913, then as is clearly implied in the case, the entire proceeds of the sale would not have been held to be capital assets but only the original cost price, and that part of the proceeds which represented the difference between the selling price and the original cost would have been taxable.[9a]

In the case of *Gulf Oil Company* v. *Lewellyn, Collector, supra,* certain subsidiary companies of the plaintiff holding company declared dividends in 1913 out of earnings, all of which accrued prior to January 1, 1913. All of the stock of the subsidiaries except directors' qualifying shares was owned by the plaintiff company. The Collector of Internal Revenue held that these dividends were taxable for the year 1913, against the parent company. The plaintiff paid the taxes under protest and brought this suit to recover the amount so paid, claiming that the income represented by dividends,

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[9] Supra, note 3.

[9a] 2137, T. D. 2090.

had not accrued to it subsequent to March 1, 1913. The trial court sustained the contention of the plaintiff, relying on the case of *Bailey* v. *Railroad Company, supra.*[10]

The ourt after quoting at length from the *Bailey Case* proceeds as follows:—(p. 716). "The foregoing seems to be a direct authority in support of the contention of the plaintiff in the present case, for the language of the act of 1913 is no clearer in showing an intent of the lawmakers to tax earnings accrued prior to the time they were subjected to the operation of the act than was the language of the act of 1864. The argument that there should be a different construction of the act of 1913 from that given to the act of 1864 is weakened by the fact that, at the time the earnings in the present case accrued, *the authority given to Congress by the Sixteenth Amendment was wanting.* (*Italics ours*). It seems to be perfectly clear that the advances in the value of property during a series of years can in no proper sense be considered gains, profits, or income of any one particular year of the series, although the entire amount of the advance may be at one time turned into money by the sale of the property".

The Court then proceeds to discuss the cases of *Lynch* v. *Turrish* and *Lynch* v. *Hornby, supra,* and to subscribe to the doctrine therein laid down. The Court then continues, p. 716:—"The specific facts in each of those cases, (*Lynch* v. *Turrish* and *Lynch* v. *Hornby*) are not specially material. The complaints of the plaintiffs therein were generally the same as the complaint of the plaintiff in the present case. Each had been assessed and compelled to pay a tax levied upon a distribution of assets, because of the mistaken view of the collector of internal revenue that such distribution of assets was 'income, gains, or profits within the meaning of the Income Tax Law' ".

And again p. 716:—"It is perhaps worthy of observation that Congress, being without authority to levy an income tax until February 25, 1913, when the Sixteenth Amendment was adopted, provided in Act 1913, par. G. (c) that the tax for that year should be upon the entire net income accrued within that portion of said year from March 1st, to December 31st, both dates inclusive, to be ascertained by taking five-sixths of the entire net income for said calendar year".[11]

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[10] Supra, note 4.

[11] Art. 1, Sec. 2 of the Constitution provides "Representatives and direct taxes shall be apportioned among the several states which may be included within this Union according to their respective numbers". Art 1, Sec. 8, "The Congress shall have power to lay and collect taxes, duties, imposts and excises * * * * but all duties, imposts and excises shall be uniform throughout the United States". Art. 1, Sec. 9, "No capitation or other direct tax shall be laid unless in proportion to the census or enumeration herein

The Court summarizes its conclusion as follows:—"The dividends in question in this suit were not subject to the tax imposed, because they were a distribution of surplus earnings arising through a period of years, and which had accrued to, and the equitable ownership thereof was vested in, the plaintiff prior to January 1, 1913, and such earnings were not intended by Congress to be subject to taxation."

DECISIONS CONTRA.

The United States Circuit Court of Appeals reverses the District Court in the case last above discussed, holding that such dividends were taxable.[12] In doing so the court followed the late case of *Southern Pacific Company* v. *Lowe*.[13] To the same effect is the case of *Towne* v. *Eisner*. We believe that the three last named cases are incorrectly decided.[14] We shall consider them in the order in which they were decided.

