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Income Tax Department

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Rulings in connection with several of the federal taxes have been issued by the treasury department during the past month.

I. INCOME TAX

T. D. 2468 contains a new form called form 1012 (revised), to take the place of forms 1012, 1012A, 1012B, 1012C and 1012D for use in making the monthly list return of normal income tax withheld from interest paid on bonds and mortgages or deeds of trust or other similar obligations of corporations, etc. The modifications on the previous form seem slight.

T. D. 2475 gives the decision of the United States circuit court of appeals in the case of the Union Hollywood Water Co., a public utility corporation, vs. John P. Carter, a collector, the basis of the action being the payment under protest of certain taxes under the corporation excise tax law of 1909. Two interesting points are decided in this case. The first one is that, notwithstanding the fact that a public utility company may not be the owner of its plant and property devoted to public use in the sense of personal ownership, but is merely entrusted with the use thereof, which it must devote to the public, nevertheless it is still a corporation "organized for profit and having a capital stock represented by shares" and is subject under the law to pay the excise tax on its whole income. The other point dealt with in the case relates to receipts from consumers to pay for service connections to be laid in public streets, which receipts were practically all spent in laying such service connections. The corporation, while including the receipts in the return as part of its gross income, claimed as deductions the amount so expended by it for service connections and pipe extensions. The court held that the moneys contributed by the consumers were properly included in the gross income, but that the moneys expended were invested in permanent improvements which tend to enhance the rental and the market value of the water system and were not permitted to be deducted from the gross amount of the income as they do not come within any of the permitted classes of deductions mentioned in the statute.

T. D. 2476 extends the time in which nonresident alien individuals and corporations and American citizens residing or traveling abroad may make returns of income for 1916 to September, 1917.

II. CAPITAL STOCK TAX

T. D. 2457 gives the opinion of the commissioner of internal revenue that a company organized for the purpose of owning, developing and speculating in mining land or other real property is engaged in business within the language of the several supreme court decisions and is subject to the capital stock tax imposed by the act of September 8, 1916.

T. D. 2467 modifies a previous ruling and now provides that any surplus or undivided profits of a foreign corporation invested in United States bonds or other securities having no connection whatever with the actual business of the corporation transacted in this country should not be included in "capital invested in the United States."

III. Munition Manufacturers' Tax

T. D. 2458 also modifies a previous ruling as to the taxation of net profits received in 1916 on contracts partly executed prior to January 1, 1916. The commissioner now holds that all net profits received in 1916 on contracts not fully completed prior to January 1, 1916, are taxable even though partly earned in a prior year. The test to be applied evidently is whether or not the contract under which the profits accrued was fully performed prior to January 1, 1916. If the contractor had fully complied with all the terms of the contract, both as to manufacture and delivery, the profits even though collected in 1916 need not be included in the return; but if any part of the contract was not completed then all the profit is required to be included in the return. The commissioner's position may be in accordance with the law, but it certainly is not just or equitable and rather seems to carry his function of collecting as much as possible for the government to extremes.

In addition to the rulings there is published under the heading of *Income Tax* a letter from the deputy commissioner dealing with including among the deductions of a corporation the amount of discount and expenses of an issue of five-year bonds. The commissioner states that the amount of discount and expenses should be prorated over the life of the bonds and the due proportion included among the deductions each year. And this is permitted notwithstanding the whole amount was written off against surplus in the year of issue. It is gratifying to have this clear expression of the position of the department because we must confess we had still been of the opinion that the department would not allow as a deduction any item which was not reflected in the books of account of the corporation in the year of the return.

There is also included in the income tax division a letter from a correspondent dealing with the position of accountants under the income tax law which brings up a matter of great interest in these times when federal taxation generally is becoming so important a matter to every American citizen.

I. Treasury Rulings on Income Tax

(T. D. 2468, March 26, 1917)

Revision of monthly list return, form 1012, and amending T. D. 1914 of December 9, 1913, accordingly.

Income tax forms 1012, 1012 A, 1012 B, 1012 C, and 1012 D, as provided by T. D. 1914 of December 9, 1913, and as required to be used prior to the date of this regulation, are hereby superseded and from and after the date of this regulation the monthly list return of normal income tax

withheld from interest paid on bonds and mortgages or deeds of trust or other similar obligations of corporations, etc., shall be in the following form:

Form 1012. (Revised.)

To be Filled in by the Internal Revenue Bureau.
File No. .....
Audited by .....

