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Income Tax Department

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There have been no publications of importance by the Treasury department during the past month, and the rulings which are printed in this number relate to matters of minor interest only.

T. D. 1950 informs the collectors of their powers in regard to granting extension of the time for lodging returns, and of the penalties for refusal or neglect to file returns within the prescribed time.

T. D. 1953 permits collectors to mark returns of citizens received from foreign countries up to March 31 as having the time extended to cover the period of filing such returns; and instructs them that letters, stating amount of income, received from the consular service and others residing in foreign countries, in reply to cables from the State department, are to be accepted as tentative returns, so far as the date of filing is concerned—to be substituted for the proper forms when these are ultimately received.

T. D. 1955 again extends the waiver of the requirement that numbers of bonds should be filled in on certificates to June 30, 1914.

It may be assumed that the Treasury department has now disclosed its complete interpretation of the law and that future rulings will be devoted to administrative details only, so that it now lies with the taxpayer to obtain the courts' relief from those regulations which he considers out with the powers devolved on the department by the law and elucidation of the various points in the law and regulations which are in doubt.

However, the present indications are that the first case to be laid for decision by the courts will be on the constitutionality and validity of the law itself and not upon its interpretation.

In this connection, two cases which may ultimately prove to be of vast importance have been filed within the past month. These are Brushaber *vs.* Union Pacific Railroad Company, filed in the United States district court for the southern district of New York, and J. F. and H. E. Dodge, of Detroit *vs.* William H. Osborn, Commissioner of Internal Revenue, filed in the Supreme Court of the District of Columbia.

In the Brushaber *vs.* Union Pacific Railroad Company equity suit the question of the constitutionality of the law is raised from many points of view. The complainant, a stockholder of the defendant company, asks that the latter be enjoined from voluntarily making the returns and paying the taxes imposed by the law, and he gives numerous reasons why his request should be granted. Included among the reasons given are found most of the points which have been used in argument against the act, and, while reserving any comments and criticisms to which the pleadings may obviously lend themselves, perhaps a brief mention of the points raised will not come amiss at the present time.

In the first place, the complainant avers that so much of the provisions of the law as seeks to impose a tax upon net income received prior to October 3, 1913 is unconstitutional and void, for the reason that such receipts had, prior to the date of the act, become property and capital and had ceased to be income, and such provisions were thus repugnant to and in conflict with the third clause of the second section and the fourth clause of the ninth section of article 1 of the Constitution, because they imposed a direct tax which had not been apportioned among the states according to population, and which had not been laid in proportion to a census or enumeration.

He further contends that the taxes imposed by the act are unconstitutional and void in that there are specifically exempted from the imposition of the tax certain organizations, societies, associations and other corporations which are direct competitors of corporations and individuals subject to the tax, and that the restricted powers of the Federal government do not permit of such exemption.

Again, he avers that the taxes proposed to be assessed and collected and the provisions of the law providing for the assessment of such taxes are unconstitutional and void in that they are inconsistent with and violate the provisions of the fifth amendment to the Constitution: that property shall not be taken without due process of law and that private property shall not be taken for public use without compensation, for the reason that said provisions involve discrimination and classification of the persons and corporations and of the incomes of persons and corporations within the scope of said provisions which are arbitrary and unreasonable and constitute class legislature. In justification of this averment he points to (1) the specific exemptions of $3,000 and $4,000, which he says are exemptions of amounts greatly larger than amounts the tax upon which would equal the expense of collecting—contended by him to be the only constitutional measure of exemption; (2) the denial of any specific exemption to a corporation; (3) the fact that, where a corporation has assumed and agreed to pay the tax directed by the Act to be withheld, compliance with the statute requires it to pay the tax where the creditor, although entitled to exemption in respect that his entire net income amounts to less than $3,000, fails to file a claim to exemption with the corporation; (4) the fact that, in the case of a corporation indebted for more than the amount of its capital stock, the result of the operation of the act is to tax as income of the corporation monies received and disbursed not as earnings but as interest payments to its creditors, and which in the hands of its creditors are again taxed for the same year as income of the creditors; (5) the fact that while domestic corporations generally are restricted as above indicated in the amount they may deduct as interest, there is no such restriction on banks, banking associations, loan or trust companies; (6) the fact that corporations have to pay the normal tax on dividends received from other corporations, while individuals are not so taxed; (7) the provisions of the law with regard to the additional tax whereby discrimination and classification is made solely upon the basis of wealth and is not founded upon a

difference that the restricted powers of the Federal government permit to be the basis of classification; (8) the discrimination between and classification into two distinct classes—owners of taxable income part or the whole of which is withheld at the source, and owners of taxable income no part of which is withheld at the source—whereby the former, unlike the latter class, is deprived of the use and benefit of the moneys so withheld during the period between the date of the withholding and the date it is actually paid to the Treasury; (9) the refusal to allow the specific exemption of $3,000 or $4,000 or the deduction of the amount of dividends received with respect to the additional tax; (10) the discriminations which are based solely upon the circumstance whether the husband and wife are living together or permanently apart; (11) the fact that a person from whom tax has been deducted at the source may have again to pay the tax on the default of his fiduciary or withholding debtor; (12) the benefit and advantage to one who owns his home over one who rents it; (13) the privileges extended to farmers, etc.