In the *Lowe Case* the facts were that the plaintiff a holding company owned all of the stock of certain subsidiary companies except directors' qualifying shares. The subsidiary companies in 1914 declared certain dividends out of earnings, all of which accrued prior to July 1st, 1909. The Collector of Internal Revenue assessed the Southern Pacific Company on these dividends for the first six months of the year 1914. The taxes were paid under protest and this suit was then brought to recover the same. The Court, in holding that the dividends were taxable, attempts to draw certain distinctions which would serve to differentiate the case before it from

before directed to be taken". An income Tax Law was passed by Congress in 1861 to provide additional revenue during the Civil War period, Chap. 45, Secs. 49, 51; 12 Stat. L. 309. This Act as amended by various Acts continued in force until 1871, when it expired and was not re-enacted. The courts in passing on the constitutionality of the Act of 1861 and its amendments, held that an income tax is not a *direct* tax, and that, therefore, the Acts were not unconstitutional. Springer v. U. S., 102 U. S. 586; Clark v. Sickel, 5 Fed. Cas. No. 2862, 14 Int. Rev. Rec. 6; Smedberg v. Bentley, 22 Fed. Cas. No. 12964, 21 Int. Rev. Rec. 38. However, that part of the Wilson Tariff Act of 1894 which undertook to impose an Income Tax, as stated in the text, was held unconstitutional by the Supreme Court of the United States, as being a *direct tax* in the case of Pollock v. Farmers Loan & Trust Company, 157 U. S. 429 (Rehearing 158 U. S. 601). In the dissenting opinion of Mr. Justice Harlan on the rehearing (p. 638) in the Pollock case, it is pointed out that a tax upon income derived from business operations or from the practice of a trade or profession, was not a direct tax, and that no apportionment among the states would be necessary in so far as a tax upon income is laid upon those subjects alone. However, all nice distinctions of this nature were wiped out and made of no further importance by the passage of the Sixteenth Amendment which provides as follows:—"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived without apportionment among the several states, and without regard to any census or emuneration".

[12] Lewellyn, Collector, v. Gulf Oil Corporation. Supra, note 1.

[13] Supra, note 2.

[14] Supra, note 2.

earlier cases such as *Gray* v. *Darlington* and *Lynch* v. *Turrish.* The Court at p. 849 says:—"But how this surplus is made up, whether from earnings of the company or increase in value of land does not appear" and again, at p. 851:—"But nowhere does the testimony or statements warrant a finding that this surplus is an increase to capital by a year to year enhancement of the value of the capital of the railway company, and is not from any enhancement of the value of land or property of the corporation."

The distinction is clearly not a valid one, the doctrine of *Gray* v. *Darlington* and of similar cases being broad enough to cover all forms of profits or increase in valuation accruing prior to the incidence of the tax. The Court, however, to bolster up its decision advances the argument that (p. 850):—"The government cannot tax undistributed surplus as income to the stockholders because they were (it was) income to the stockholder when paid and not before. While it may be that the plaintiff owning all of the capital stock of the Central Pacific Company could have begun some action to have disbursed the surplus, still it did not do so. The accumulation of surplus of itself does not entitle stockholders to dividends. * * *"

"A stockholder has no interest in the profit of a corporation until a dividend has been declared."

The answer to this contention is twofold.

First—The statement that "the government cannot tax undistributed surplus as income to the stockholders" is incorrect in view of the language of the Act of October 3, 1913, which expressly authorizes the levying of the additional tax upon the interest which the individual shareholder would have in undistributed profits, if distributed,[15] and

Secondly—The equitable beneficial interest in such undistributed profits is at all times vested in the individual stockholder who is entitled ultimately to receive them.[16] The earnings of a corporation, the moment they are earned, enhance the value of the stock owned by its stockholders and *accrue* to the benefit of the stockholders even though not distributed until years later.

Again the court relies on the case of *Edwards* v. *Keith.*[17] But this case is clearly distinguishable since in the *Edwards Case* the contention was that insurance premiums paid over a period of years under a contract by which the agent was to receive a portion of such annual premiums on all policies written by him, accrued during the year the policies were written and were therefore, not taxable in the year received. The court in the *Edwards Case,* how-

[15] Subdivision 2 of Sec. 2, Act of October 3rd, 1913.

