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Roscoe L. Thomas

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# Federal Income Taxation

BY ROSCOE L. THOMAS

WHILE something in the nature of taxes may be found in the most ancient history, it is safe to say that taxation as we now understand the term is something new in the world's history. We now consider taxes as a regularly recurring burden falling upon all inhabitants of a country, and we expect taxes to defray the greater portion of the heavy and increasing expenses of our various governments.

The problem of distributing the burdens of taxation is age old and is intimately connected with and affected by the governmental structure and the traditions of the people. Interest in taxation varies from time to time. People all over the country are now interested in the problem perhaps as never before.

Demands for public services and resulting governmental costs have tremendously increased in recent years. Most of these increased costs have been added to the tax burden on incomes and property. As a result, taxes are little short of confiscatory and property owners are everywhere seeking relief.

## HISTORICAL REVIEW

In taking up the discussion of the income tax in the United States it is doubly important to treat it from the historical point of view. For in the first place, not only is it true that one generation is prone easily to forget the experiences of its predecessor, but in the second place the correct interpretation of certain important clauses in the American Constitution which have a vital bearing upon our topic depends in very large measure upon the historical setting.

The first general tax law in the American colonies, with the exception of the early poll tax in Virginia, was the law of

1634 in Massachusetts Bay. This provided for the assessment of each man "according to his estate and with consideration of all other his abilities whatsoever."

It was not until seven years later that "ability" was defined to include something more than mere property. This, however, occurred not in Massachusetts Bay, but in the colony of New Plymouth.

The principle thus laid down in the records of Massachusetts Bay was soon adopted by other colonies. The colony of New Haven, for instance, at first levied a land tax. As early as 1640, however, personal property was assessed, by the provision that a new rate should be "estreated, half upon estates, half upon lands." In 1645 it was seen that even this was not adequate, and a proposal was made to tax others besides property owners; but no decision was reached at that time. As the dissatisfaction grew, a committee was appointed in 1648 to inquire into the feasibility of the Massachusetts system of taxing all property in general, and also of levying a tax on the profits of those who possessed no property. The committee reported that they were in doubt as to the advisability of taxing houses and personal property, but that "for tradesmen they think something should be done that may equal in ways of rating them for their trades." As a result the law of 1649 was enacted, which introduced the taxation of profits of laborers, tradespeople, and others.

Except as to the rates, this form of law continued unchanged till 1777. The law enacted in this year gives a fuller interpretation of income than any hitherto. Taxpayers are assessed "on the amount of their income from a profession, faculty, handicraft, trade, or

employment; and also on the amount of all incomes and profits gained by trading by sea and on shore and by means of advantages arising from the war and the necessities of the community."

The first suggestion of a federal income tax was made in January 1815, by Secretary Dallas. As a so-called direct tax on lands and slaves was already in existence, Dallas, like virtually everybody else at the time, assumed that this suggested income tax would not be one of the direct taxes contemplated by the constitution.

It was not until the outbreak of the Civil War that the Government again resorted to the system. On July 4, 1861, Secretary Chase made a report in which he suggested that a small part—not to exceed twenty millions—of the required revenue be raised by direct taxes or internal duties or excises, or both.

As a matter of fact, the act of 1861 was never put in force.

The law of 1862 imposed a comprehensive code of internal revenue taxes, of which the income duty formed only a part.

As the war progressed, the need of more revenue was apparent, and in the spring of 1864 Congress prepared a far more elaborate and comprehensive code of taxation, which finally became law on June 30th. This law included some important changes in the income-tax provisions, which were preceded by an interesting discussion. A large part of this discussion turned on the question of graduation.

For almost two decades after the abandonment of the income tax the subject disappeared from the public mind. During the beginning of the nineties, however, the situation changed.

The 1894 income-tax law was copied, with a few important exceptions, almost word for word from the old legislation of the Civil War period. I shall therefore only summarize its chief provisions.

The tax was to begin on January 1, 1895, and to continue for five years. The

rate was two per cent on the excess over \$4,000. It was levied upon all "gains, profits, and incomes derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation."

The enactment of the income-tax law of October 3, 1913, marks a new stage in the history of American finance. As in the case of England with its first income tax of 1798, our Civil War income tax was avowedly a temporary measure; and just as the English income tax was reintroduced in 1842 in order to make good the loss in revenue occasioned by the repeal of the "corn" laws, so the American law was enacted to compensate for the loss of revenue due to the new tariff.

The chief argument which was responsible for the passage of the sixteenth amendment and for the enactment of the law was that wealth was escaping its due share of taxation. This amendment reads as follows: "The Congress shall have the power to lay and collect taxes on income from whatever source derived, without apportionment among the several states and without regard to any census or enumeration."

Since the enactment on October 3, 1913, of the revenue act of 1913, Congress has enacted thirteen new laws or major changes in prior laws.