The complainant also contends that the act is invalid in that it unlawfully delegates to the secretary of the treasury to decide in certain cases whether accumulations of profits are unreasonable for the purposes of the business.

In the equity suit of Dodge *vs.* Osborn it is narrated that the plaintiffs are parties in business under the firm name of Dodge Brothers, and bring the suit as individuals and as partners and that the defendant holds the office of commissioner of internal revenue in the government of the United States, and he is sued in both his official and his individual capacity. The plaintiffs pray that Wm. H. Osborn may be made the defendant in their bill of complaint and required to answer thereto, and that relief be granted as follows:

(1) That the income tax law may be declared defective and inoperative, for the reason that it provides for the assessments of income taxes without an opportunity being given the individuals and corporations to be assessed to show what their assessments in justice and right ought to be, the law being in this particular in conflict with the provisions of the fifth amendment of the constitution before recited;

(2) That the act may be declared to be unconstitutional and void, for the reason that the discrimination in favor of corporations and against individuals and partnerships is not within the power conferred on congress to lay taxes, etc., or the power conferred by the sixteenth amendment to levy taxes on incomes from whatever source derived, and because the provisions of the act following are in conflict with the fifth amendment, namely:

(*a*) For the levy of assessment and collection of an additional tax on the income of individuals exceeding $20,000;

(*b*) That, for the purpose of the additional tax, the taxable income of any individual should embrace the share to which he would be entitled of the profits if divided, whether distributed or not, of all corporations, etc., formed for the purpose of preventing the imposition of such tax through allowing the profits to accumulate; and

(*c*) That it permit corporations to withhold from taxation such portion of their profits as may be reasonably necessary for the

needs of the business and denies such privilege to individuals and partnerships.

(3) That William H. Osborn may be temporarily and perpetually enjoined from assessing plaintiffs or any other individuals or partnerships with any surtax whatever without first giving them proper notice of the time and place when and where they will be given an opportunity to be heard on the questions whether they are subject to a surtax and the amount thereof; and that he be likewise enjoined even after notice and hearing from assessing or collecting any surtax upon or against plaintiffs or any other individuals or partnerships similarly situated or circumstanced.

(4) That it may be further decreed that plaintiffs and other individuals and partnerships are entitled to withhold from income taxation such portion of their profits as may be reasonably necessary for the purposes and needs of the business in which they are severally engaged in the same manner as corporations, joint stock companies or associations engaged in the very same kinds of business are permitted to do.

The plaintiffs make numerous statements in support of the prayer of their suit, but these are not detailed, as sufficient information has been given to show the main line of their argument.

Cases laid on such broad lines as those that have been just indicated, should, if carried to the ultimate court of appeal, settle once and for all time the constitutionality and validity of the law; and the further progress in the courts of these two cases will be a matter of considerable interest to the public generally.

There seems to be some confusion in the minds of many as to the correct interpretation of what should be included under Item 6A in the corporation tax return, and to make the confusion worse there has recently been promulgated by a district collector of internal revenue a decision which is worth quoting. He says:

A corporation may deduct on this line the total amount of interest paid within the year upon all its indebtedness provided the amount does not exceed (at the rate paid) a sum not in excess of the interest upon its entire capital stock at the end of the year, plus half the interest-bearing indebtedness at the end of the year. In other words, if a company was paying a very large amount of interest on say $50,000 capital and $50,000 interest-bearing indebtedness, its interest deduction would be limited to $4,500 in this case, provided the interest rate was 6%. This provision applies in cases where corporations are carrying a very heavy bonded indebtedness but would not affect ordinary cases.

This interpretation is so contrary to the plain meaning of the language used in the law that there does not seem to be any room for controversy on the point. The law provides that the taxable income of a corporation shall be ascertained by deducting from the gross amount of income received within the year from all sources * * * "(third) the amount of interest accrued and paid within the year on its indebtedness to an amount of such indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year * * * ." It is evident that what is to be deducted is the interest paid on one-half of the sum of two amounts, *i.e.*, the interest-bearing indebtedness and the capital stock. To

obtain the result arrived at by the collector the word "sum" would have to appear before instead of after the words "one-half," and the provision read the sum of one-half of the interest-bearing indebtedness and the capital stock. But of course the law is not so worded, and as it now stands its only meaning can be that the amount to be deducted is not to exceed interest on one-half of the aggregate of the interest-bearing indebtedness and the capital stock.*

Treasury Rulings

(T. D. 1950 February 19, 1914)

Time for filing returns of income, and penalties in connection therewith.