[16] Collector v. Hubbard (1870), 79 U. S. 1, 18; Gulf Oil Corporation v. Lewellyn, Collector, Supra, note 3.

[17] Edwards v. Keith (1916), 231 Fed. 110.

ever, overruled this contention and in doing so pointed out that the yearly premiums did not accrue when the policies were written and in fact might never have accrued since there was no assurance that the insured would pay these annual premiums. Plaintiff's commission on such premiums could, therefore, not be said to be vested, in the year the policies were taken out, in any sense of the word. In the *Lowe Case,* however, the situation is different. The dividends which were paid in 1914, were actually earned prior to July 1, 1909, and the beneficial title thereto thereupon vested in the plaintiff. In other words the dividends accrued prior to July 1, 1909. It may be true as the Court said (p. 852) that "financial reverses or some other calamity might have destroyed the surplus" before it was actually paid out as dividends, but this does not change the fact that such dividend funds were earned and had accrued prior to the incidence of the Income Tax Law of 1913.

Towne v. *Eisner*: In this case the directors and stockholders of the Yale and Towne Manufacturing Company, in December, 1913, voted a stock dividend in payment of a dividend out of earnings, all of which were earned prior to January 1st, 1913. The share of the plaintiff Towne in such dividend was taxed under the Act of October 3, 1913. Following the usual procedure, the tax was paid under protest and this suit was brought to recover the same. The court held that the stock dividend was taxable.[18]

In arriving at this conclusion the court relied on the case of *Edwards* v. *Keith, supra,* which has already been distinguished and also the case of *Southern Pacific Company* v. *Lowe* which we have criticised, *supra.*

The court further relies on the cases of *Brushaber* v. *Union Pacific R. R. Co.* and *Van Dyke* v. *City of Milwaukee.*[19] Neither of these cases supports the position of the court. It is true that the *Brushhaber Case* in passing on the constitutionality of the Act of October 3, 1913, held that that Act was constitutional even though it was retroactive to the extent of taxing incomes accruing at any time *subsequent* to March 1, 1913, but the court had no occasion to and did not pass upon the question of the right of the government to levy a tax retroactive in its operation to a point prior to the effective date of the Sixteenth Amendment. Indeed while the point now under consideration was not involved in the Brushaber case, the language of the court in that case directly supports our contention. The Court at p. 20 speaking by Mr. Chief Justice WHITE says:—"But the date of the retroactivity did not extend beyond the

[18] Supra, note 2.

[19] Brushaber v. Union Pacific Ry. Co. (1916). 240 U. S. 1; Van Dyke v. City of Milwaukee (1915), 159 Wis. 460.

time when the Amendment was operative, and there can be no dispute that there was power by virtue of the Amendment during that period to levy the tax, without apportionment, * * *"

The Van Dyke Case is not in point since it arose under the state Income Tax Law of Wisconsin and it has never been doubted that a state can, if it sees fit, pass an income tax law, retroactive in its effect, the several states not being restricted in the passage of income tax laws as was the Federal Government prior to the passage of the Sixteenth Amendment. The *Eisner Case* is to be reviewed by the Supreme Court of the United States on a writ of error.[19a]

Coming now to the decision of the Circuit Court of Appeals in the *Gulf Oil Case* the court in reversing the trial court attempts to distinguish the cases of *Lynch* v. *Turrish* and *Lynch* v. *Hornby, supra,* but with no better success than attended the efforts of the court in the *Loew Case.* The Court of Appeals ignores the reasoning of the trial court and the constitutional aspect of the case.

In all three of the cases last discussed, the *Lowe, Eisner* and *Gulf Oil Cases,* the court rings the changes on the distinction between "income" and "capital assets" and attempts to distinguish *Lynch* v. *Turrish, supra,* and similar cases on that ground. While the distinction is often an important one it is not the controlling factor in these cases. The question is not as to the nature of the fund sought to be taxed whether income or capital but whether or not an income tax can be imposed on earnings accruing prior to the incidence of the tax. If the earnings accrued prior to the incidence of such tax, then they are not taxable, irrespective of whether the fund retains its status as income or has been merged into capital.