#### INCOME

The rapid extension of income taxation during the present generation has given a new impulse to the study of income. The question "What is income?" has become a burning question for legislatures, administrators, judges, statisticians, and economists.

Many learned persons have, in times past, practically despaired of defining income. The same despairing attitude is taken by one of the latest English writers, Raymond Needham, barrister-at-law, when he said, "What is really at the root of the trouble is the impossibility of saying what is income. And

that, I take it, will go on, no matter how the act is worded."

An economist, in defining income, said, "Income is the money value of the net accretion to one's economic power between two points of time."

The public accountant would probably say, "The net income of a business is the surplus remaining from the earnings after providing for all costs, expenses, and allowances for accrued or probable losses."

It is interesting to note how actual experience has forced men's minds toward the realization of the true meaning of income. The first examples will be taken from the experience of the United States Government with income taxes.

Ever since the first direct income tax was levied by the Federal Government in 1861, the definition of income as a legal concept has been undergoing an evolution at the hands of Congress and the courts, primarily the Supreme Court of the United States.

We find, in the early statutes, very few attempts to define income. At first "income" seemed to include a great deal of capital. The law of June 30, 1864, included under income undivided profits and other unrealized capital gains, as well as realized profits and realized capital gains. This naturally led to litigation (e.g., *Brainard v. Hubbard*, 12 Wall, 2).

The law of 1894 included gifts and inheritance of personal property as income, but no real estate. Consequently, the meaning of the statutes themselves is always vague and varying.

While it would seem that a truer concept lies chiefly in the gradual disentangling of income from capital, we find taxable income of today being extended to sources far afield to the popular concept of income.

In one of the early cases coming before the United States Supreme Court following the adoption of the sixteenth amendment, the court as the foundation for its decision defined income as follows:

"Income is the gain derived from capital, from labor, or from both combined, something of exchangeable value, proceeding from the property, severed from the capital, however invested or employed and received or drawn by the recipient for his separate use, benefit and disposal."

The clarity of this definition would seem to leave no room for ambiguity or misunderstanding of the meaning of income, and yet its significance must be interpreted in the light of subsequent decisions.

The problem of stock dividends has received more attention from the courts than any other problem in income-tax theory. The United States Supreme Court as early as May 19, 1890, decided:

"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."

Since the passage of the revenue act of 1913, the courts have been called upon repeatedly to pass upon the taxability of stock dividends, as well as other financial transactions, but only a few of the controlling decisions need be cited as examples of the difficulty in determining "what is income."

On March 8, 1920, the Supreme Court, notwithstanding the provisions of the revenue act of 1916 that stock dividends were taxable at their cash value on the date of distribution, handed down a decision in the case of *Eisner v. Macomber*, 252 U. S. 189, holding that stock dividends were not income, and saying in part, "A stock dividend, consisting of new stock issued to the stockholders in proportion to their previous holdings, for profits capitalized, without any distribution of profits, is not 'Income' within constitutional amendment No. 16, and revenue act, September 8, 1916, in so far as it

provides for the taxation thereof as 'Income.'"

This was construed generally to mean that stock dividends were not taxable as income. However, sixteen years later on May 18, 1936, the same court decided in the case of *Koshland v. Helvering*, 56 S. Ct. 767, that, where a preferred stockholder received common stock in part payment of the dividend on the preferred stock, the common stock was taxable income; therefore, the value of the common stock should not be apportioned against the cost of the preferred.

In the case of *Bowers v. Kerbaugh-Empire Co.*, 271 U. S. 170, involving the settlement of a debt payable in German marks at a time when the mark had declined in value to only a fraction of a cent, the court handed down a decision on May 3, 1926, holding that a "transaction whereby borrower of German marks repaid them at time when they had fallen in value held not to result in gain from capital or labor, so as to authorize income tax, where result of whole transaction for which money was borrowed was a loss."

This decision was taken to mean that, where a debt was settled for less than its face value, the difference was not taxable income.

And so, this construction continued until November 2, 1931, when the court handed down a decision in the case of *United States v. Kirby Lumber Co.*, 284 U. S. 1, holding that "where corporation purchases bonds theretofore issued by it at price less than issuing price, making clear gain, and there was no shrinkage of assets, difference held gain or income for taxable year."

In determining the power of a state to tax income from patents, the court held on May 14, 1928, in the case of *Long v. Rockwood*, 277 U. S. 142, that "a state may not tax the income received by one of her citizens as royal-

ties for the use of patents issued to him by the United States"; some four years later, however, in a decision handed down on May 16, 1932, in the case of the *Fox Film Corporation v. Doyal*, 286 U. S. 128, the court held that "copyrights are not federal instrumentalities and income derived from them is not immune from state taxation."

Thus we have some conception of the difficulty in defining "Income."