United States Internal Revenue

MONTHLY LIST RETURN OF AMOUNT OF NORMAL INCOME TAX TO BE PAID AT THE SOURCE

To be made in duplicate to the collector of internal revenue for the district in which the withholding agent is located, on or before the 20th day of each month following that for which this return is made, showing the names and addresses of persons who have received payments of interest upon bonds and mortgages, or deeds of trust, or other similar obligations of corporations, etc., on which the withholding agent is liable for the normal tax of 2 per cent.

.....
(Name of debtor organization.)

.....
(Full post-office address.)

.....
(Name of withholding agent.)

.....
(Full post-office address.)

(Above space to be stamped by collector, showing district and date received.)

(If debtor corporation makes its own withholding return, no entry need be made above on line provided for name of withholding agent.)

For the Month of....., 19..

I certify that the following is a true and complete return of all normal tax amounting to $....., required to be withheld and paid by the above debtor organization, with respect to all interest payments made during the month stated above, upon its bonds and mortgages, or deeds of trust, or other similar obligations; and that there are herewith inclosed all certificates* which were presented with coupons or with respect to interest orders.

To.....
Collector.

.....District of.....

.....
(Address.)

Signed:

.....

.....
(Capacity in which acting.)

*List alphabetically below only certificates disclosing tax liability, but transmit all certificates with this return.

Note.—All substitute certificates of collecting agents, authorized by regulations, that are received by debtors or withholding agents will be considered the same as certificates of owners, and in entering same in making monthly list returns, debtors or withholding agents will enter the name, address, and the number of the substitute certificate of the collecting agent in lieu of the name and address of the owner of the bonds.

Name of payee	Address in full	Amount of income on which withholding agent is liable for tax	Amount of tax liability
.....	.....	$.....	$.....
.....	.....	.....	.....
.....	.....	.....	.....
Total (continue on form 1012 A, revised, if necessary).....		.....	.....

While certificates are required to be listed alphabetically where the volume of business is sufficiently large to require or make advisable a daily listing of certificates, in all such cases alphabetical listing will not be insisted upon, but all certificates must be packed and forwarded to this office in the order in which listed.

Where an extension sheet is required it shall be in the following form:

UNITED STATES INTERNAL REVENUE

CONTINUATION SHEET—FORM 1012 A—(REVISED)

Name of payee	Address in full	Amount of income on which withholding agent is liable for tax	Amount of tax liability
Totals brought forward.....	.....	$.....	$.....
.....	.....	.....	.....
.....	.....	.....	.....
Totals carried forward.....		.....	.....

Return on this form shall be made monthly on or before the 20th day of the month for income tax withheld in the preceding month.

The use of forms 1012 A, 1012 B, 1012 C, and 1012 D is discontinued.

A summary of monthly list returns as herein provided and made during a calendar year will be listed on income tax form 1013, and this annual list will be filed with the collector of internal revenue on or before March 1 of each year and will constitute the annual withholding return of debtor corporations or their withholding agents for normal income tax withheld from interest paid on bonds and mortgages or deeds of trust or other similar obligations of corporations, etc.

This return shall be printed on white paper, on sheets in size 16 by 10½ inches, and shall be printed to read along the 10½-inch dimension, with horizontal and column lines and headings as shown by the form herein provided. These forms will be furnished by the government.

Monthly list returns made on forms in use prior to the date of this regulation will be accepted by the government up to and including April 20, 1917, but all monthly list returns for April and subsequent months shall be made on the form here prescribed.

Corporation excise tax—Act of August 5, 1909—Decision of court

1. PUBLIC UTILITIES.

The fact that plaintiff was a public utilities corporation which, under the laws of the state, was not the owner of the property but merely entrusted with the use thereof, which it must devote to the public, does not entitle it to more favorable treatment than other corporations, it being a corporation organized for profit, having a capital stock represented by shares, and the act making no exceptions in favor of public utilities.

2. MONEYS RECEIVED FROM CONSUMERS OF WATER FOR SERVICE CONNECTIONS AND PIPE EXTENSIONS.

Moneys so received for service connections and pipe extensions are not permitted to be deducted from the gross amount of the income, for they do not come within any of the permitted classes of deductions mentioned in the statutes. Moneys so expended are invested in permanent improvements, which tend to enhance the rental and market value of the water system. (238 Fed., 329.)

The appended decision of the United States circuit court of appeals in the case of the *Union Hollywood Water Co. vs. John P. Carter,* collector, is published for the information of internal revenue officers and others concerned.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

Union Hollywood Water Co., a corporation, plaintiff in error, vs. John P. Carter, collector of the United States internal revenue for the sixth district of the state of California, defendant in error. No. 2837.