To summarize the argument supporting the doctrine of *Gray* v. *Darlington* and the cases which have followed it and rejecting the principles laid down in the *Gulf Oil* and similar cases: The Act of 1913 provides for a levy of income tax only "upon the entire net income arising or accruing in the preceding calendar year".[20] However, it may be conceded as suggested in the *Bailey Case, supra,* that it would be competent for Congress to pass an income tax law taxing a fund which had accrued during a preceding year, and Congress has in fact done so in the Income Tax Acts of 1916 and 1917, but this

[19a] After the above article was written but before going to press, the Supreme Court of the United States (January 7th, 1918) handed down its decision in the case of Towne v. Eisner, supra, reversing the trial court. The Supreme Court, however, bases its decision upon the sole ground that stock dividends are not proper subjects of income taxation, the theory being that "'A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interest of the shareholders. Its property is not diminished and their interests are not increased'."

The Court quotes the above language from the case of Gibbons v. Mahon, 136 U. S. 549.

[20] Sec. 2 A., Subdivision 1, Act of October 3rd, 1913.

retroactivity cannot extend to a date prior to the effective date of the Sixteenth Amendment. That Congress by the Act of 1913 did not intend and did not attempt to do this, is apparent from the language last above quoted from the Act and it is also apparent from the further fact that a special provision is contained in that Act limiting the taxable income for that year to that which accrued subsequent to March 1, 1913, the date when the Act became operative.[21] But in any event Congress could not, *in 1913*, have legally passed an income tax law affecting income accruing in an earlier year. In other words, if prior to the passage of the Sixteenth Amendment, Congress did not have authority to lay a tax on income then it cannot, subsequent to the date of the Amendment, pass a law retroactive to a point prior thereto.

The Present State of the Law

In 1894, Congress in enacting the Wilson Tariff Act undertook to lay a tax on incomes.[22] The following year the Supreme Court of the United States in the leading case of *Pollock* v. *Farmers' Loan & Trust Company* held the Act unconstitutional in so far as it applied to incomes derived from the renting of real property or from the investment of personal property.[23] This decision resulted in the passage of the Sixteenth Amendment to the Constitution of the United States. Just as the decision in the *Pollock Case*, which was undoubtedly correct, created the necessity for the passage of the Sixteenth Amendment as a condition precedent to the enactment of any valid income tax legislation, so the erroneous rulings of the Treasury Department, made it incumbent upon Congress to define specifically, "gains" and "dividends", with reference to the time of their accrual, so as to secure uniformity in the administration of the law. In doing so Congress no doubt took cognizance of the fact that February 25th, 1913, the effective date of the Sixteenth Amendment was the earliest date upon which the incidence of the tax could be fixed—that "gains, profits and income", accruing prior to that date could not be reached for purposes of income taxation. In view of the pressing needs of the Government for additional revenue, however, Congress no doubt desired to make the scope of the law as wide as possible and accordingly fixed on March 1st, 1913, a few days after the taking effect of the Amendment, as the date of incidence.

[21] Par. G. (c), Act of October 3rd, 1913.

[22] Act of Congress, August 27th, 1894, 28 Stat. 509, c 349.

[23] Pollock v. Farmers' Loan & Trust Company (1895), 157 U. S. 429, on rehearing 158 U. S. 601.

