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Tax News

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TAX NEWS

TENNIE C. LEONARD, C.P.A., *Memphis, Tennessee*

It has long been an axiom that income taxes and equity have nothing in common. It is becoming equally evident that there is no consanguinity between income taxes and consistency.

In a decision recently handed down by the Tax Court (Vander Poel, Francis & Co., Inc., 8 TC 407) the Court held that although a cash basis taxpayer has constructively received a payment of salary it does not follow that the cash basis employer constructively paid the salary, and hence may not deduct it. The Court conceded that the decision lacked logic but held that deductions are a matter of legislative grace and must be strictly construed. Two judges dissented. The Court did not, however, attempt to pass on the source of the income the employee received.

In another decision, equally inconsistent but perhaps more understandable (Barbara M. Lockard, 7 TC 1151), the Court held that although for gift tax purposes the taxpayer had made her husband a taxable gift, for income tax purposes she had not, and must pay taxes on the income from the gift.

* * *

It is very seldom that a Circuit Court of Appeals will take the trouble to figuratively pat the taxpayer on the back and tell him he's right and that he has the Court's sympathy. When the Fifth Circuit Court did that very thing recently, "Tax Barometer", Research Institute of America, and "What's Happening" all considered the Court's dictum worthy of quotation. We do too, and here is what the Court had to say in a case involving unreasonable compensation:

> "The point is often made in tax cases that the fixing of salaries of the sole stockholders between themselves and the corporation is not an arm's length transaction and therefore should be carefully scrutinized, but as an apposite to this it would appear also that the tax gatherers ought, in appropriate cases, to consider the fact that the sole stockholders often not only risk their capital and credit, but also the loss of their time and effort, knowing full well that the corporation must first earn their salaries before they can be paid, and that salaries of all other employees must be paid before theirs, and to that extent their salaries are, more or less, contingent. Generally, contingent compensation is expected to be larger than compensation that is fixed and definite. It would not seem to be an unreasonable business practice for an employer to recognize sacrifices made by employees in the hard formative days by granting a more generous compensation in the days that are lush. Neither the statutes nor the regulations seem to require that this be done, unless they impliedly contain the concept that that which is right and that which is just would also be reasonable."

It would be nice to be able to report that the Fifth Circuit, after such a sales talk, had held that the salaries paid were reasonable, but the sad fact is that it held that reasonableness of salaries is a question of fact and not of law and that under the Dobson rule, the decision of the Tax Court, adverse to the taxpayer, must be upheld. (Commercial Iron Works, CCA 5th)

* * *

If we appear to be something less than awe-struck at the wisdom of tax courts in general in this issue, it may be because we have just been slapped down in one of our own cases. The issue involved was the addition to a reserve for bad debts for the years 1942 and 1943. The Commissioner disallowed the total additions to the reserve for those years on the grounds that the existing reserves were sufficient. By the time the examining officer got around to looking at the reserve, those accounts that were of dubious value in 1942 and 1943 had finally been collected. The Tax Court's decision (John Fa-

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bick Tractor Company, TC Memo No. 12519) upheld the Commissioner and stated:

"We have no means of measuring the actual risk involved in those accounts which caused concern to the petitioner's officers. We do know that those accounts were collected in full."

Of course, every tax practitioner is entitled to a brief period of lamentation over a lost tax case, but while there was ample reason for the Court's decision, we would have felt so much better if the reason hadn't been hindsight applied in 1948 to a 1942 transaction, a method the Tax Court itself abjured in Apollo Steel Company, TC Memo opinion, Docket No. 3436.

* * *

Every accountant preparing a tax return has at one time or another claimed deductions for small amounts as "net cash shortages". Usually, when the deductions are small they are not questioned by the examining officer, but where the amounts are substantial, the taxpayer may be called upon to prove his loss, and it is necessary to show the examiner more than the fact that the books don't balance. (Nelson, 6 TC 764; Columbia, 21 BTA 1270; Fair Store, 11 BTA 1033; Union Savings, 10 BTA 1175.) But the First National Bank of Bellflower (10 TC No. 44) proved its loss and was allowed a deduction of $1,700 for checks returned to its depositors without having been charged to their accounts. It took an audit to establish the loss.

* * *

The Commissioner and the Courts frequently rely on Code Section 41 in so far as it relates to computation of net income by such method as will "clearly reflect the income". However, a recent case, Carver, 10 TC No. 23, has applied Section 41 as it relates to computing net income in accordance with the method of accounting regularly employed in keeping the books of a taxpayer. Mr. Carver started a printing business in 1909. Until 1925 he kept his books on the cash basis. In 1925 he adopted an accounting system developed by the printing industry and changed his records over to the accrual method; however, he continued to make his tax returns on the cash basis. In 1941, the Commissioner challenged Mr. Carver's return, relying on Code Section 41, made adjustments necessary to place the return on the same basis as the books, and increased his 1941 tax by $25,000. The Tax Court in upholding the Commissioner said that it did not matter why the Commissioner had failed to make the change prior to 1941. He had authority to decide that the changes should be made in that year. Taxpayers will do well to take cognizance of such tax traps. When these obscure provisions are overlooked or when changes in method or time of reporting are made without permission of the Commissioner, the taxpayer is at the mercy of the Commissioner. It usually develops that there is no mercy and the adjustments fall in a year when it will hurt (cost) the most.