Before GILBERT, MORROW and HUNT, circuit judges

GILBERT, circuit judge: The plaintiff in error, a corporation, having paid under protest certain taxes under the act of August 5, 1909, section 38, for the years 1912 and 1913, brought an action in two counts to recover the sums so paid. The facts and the questions involved are the same in the two counts, and it will be sufficient to refer only to the first.

It is alleged therein that the plaintiff in error, being a public utility corporation engaged in furnishing water for domestic use and irrigation, received in the year 1912 from consumers, to pay for service connections to be laid in public streets, the sum of $33,024.50, and that it expended in laying such service connections the sum of $31,006.12, that in the same year it received from property owners and persons engaged in the subdivision and sale of real estate, to pay for extensions of the water system to their property the sum of $52,895.65, and expended in laying such extensions in and through such property the sum of $51,235.12. Upon all of said sums so received for service connections and for the extension of the system into the lands of others, the plaintiff in error was required to pay a tax, although in its income tax returns, while it had included those receipts in its gross income, it had claimed a credit and deduction for the amount so expended by it for service connections and pipe extensions. The court below denied the right of the plaintiff in error to recover.

The plaintiff in error contends that the moneys so received from property owners were not "gains, profits, or income" within the meaning of the statute; that they were moneys contributed solely for the purposes designated, and for the benefit of the contributors of the same, and were not subject to distribution among the stockholders of the corporation as dividends or otherwise, and could be used only for the specific purposes

for which they were contributed; that while the effect of the connections and extensions was to increase the plaintiff in error's plant, it was not to increase its gains, profits or income.

The question so presented does not seem to have been considered in any reported case. The statute provides that for the determination of the amount of the annual excise tax, which is fixed as the equivalent of 1 per cent. of the net income above $5,000, the net income shall be ascertained by deducting from "the gross amount of the income of such corporation . . . received within the year from all sources": (1) Its expense of operation paid out of income; (2) its losses, including a reasonable allowance for the depreciation of its property; (3) certain interest paid by it; (4) taxes paid by it; (5) dividends on stock of corporations subject to the excise tax. The plaintiff in error being a public utility corporation, we may assume that in the ordinary course of its business its income consisted principally of the sums paid to it by consumers for the use of water furnished by it. But it may also have other income, and we are of the opinion that contributions made by consumers of water or owners of land tracts for service connections and pipe extensions are income within the meaning of the act. Such contributions are moneys which come to the corporation in the ordinary course of its business, and they are properly included in a statement of its gross income "received within the year from all sources," and the corporation is liable to pay a tax thereon, notwithstanding that all or nearly all of the sum so received may have been expended within the year in betterments and the extension of its system.

Moneys so received for service connections and pipe extensions are not permitted to be deducted from the gross amount of the income, for they do not come within any of the permitted classes of deductions mentioned in the statute. Moneys so expended are invested in permanent improvements which tend to enhance the rental and the market value of the water system. They are not in the nature of improvements made merely to facilitate the transactions of a growing business, the expenses of which have been held deductible as necessary expenses of the business in computing the taxable net income of the corporation. *Connecticut Mutual Life Insurance Co. vs. Eaton* (218 Fed., 206).

The plaintiff in error claims that it should be distinguished from ordinary business corporations in that it is a public utility company, and under the laws of California it is not the owner of its plant and property devoted to public use in the sense of personal ownership, but is merely entrusted with the use thereof, which it must devote to the public. But we are unable to see in that fact any ground for holding that it is not subject to the plain provisions of the statute. It is still a corporation "organized for profit and having a capital stock represented by shares." It does not deny that it is subject under the law to pay an excise tax. If so, it is subject to pay the whole of the tax, and it is to be dealt with precisely as any other corporation. The statute makes no exception in favor of public utility corporations.

Nor do we think that a different conclusion should be reached because of the fact that the railroad commission of California has decided that meters and service connections paid for by consumers are not to be included in the valuation of the water company's plant upon which it is entitled to earn a fair return. *City of Eagle Rock vs. Eagle Rock Water Co.* (3 C. R. C., 1054); in the matter of the application of the San Gabriel Valley Water Co. (8 C. R. C., 481). In the latter of these cases the commission said:

Although these pipes were expressly donated to the company, they are not the property of the water company, and as such the company is entitled to a return on their fair value. On the other hand, the use value is

not measured by an estimate of cost, for there are a number of these pipe lines that have only one consumer for a large investment, and it is obviously unfair to permit it to become a burden upon the remainder of the system.