Pursuant to this design we find in the Act of September 8th, 1916, the following definition of "gain";—

"For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived".[24]

This provision is not amended by the Act of October 3rd, 1917. As the law now is, therefore, the gain derived from the sale or other disposition of property acquired by a corporation prior to March 1st, 1913, and sold subsequent thereto shall be determined by deducting from the selling price, the "fair market price or value" as of March 1st, 1913, even though the original purchase price was much less or much greater than the market price as of that date.[25]

As to property acquired subsequent to March 1st, 1913, there can also be no difficulty. Here the rule is that the gain from the sale of property acquired subsequent to March 1st, 1913, for the purpose of the Act shall be the difference between the selling price and the actual price paid for it together with the expense incident to the procurement of the property in the first instance, and its sale thereafter, plus the cost of improvement or development, if any. In determining the cost of property for the purpose of arriving at the profit realized upon the sale it will be permissible for the corporation to add to the initial cost, such carrying charges as interest, taxes, insurance, etc., provided such carrying charges have not been deducted from the net income returned for years subsequent to the incidence of the tax and prior to the date of the sale.[26]

The entire "gain" as thus defined, is taxable in the year in which the property is sold or disposed of, and is not pro-rated even though the increase in value is a gradual accretion extending over a period of years. This is merely a way of saying that the law takes no cognizance of increase in valuations evidenced merely by book entries. It only concerns itself with a completed, a closed transaction.[27]

The term "dividends" is defined in the Act of September 8th, 1916, as follows: *"Provided,* that the term dividends as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association or insurance com-

[24] Sec. 2 (c), Act of September 8th, 1916.

[25] T. D. 2090.

[26] T. D. 2137.

[27] Baldwin Locomotive Works v. McCoach (1915), 221 Fed. 59; United States v. Guggenheim Exploration Co. (1917), 238 Fed. 231; T. D. 2185.

pany out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association or insurance company, which stock-dividend shall be considered income to the amount of its cash value."[28]

This proviso or definition does not appear in the 1913 Act and like the definition of "gain" *supra,* was no doubt inserted in the 1916 Act as a guide to and indeed a check against erroneous rulings in the future by the Treasury Department, and by the Courts such as those already referred to. But it should be noted that neither of the two provisions of the Act of 1916, last above referred to restricted the range of the tax. On the contrary they greatly enlarged it since under the Act of October 3rd, 1913, only "gains, profits or income" *accruing during the taxable year* were properly taxable, whereas under the Act of September 8th, 1916, as it originally was, and also as amended, the taxable field is extended so as to embrace all "gains, profits or income" *accruing* subsequent to March 1st, 1913, and *received* in the taxable year.

This conclusion is irresistible when we consider the above provisions taken in conjunction with the radical difference in the opening words of the 1913 Act and those of the Act of 1916, as amended. The earlier Act provides that, "There shall be levied, assessed and paid annually upon the entire net income *arising* or *accruing from all sources during the preceding calendar year,* to every corporation, etc." The language of the instant Act on the other hand is that "There shall be levied, assessed, collected and paid annually upon the total net income *received in the preceding calendar year* from all sources by every corporation."

The case of *Southern Pacific Company* v. *Lowe, supra,* furnishes a remarkable instance of judicial oversight which strengthens the argument that that case is incorrectly decided. The Court in summing up its conclusion in that case uses the following language: "Since these dividends were received within the six months and were paid as part of the gross income to the plaintiff as a stockholder of the railroad company *and were received within the year 'from all sources,'* (Italics ours) I am of the opinion that the collector was right in levying this assessment and collecting this tax; and accordingly, there must be judgment directed for the defendant * * *"[28a] The words *"were received within the year from all sources"* do not appear at all in the Act of October 3rd, 1913, but are substituted in the

[28] Sec. 2 (a), Act of September 8th, 1916.

[28a] Supra, note 2 at p. 853.

Act of September 8th, 1916, for the words *"arising or accruing from all sources during the preceding calendar year"* which is the langauge of the Act of October 3rd, 1913. The change in the law is a vital one as will be readily seen by a simple illustration. The X Trust Company performed services for a client during the years 1911 and 1912, for which it rendered a bill of $5,000.00 on January 1st, 1913, and received payment June 1st, 1913. No services are rendered in the year 1913 or after the incidence of the tax. No part of the $5,000.00 is taxable as income. The same services are rendered during the years 1915 and 1916 and payment is *received* in 1916. The entire $5,000.00 is taxable as income in 1916, the year in which it is *received.*