#### VALUATION

"Value" is another very significant tax word with variable statutory meanings according to where and how it is used, and I dare say it stands unexcelled by any other word in the tax laws in the production of taxes and the provocation of litigation.

The word "value" in connection with income taxes first appeared in the revenue act of 1916, with application to property values on March 1, 1913. Section 2(c) of the 1916 act is as follows:

"For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, the fair market price or value of such property as of March 1, 1916, shall be the basis for determining the amount of such gain derived."

The wording as to value was changed in the revenue act of 1918 to read "fair market value." In the revenue act of 1921 it was liberalized to read "readily realizable market value," but this was the first and only appearance of this phraseology, for in the revenue act of 1924 it was restored to "fair market value," and thus it has been in all subsequent acts.

While transfer taxes have been levied at various times prior to 1916, the last of which, the war-revenue act of 1898, imposed a tax measured by "actual value" and "clear value," as well as "value," the revenue act of 1916 was the first to impose a federal

estate tax at specified percentages on the "value" of the net estate. This was followed by a gift tax in the 1924 act, which provided that "the fair market value thereof at the date of the gift shall be considered the amount of the gift." In the revenue act of 1932, "fair market" was discarded and the term "the value thereof at the date of the gift" was used instead.

The revenue act of 1916 also imposed a tax on the "fair value" or "fair average value" of the capital stock of corporations, which was continued until the revenue act of 1928, when it was abandoned as a taxing measure.

The capital-stock tax imposed by recent acts is so different in theory that it has no place in relation to value. It seems logical, in view of the rule of statutory construction that a difference in phraseology leads to a difference in result (*Helvering v. City Bank Trust Co.*, 296 U. S. 85), that Congress intended to draw a distinction between "value" for estate- and gift-tax purposes and "fair market value" for income-tax purposes, as well as "fair value" for capital-stock-tax purposes, when it used all these differing terms in the same 1916 act.

It may not be necessary for "value" to mean the same thing in the different sections of the same law; it may have variable meaning in keeping with a definition given by Mr. Justice Holmes in *Towne v. Eisner*, 245 U. S. 418, wherein he said, "A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used."

Whether the word "value" be a vague symbol or a reality, we find one department of the taxing authorities in conflict with another department in fixing values.

It may be noted, in passing, that in the days of invested-capital valuation for the purpose of the excess-profits

tax, the interests of the taxing authorities were in a low valuation while the interests of the taxpayer were in a high valuation. Although not of current interest, invested-capital cases afford a wealth of valuable material.

The concept of "value" has become increasingly a basic necessity as revenue laws have multiplied. It has lost none of its importance after twenty odd years of modern income taxation; its importance increases with each new act.

The recent revenue acts make it necessary to determine and compute the "fair market value" of a distribution in kind, as well as of dividends paid in obligations of the issuing corporation.

An able writer on taxation propounds a query which I will leave with you as follows: "When dealing with legislation employing the word "value," two questions arise: (1) What does the legislature mean? (2) If it means a given thing in given statute, is a statute in which value has that meaning a fair statute?"

#### COURT DECISIONS

The principle that all taxpayers are presumed to understand a federal tax law as the Supreme Court will finally declare the law has worked many hardships. The severity is particularly acute where taxpayers rely to their sorrow upon erroneous regulations or interpretations of court decisions. From the interpretations given to the decisions herein recited it would seem that a taxpayer is at times presumed to know that the law is the opposite of the interpretations made by the taxing officials.

Taxpayers for years have relied upon the apparently established rule that all stock dividends were nontaxable, only to find suddenly that stock dividends which change the proportionate interests of stockholders are not exempt from income taxation and that the amount by which a debt is settled for less than its face value may or may not be taxable income.

With opportunities for this confusion of thought to run as a stream through grass, unseen perhaps but always there, multiplied with each successive revenue act, it is with much skepticism as to any amelioration of this confusion that I view the revenue act of 1938 with all of its highly accentuated concepts of income.

#### REVENUE ACT OF 1938

Congress has heretofore gone, and continues by the revenue act of 1938 to go, to great lengths to define taxable income by including the gross income from all transactions entered into for profit, but restricting allowable deductions to the point that taxable net income is a statutory conception of some almost indeterminable amount hidden somewhere between gross income and

nothing, and if and when found may be subjected to further refinement as to the class of income and thereby taxed at varying rates.

Corporations have, by the 1938 act, been further classified not only as to the nature of the business, but as to the amount of taxable net income, which for tax purposes is further classified into "ordinary net income" and "special class net income."

Corporate taxpayers are now so classified by statutory concept that, by mere change in the stock ownership or the source or amount of income, they are subject to drastically different rates of taxation. If finally, we are to have a separate income-tax law for each corporate taxpayer, it would seem not unreasonable to query the ultimate source of the income-tax dollar.