It does not follow from these decisions of the California commission that moneys contributed for service connections must not be regarded as income, gains or profits for the purpose of determining the amount of the excise tax under the law of the United States. In *Stratton's Independence vs. Howbert* (231 U. S., 400, 417) the court said:

Evidently congress adopted the income as the measure of the tax to be imposed with respect to the doing of business in corporate form because it desired that the excise should be imposed, approximately at least, with regard to the amount of benefit presumably derived by such corporations from the current operations of the government.

The court further said:

Moreover, congress evidently intended to adopt a measure of the tax that should be easy of ascertainment and simply and readily applied in practice.

And further observed:

It was reasonable that congress should fix upon gross income, without distinction as to source, as a convenient and sufficiently accurate index of the importance of the business transacted.

And from this point of view it makes little difference that the income may arise from a business that theoretically or practically involves a wasting of capital.

The judgment is affirmed.

(T. D. 2476, April 5, 1917)

Extending provisions of T. D. 2445 of February 12, 1917, which granted an extension of time in which to file returns of income for 1916 by nonresident alien individuals and corporations and American citizens residing or traveling abroad.

The provisions of T. D. 2445 of February 12, 1917 (extending "to include May 1, 1917," the time in which nonresident alien individuals and corporations and American citizens residing or traveling abroad may make returns of income for 1916) are hereby extended to include September 1, 1917.

In all such cases there is required to be attached to the return a statement of the reasons for the delay, and if any extension of time beyond September 1, 1917, shall be necessary, it is required that an application be made in each particular case, with a statement for the reasons for the request.

II. Treasury Rulings on Capital Stock Tax

(T. D. 2457, March 14, 1917)

Capital stock tax

A corporation organized for the purpose of buying, owning, exploring, developing, leasing, improving, selling, and dealing in lumber lands, mining lands, or other real property is "engaged in business" and subject to the capital stock tax.

Sir: Receipt is acknowledged of your letter of the 9th instant, inclosing a copy of a communication from the ——— Coal & Coke Co., which is assessed $325.25 capital stock tax on your form 23 C for January, 1917, folio 4, line 11, contending that it is not subject to this tax, inasmuch as

it is "not an operating company, but is the owner of lands and coal lands . . . which have never been mined since the organization of the company."

Mr. ———, secretary and treasurer of the company, refers to a statement made by a collector of internal revenue that he "is not enforcing the payment or assessing any taxes against companies that are not operating."

In reply to your inquiry you are advised that Mr. ——— has undoubtedly misinterpreted the statement of the collector as applying to his company. Under the decision of the supreme court in the case of *Von Baumbach vs. Sargent Land Co. et al.*, decided January 15, 1917 (printed in T. D. 2436) it is very clear that a company organized for the purpose of buying, owning, exploring, developing, leasing, improving, selling, and dealing in lumber lands, coal or other mining lands, tenements, and hereditaments is an active corporation if it performs *any* of those powers, and is subject to the capital stock tax.

It appears from Mr. ———'s letter that the ——— Coal & Coke Co. is not a corporation that has discontinued business, as in the case referred to in *Zonne vs. Minneapolis Syndicate* (220 U. S., 187), but is still active and is maintaining its organization for the purpose of continued efforts in the pursuit of profit and gain and such activities as are essential to those purposes.

A number of inquiries have been made regarding the liabililty of corporations of this character to the capital stock tax, and this office has held in each case that a company organized for the purpose of owning, developing, and speculating in mining land or other real property is engaged in business within the language of the several supreme court decisions, and is subject to the capital stock tax imposed under section 407, act of September 8, 1916.

(T. D. 2467, March 27, 1917.)

Capital stock tax

Paragraph 2 of T. D. 2417 of December 16, 1916, amended.

The ruling published in paragraph 2 of T. D. 2417, of December 16, 1916, is hereby amended and corrected to read as follows:

Any surplus or undivided profits of a foreign corporation that are invested in United States bonds or other securities having no connection whatever with the actual business of the corporation transacted in this country may be stated on the return, form 708, under item 3, but should not be included under item 1 as "capital invested in the United States."

III. Treasury Rulings on Munitions Manufacturers' Tax

(T. D. 2458, March 16, 1917.)