* * *

Code Section 107 provides for special advantages to individuals or partnerships who receive in one year eighty per cent of the compensation for services rendered over a period of three or more years. If the conditions of Section 107 are met, the current year's tax is computed as if the compensation had been received ratably over the years in which the services were performed. There has been considerable doubt in the minds of tax practitioners as to how the forgiveness features of the Current Tax Payment Act affect the computation of long-term compensation under Code Sec. 107. They have been reluctant to accept a Bureau ruling issued in 1945 to the effect that the forgiveness provisions of the Current Tax Payment Act were not to be applied to the 1942 and 1943 portions of the computation of the tax for 1944 under Section 107. All doubt is now removed as the Bureau has reversed its ruling of January 11, 1945, and states in a special ruling released on February 6, 1948 that its present position is that the forgiveness provisions of the Act may be applied in computing the tax on long-term compensation received in 1944, or a subsequent year, even though all or part of such income was earned in the year 1942 and/or 1943.

* * *

A new ruling by the Treasury Department —IT 3888, 1948-3-12741—will be of particular interest to women. It deals with the situation of a woman with no gross income. During the taxable year she became a widow and was remarried to a second husband before December 31st. The Treasury Department quite generously holds that she was an exemption on the final return of the deceased husband, and also an exemption on the return of the husband with whom she was living at December 31st. Thus, one wife was good for $1,000 in income tax exemptions, whereas the wife to whom nothing ever happens is worth only $500 in exemptions.

This ruling is interesting when compared

(Continued on page 13)

Machines used include 3 alphabetic tabulators, 2 collators, 1 sorter, 1 multiplying punch, 1 alphabetic interpreter, 1 reproducing summary punch, 1 combination gang punch and summary punch, 3 alphabetic key punches, 1 numeric key punch and 1 numeric verifier.

There are 14 permanent plug boards used on the tabulators. Some are used for two or more applications by simple changes in an auxiliary panel which gives flexibility to the boards.

In addition to labor savings, there is a corresponding saving in supervision and floor space. Another distinctive advantage lies in the overall effect of smooth running operation on morale. Moreover, the fact that punched card accounting is handled by a department entirely independent of departments in which entries originate greatly facilitates internal audit control.

Altogether, advantages seem to equal uses, and the uses to which tabulating equipment may be put are as broad as the imagination of management.

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with IT 3832, CB 1947-1, 28, which holds that no husband is entitled to exemptions for two wives, even though he supported both of them during the year, and not even one wife if the second claims her own exemption.

This sort of thing must have implications of some kind, but just what they are is beyond us. What conclusions do you draw from the Treasury's reasoning?

* * *

The Treasury Department has finally been able to count the individual income tax returns filed in 1945 and finds there were 49,965,474 of them, an increase of 6.1% over 1944. The tax liability shown by the returns was $17,050,378,000, an increase of 5.1% over 1944. This would mean an average of $341.24 per return, but a great many of the returns showed no tax liability at all, or even refunds due. The Treasury Department estimates that of a total of 52,800,000 returns of all kinds filed in 1946, 14,100,000 were not taxable. The Treasury Department estimates that the tax reduction bill now before Congress would remove 6,300,000 persons from the tax rolls, but that still leaves a lot of tax returns to be filed.

* * *

Now that the Tax Department, 1948 Series, has been launched, we hope in future issues this year to discuss current rulings and decisions of general interest as they appear, to disseminate such news as comes to hand of new theories and methods in tax work, with particular emphasis on what Mr. J. K. Lasser calls "tax craftsmanship" rather than on the finer points of the legal lore of taxation. If you've had an interesting or unusual experience in taxation, share it with us; if you have questions, send them in. We'll try to find someone who can answer them.

DETECTION OF IRREGULARITIES

Failure to observe the precaution of sending out confirmation requests in their own envelopes caused auditors to muff a shortage in the accounts of one of their clients. The treasurer of the corporation, whose offices were outside New York City, recorded on the corporation's books an account in the name of a fictitious bank in New York. He then from time to time misappropriated funds and recorded such funds as transfers to this fictitious bank. There were so few transactions in the account that it was regarded as dormant.

The auditors regularly sent out requests for confirmation of all bank balances, but mailed them in the client's envelopes. When the envelope was returned to the client as undeliverable, the treasurer received it, completed the confirmation, signed a fictitious name as representing an official of the bank, inserted the confirmation in the return envelope, and took it to New York and mailed it to the auditors.

The shortage was disclosed when new accountants took over and followed the established procedure of mailing all confirmation requests in envelopes bearing their own corner imprint.

* * *

PRONOUNCE IT CORRECTLY

Considering the vast number of manufacturing concerns which employ public accountants, it is really too bad that any of us should mispronounce the word *manufacture* and its derivatives. Along with millions of other Americans, we too often pronounce the *u* as if it were *a* and say *man a fac ture*. The *u* should be clearly pronounced; as, *man you fac ture*.

Government is a word with a large place in the accountant's conversation. Close listening will reveal that a large number of us drop the *n*, pronouncing it *gov er ment*. Let's not cheat the government out of one of its letters.

JENNIE M. PALEN