The Act of October 3rd, 1917, materially amended the Act of September 8th, 1916, in regard to dividends. Subdivision (b) of sub-section 31, is new and works a radical change in the law.[29] Prior to the passage of the amendment it was held by the Commissioner of Internal Revenue that a corporation might declare dividends subsequent to March 1st, 1913, out of earnings earned prior to that date without having first distributed as dividends, "the most recently accumulated undivided profits or surplus" provided that the corporation should "specifically inform the stockholders that the dividends were declared and paid", out of surplus and profits accrued prior to March 1st, 1913, and should make proper entries on the books of the corporation showing that fact. In this connection it was said by the Commissioner, that "it is immaterial to this office whether dividends are paid out of current earnings or surplus acquired prior to March 1st, 1913."[30]

All this has been changed by the amendment which specifically provides that any distribution to stockholders "shall be deemed to

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[29] Subsec. 31 (b) of Sec. 1211, Act of September 8th, 1916, as amended by Act of October 3rd, 1917, on account of its importance is here set out in full and is as follows:

"(b). Any distribution made to the shareholders or members of a corporation, joint-stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, joint-stock company, association, or insurance company, but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen."

[30] Letter to Corporation Trust Company signed by Acting Commissioner David A. Gates, dated January 23rd, 1917.

have been made from the most recently accumulated undivided profits or surplus and shall constitute a part of the annual income of the distributee for the year in which *received* and shall be taxed to the distributee *at the rate prescribed by law for the years in which such profits or surplus were accumulated by the corporation* but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise exempt from the tax after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen has been made".[31]

It follows, therefore, that all earnings or profits earned and accumulated subsequent to March 1st, 1913, must now first be distributed by a corporation, subject to be taxed in the hands of the stockholders. After this has been done then "gains, profits and income" accruing prior to March 1st, 1913, may be distributed to the stockholders as dividends and will be tax free.[32]

From what has already been said it is apparent that there is an important distinction between the method in which *dividends* accruing over a period of years and *gains, profits and income* of a corporation, not *distributed as dividends,* accruing over a like period, are now taxed." In the case of dividends, while the entire amount of the dividend is taxable in the year received, (subject to the limitation that "gains, profits and income" accruing prior to March 1, 1913, are not taxable at all) it may represent items earned over a series of years, in which event the several rates in force in the years in which such items were earned will apply.[32a] On the other hand gains or profits other than dividends, as for example, increases in value of land during a series of years or compensation for services extending over several years would be taxed in their entirety, in the year the gain or profit was received, at the rate of taxation in force that year.

[31] Supra, note 29.

[32] Supra, note 29.

[32a] The point is further illustrated by a late ruling of the Treasury Department:— "Where a Non-resident Alien (Corporation) received a dividend in 1916 from a Domestic Corporation which was earned by the corporation partly in 1915 and partly in 1916, the tax to be withheld is 2 per cent of the entire dividend," T. D. 2584. (Released for publication November 24th, 1917.) This ruling is correct under the Act of September 8th, 1916, because the dividend was "received" in 1916 and the 1916 rate of 2 per cent is applicable. The ruling would be incorrect as applied to a similar case arising under the Act of October 3rd, 1913, for the reason that only that part of the dividend "accruing" during the taxable year would be taxable. But it should be noted further that the ruling would also be incorrect as to dividends paid in 1917, since under the Act of September 8th, 1916, as amended by the Act of October 3rd, 1917, the dividend would be apportioned, the part "accruing" in 1915 being taxable at the rate for that year (1 per cent) and the part accruing in 1916 would be taxable at the 2 per cent rate.

In the practical administration of the law, cases will no doubt arise in which it will be difficult to determine what is the "most recently accumulated undivided profits or surplus". The law specifically requires the paying corporation to give "information at the source" including the names and addresses of stockholders, and the number of shares owned by each, and the tax years and applicable amounts in which such dividends were earned in such form and manner as may be prescribed by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury."[33] While not in terms required by the Act it would seem also to be the duty of the corporation or individual receiving the dividend to ascertain this information from the paying corporation and to make their returns accordingly. However, these are mere matters of detail. The important point is that Congress has definitely withdrawn from the field of income taxation, "gains, profits and income" accruing prior to March 1st, 1913, and has also established a workable, and as we believe, equitable means of taxing corporate earnings accumulated subsequent to March 1st, 1913.