Munitions manufacturers' tax

Net profits received in 1916 or subsequent years on munitions contracts entered into but not fully performed prior to January 1, 1916, shall be returned for the purpose of the tax as income of the year in which received.

Your attention is called to the fourth full paragraph of article 10, regulations 39, issued under date of October 24, 1916, which reads as follows:

If, however, the contracts were not fully performed prior to January 1, 1916, any profits resulting from that part of the contracts performed subsequent to January 1, 1916, must be returned for the purpose of the tax.

This paragraph would imply that any profits received subsequent to January 1, 1916, resulting from that part of the contracts performed prior to that date, might be omitted from the income returned for the purpose of the tax. To the extent that this paragraph is subject to this interpretation, it is erroneous.

Section 301 of title III of the act of September 8, 1916, contains a proviso which reads as follows:

Provided, however, that no person shall pay such tax [12½ per cent. on the entire net profits] upon net profits received during the year nineteen hundred and sixteen derived from the sale and delivery of the articles enumerated in this section under contracts executed and fully performed by such person prior to January first, nineteen hundred and sixteen.

This proviso applies only in cases wherein the contracts were both executed and *fully performed* by the contractor prior to January 1, 1916, all manufacturing having been completed and all deliveries having been made, so that there remains only the collection of any amounts due and unpaid on such fully performed contracts.

In such cases the amounts received subsequent to January 1, 1916, on such fully performed contracts will not be returnable for the purpose of the tax when received. If, however, subsequent to January 1, 1916, net profits are received on contracts entered into and but partially completed prior to that date, the amount of such net profits so received on such partially completed contracts shall be returned as taxable profits for the year in which received. Except as indicated in the proviso hereinbefore quoted, the tax imposed by this title is assessable upon the entire net profits *received or accrued* during the taxable year.

Whether any net profits received subsequent to January 1, 1916, are taxable under this title will depend upon whether or not the contract under which the profits accrued was fully performed prior to that date. Unless the contract was so fully performed prior to January 1, 1916—that is, unless the contractor had fully complied with all the terms of his contract, both as to the manufacture and delivery of the articles covered by the contract—any profits received subsequent to January 1, 1916, on such contract, even though in payment of deliveries made prior to that date, must be returned for the purpose of the tax for the year in which received.

In so far as the paragraph in article 11, regulations 39, implies that any profits which accrued on deliveries made in 1915 under contracts not fully performed prior to January 1, 1916, and which profits were received subsequent to that date, should not be returned as taxable income when received, it is erroneous, and is hereby annulled.

The tax being imposed upon net profits received or accrued, the revised ruling, as hereinbefore set out, contemplates that all *net profits received* subsequent to January 1, 1916, on contracts not then fully performed must be returned as taxable profits of the year in which received. regardless of when they may have been earned or accrued. Hence net profits received subsequent to January 1, 1916, on deliveries made under contracts which were but partially performed at that date constitute taxable income of the year in which received and cannot be lawfully excluded therefrom.

Collectors will advise munitions manufacturers of the substance of this decision.

Copy letter re Discount on Bonds

Treasury Department, Washington, March 8, 1917.

GENTLEMEN: This office is in receipt of your letter of the 1st instant in which you state that in the year 1915 your corporation sold an issue of five year first and consolidated mortgage bonds at a discount and wrote

the entire amount of the discount and re-financing expenses off against surplus in that year, and that now a representative of this office who has been making an examination of your books has stated that it is a rule of the department that if the above practice is followed no deduction therefrom can be made in years subsequent to that in which a loss through discount on bonds had been sustained and charged off against surplus.

In this connection you are advised that if the examining officer made the statement which you attribute to him it was evidently an error, inasmuch as this office has consistently held that discount on bonds issued by a corporation and the expenses incidental thereto should properly be distributed over the life of the bonds and an equal amount be deducted annually instead of claiming the entire deduction in one year. Even though in the year 1915, when such bonds were issued at a discount, you charged the entire amount to surplus, this office is of the opinion that you are entitled to an annual deduction, based upon the life of the bonds, to make good at the time the bonds mature the entire loss which will have been sustained by your corporation through the discount on the bonds and expenses of issuing the same. It is requested, however, that if possible you will make entries on your books which shall tend to show in future years the amount originally written off against surplus on this account in 1915, the number of years constituting the life of the bonds and the amount claimed annually in preparing your return of annual net income. This would serve the purpose of furnishing the required information to any examining officer who might have occasion to examine your books in some future year.

Respectfully,
(Signed) L. F. SPEER,
Deputy commissioner.