To collectors of internal revenue:

You are advised, and will so announce from your respective offices, that the law and regulations require returns of income for the taxable period, March 1 to December 31, 1913, to be made and filed on or before March 1, 1914. The law is mandatory and allows no discretion to be exercised by any officer. Section 3176, Revised Statutes of the United States, as amended and made part of the income-tax law, gives to collectors of internal revenue (they being satisfied as to the merits of the claim, and in the reasonable exercise of their judgment and discretion) authority to grant extension of time not to exceed 30 days from the time prescribed by law in which to file a return of net income, and then only in cases where such failure, neglect, or refusal is the result of "sickness or absence."

You are also advised, and will so announce, that there will be no change in income-tax regulations as they now exist prior to March 1, 1914, and that all persons and corporations required to make a return which have not as yet done so should make and file their returns at the earliest opportunity and on or before March 1.

Collectors will forward to this office immediately a report showing the number of returns filed in their respective offices as of February 20, 1914.

* Since the above was written a ruling has been made by the Treasury department on the question of the proper amount to be deducted as interest by corporations in their returns. The ruling was received too late to be printed in this number, though it may be said that generally it upholds the interpretation given by the collector as above quoted. It appears difficult to understand the mode of reasoning by which the above result is arrived at, unless it is held that the indebtedness is made up of various separate amounts and that it is one-half of the sum of these amounts that is to be added to the capital stock. However, the ruling fixes the position in the meantime, and it now lies with the corporations which made up returns on a different footing to make their interest deductions conform to the new interpretation.

Penalties and additional tax, in connection with refusal or neglect to file return of income within the prescribed time.

As to corporations.—For neglect or refusal to make a return within the prescribed time, corporations are liable to a penalty not to exceed $10,000; and in case of neglect or refusal to make, or for a false or fraudulent return made, 100 per cent is to be added to the tax; and in the case of neglect or refusal to make and verify a return within the prescribed time (except in case of sickness or absence) 50 per cent is to be added to the tax; and in case of an officer of a corporation or like institution charged with the duty and responsibility of making and verifying a return who makes a false or fraudulent return with the intent to defeat or evade any assessment or tax, he shall be guilty of a misdemeanor, and be subject to a fine not to exceed $2,000, or to imprisonment not to exceed one year, or both, at the discretion of the court, together with costs.

As to individuals.—For neglect or refusal to make a return within the prescribed time, the penalty is not less than $20 nor more than $1,000; and in case of intentional neglect or refusal to make, or for a false or fraudulent return made, there shall be added 100 per cent to the tax; and in case of neglect or refusal to make a return within the prescribed time (except in case of sickness or absence) there shall be added 50 per cent to the tax.

(T. D. 1953 March 2, 1914)

Extension of time for filing returns under income-tax law by citizens of the United States living abroad.

To collectors of internal revenue:

Referring to that portion of section 3176, as incorporated in the income-tax law, which provides that—

In case of neglect occasioned by sickness or absence as aforesaid, the collector may allow such further time for making and delivering such list or return as he may deem necessary, not exceeding thirty days—

you are informed as follows:

Various citizens of the United States living abroad were unable through such absence from this country to inform themselves as to the requirements of the law, and were also unable to obtain the necessary blank forms on which to make their returns of annual net income for the income tax. You are therefore authorized to mark the returns received from foreign countries after March 2 and up to and including March 31 as having the time extended to cover the period of filing such return.

The State department has cabled the consular service and others residing in foreign countries that they shall forward a letter, in which

their income shall be stated, and that such letter will be received in lieu of the return so far as the date of filing is concerned.

Such letters are now coming to this office, and they are being forwarded to the various collection districts to be held as tentative returns until the returns on Form 1040 shall be received. The regular returns on Form 1040 when received should be attached to the tentative returns and both should be forwarded to this office with the assessment lists on which the same shall be listed. The date of filing the returns should be considered that on which such tentative returns were filed.

(T. D. 1955 March 10, 1914)

Extension to June 30, 1914, of waiver of T. D. 1901, Treasury requirements for the filling in on certificates of the numbers of the bonds of corporations, etc.

Notice is hereby given that T. D. 1901, issued November 28, 1913, waiving, until March 31, 1914, the requirement that the *numbers of the bonds* or other like obligations of corporations, etc., from which interest coupons are detached or upon which registered interest is to be paid shall be filled in on the certificates is hereby extended to Jun 30, 1914.

In all other respects the certificates referred to must be filled in accordance with the Treasury regulations before the coupons or orders for registered interest to which they may be attached shall be paid.