The Rule in Pari Materia.

The argument in support of our contention that the decisions reached in the *Lowe, Gulf Oil* and *Eisner Cases* are incorrect, is strengthened in view of the well established principle that acts in *pari materia,* that is, acts relating to the same general subject matter are to be construed together. "All the enactments of the same legislature on the same general subject-matter are to be regarded as parts of one uniform system. Later statutes are considered as supplementary or complementary to the earlier enactment. In the course of the entire legislative dealings with the subject we are to discover the progressive development of a uniform and consistent design or else the continued modification and adaptation of the original design to apply to changing conditions or circumstances. In the passage of each Act the legislative body must be supposed to have had in mind and in contemplation the existing legislation on the same subject and to have shaped its new enactment with reference thereto."[34]

When we come to consider therefore the language of the Act of October 3, 1913, itself, and particularly that provision which limits for the year 1913 the taxable income to that income "accruing" sub-

[33] Subsec. 26 of Sec. 1210, Act of September 8th, 1916, as amended by Act of October 3rd, 1917.

[34] Black, Interpretation of Laws, (2nd, ed.) pp. 332-334.

sequent to March 1, 1913, and when we read these provisions in conjunction with the language of the original Act of 1916, as amended by the Act of October 3, 1917, limiting taxable profits on sales of property and taxable dividends to those *accruing* after March 1, 1913, and permitting the distribution of earnings accrued prior to March 1st, 1913, as tax free dividends, the *consistent* design of Congress at all times to tax only those profits or dividends which *accrue* after the incidence of the tax to be levied is apparent:

The decisions in the *Lowe, Eisner* and *Gulf Oil Cases* are the more inexplicable, in that they were all handed down subsequent to September 8th, 1916, and while not arising under the Act of that date the definition of "dividends" therein contained limiting dividends taxable as income to those accruing subsequent to March 1st, 1913, should have had a great, if not controlling influence on the courts in construing the terms, "gains, profits and income" as used in the earlier Act.

While disclaiming all desire or intention to be unduly critical, we believe the facts warrant the statement that the Treasury Department quite consistently—or inconsistently—and the Federal Courts at times—notably in the *Gulf Oil, Eisner* and *Lowe Cases*—in the administration of the income tax laws, have been disposed to reverse the usual rule applicable to the construction of internal revenue laws in general, and specifically income tax laws, and to resolve all doubts against the taxpayer, and in favor of the Government. In this connection the late case of *Gould* v. *Gould* is most pertinent. In that case the Supreme Court of the United States, speaking by Mr. Justice McReynolds said:—"In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government and in favor of the citizen."[35]

It is perhaps pertinent to note that while income taxation has for many years in England and other countries been a constant and substantial source of revenue, until a comparatively recent time there has been a marked aversion by the American people to any form of income tax. That a present necessity for income taxation in this country exists and that such necessity will be a continuing one, seems certain. It would, therefore, be most inadvisable and impolitic for the Treasury Department and the courts to insist on a

[35] Gould v. Gould (1917, 38 Sup. Ct. 53.

theory of administration of our income tax system which would exact the last pound of flesh from the already over burdened taxpayer.[36]

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[36] While the decisions of the United States Circuit Court of Appeals are ordinarily final in income tax cases (Sec. 128, Judicial Code, 36 Stat. at L. 1133. Comp. St. 1911, p. 193), if the views above expressed are correct then it would seen to follow that there is a constitutional question involved in the case of Lewellyn, Collector v. Gulf Oil Corporation and similar cases entitling the tax payers to have the cases reviewed by the Supreme Court of the United States.

The writer has been advised unofficially by the Clerk of the United States Circuit Court of Appeals for the Third District that an application for a writ of certiorari to the Supreme Court has been or is to be made in the case of Lewellyn v. Gulf Oil Corporation, supra.