The Minnesota State Income Tax

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The modern era of the state income tax in the United States dates from its adoption by Wisconsin in 1911. Earlier experiments with it had been abandoned largely because of inefficient administration. Recent years have witnessed its adoption by an increasing number of states. A bill for an income tax was introduced into the Minnesota legislature that met in 1931, but failed of enactment into law. That legislature did, however, submit a proposal to amend the state constitution to expressly authorize the imposition of progressively graduated income taxes. That proposal, though receiving a majority of the votes cast on it at the 1932 election, failed to procure the constitutionally required majority. The legislature of 1933, relying upon the opinions of the present and a former attorney-general that a progressively graduated income tax would be valid under the existing state constitution, proceeded to enact the statute of which a brief exposition will be given in this article.

The 1933 Minnesota Income Tax Law imposes taxes upon designated groups of taxpayers, defines in great detail the principles fixing the amount of such taxes, provides methods for their collection and for the recovery by taxpayers of amounts illegally collected, establishes machinery for administering the law, and provides for the distribution and use of the revenues raised thereunder. It is quite certain that the provisions defining the taxable persons and the principles governing the amount each taxpayer

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1 See Blakey, Taxation in Minnesota, ch. 15.
2 As to the constitutional aspects of an income tax under the existing Minnesota constitution, see Rottschaefer, A State Income Tax and the Minnesota Constitution, (1928) 12 Minnesota Law Review 683.
3 Minnesota, Laws 1933, ch. 405.
will be called upon to pay are of more importance than those concerned with the administration of the law, and this discussion will accordingly stress the former. The statutory provisions dealing with them follow closely the principles and terminology found in the various federal income tax acts since 1918. It would probably be unjustified to deduce from this an inference that our legislature specifically intended to incorporate into its own law every judicial or administrative interpretation of the federal acts heretofore made. Its intention was more probably the narrower one of aiding officials and others likely to be involved in administering the law by making available to them a highly developed body of opinion entitled to great persuasive force.

LEGAL CHARACTER OF THE TAXES IMPOSED

The statute imposes two types of tax that are quite distinct in their legal character. That imposed on corporations by section 2 is a privilege tax measured for any given taxable year by the taxable net income for such year. The tax in the case of a Minnesota corporation is on the privilege of existing as a corporation during any part of a taxable year. This state cannot tax a foreign corporation on that privilege since such corporation does not derive that privilege from it. The tax on it is for the privilege, derived from this state, of transacting within it any local business during any part of a taxable year. The tax is not for the mere grant of that privilege. Section 4 (a) specifically provides that the liability for the tax imposed by section 2 shall arise on the first day of the taxable year upon which the corporation exercises any of the privileges specified in section 2, and thus impliedly makes the exercise of the privilege to transact a local business a condition to the tax liability of foreign corporations. A foreign corporation that had qualified to do a local business within this state, but whose transactions during a given taxable year consisted exclusively of inter-state or foreign commerce or of both of these, would not be taxable under section 2, although the statute might have been framed so as to tax the mere grant to such corporation of the privilege to transact local business without involving any violation of the federal commerce clause.4

Section 2 defines the character of the tax imposed on corpo-

rate taxpayers transacting local business within Minnesota for all cases except those covered by section 8. The statute was approved and took effect on April 21, 1933. Section 9 (a) requires a taxpayer to compute his taxable net income on the basis of his annual accounting period, and by section 7 (b) the first taxable year of a taxpayer on a fiscal year basis is his fiscal year ending during the calendar year 1933. It is quite probable that there were taxpayers whose fiscal year, and consequently whose first taxable year, had ended prior to the date on which the law took effect. A tax on the exercise of a privilege imposed by a statute enacted after the privilege had been completely exercised might have been held so arbitrary as to violate the due process clause of our state constitution and of the fourteenth amendment to the federal constitution.5 The imposition of a tax directly on the net income received or accrued from the beginning of the year by a statute enacted during such year but subsequent to its beginning has been held not to involve any violation of due process.6 Our state constitution contains no provision specifically prohibiting retrospective laws that are neither ex post facto nor impair the obligation of contracts, and accordingly decisions holding that a specific constitutional prohibition of retrospective legislation prevents a legislature from taxing income received or accrued prior to the effective date of an income tax law are not in point.7 The income tax statute shows a clear intention to reach income received on or after January 1, 1933. Fairness required that the same date should, if constitutionally possible, apply to all taxpayers regardless of the accident of their accounting period. The device adopted to reach that result in the case of corporations taxable under section 2 whose accounting period and first taxable year had already ended when the act became effective was to tax them directly on their net income received or accrued between January 1, 1933, and the close of their first taxable year. This is the purpose and effect of section 8. It is a wholly temporary measure that will be operative for 1933 only. It should be noted that the gross income of such corporations for such periods excludes income received from the United States, its agencies and instrumentalities, so far as immune


7See, e. g., Smith v. Dirccks, (1920) 283 Mo. 188, 223 S. W. 104.
from state taxation under federal law (sec. 12 (1) ). These items are includable in corporate gross income in computing the privilege tax imposed by section 2.

The tax imposed by section 3 is imposed directly on the taxable net income of the taxpayers to whom it applies. The liability for such tax arises concurrently with the receipt or accrual of income during a taxable year. (sec. 4 (a) ). The legal character of such tax is a matter on which courts are in rather sharp disagreement. The issue has generally arisen in cases involving constitutional objections urged against state or federal income taxes. It is certain to arise when the constitutionality of the Minnesota income tax act is presented to the courts. This justifies the consideration of the problem in this discussion.

The question of the legal character of an income tax has frequently arisen as an element in the problem of determining whether certain state constitutional provisions applicable to property taxes only were applicable to it. It has sometimes arisen as a factor in the solution of the constitutional problem of a state's jurisdiction to tax certain income. Cases of the latter type have practically no significance in connection with the type of constitutional objections likely to be urged against the general features of the state income tax on the basis of state constitutional provisions. The absolutist position that, because an income tax may be treated as a tax of a particular character for purposes of determining whether particular items of income are within a state's taxing jurisdiction, therefore it must be treated as a tax of the same character in interpreting the meaning of other constitutional provisions, is likely to receive as short shrift from the courts as the theory that, because under technical rules of property there is no transfer of property to the survivor of a tenancy by the entireties, there is no taxable transfer for purposes of imposing inheritance or estate taxes. It is, therefore, cases of the former type that are of chief importance.

The attempts of courts and text writers to construct completely exhaustive tax classifications have generally produced more confusion than enlightenment. Courts are, however, frequently called upon to determine whether particular taxes belong to one

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or another of the classes of taxes into which some constitutional provision has divided taxes for purposes of applying different constitutional provisions to various classes of taxes. Such is the division of taxes by the federal constitution into direct and indirect taxes. It is because state constitutions have frequently made particular limitations applicable to property taxes only that the question of the nature of an income tax has come before the courts as often as it has. The position that an income tax is a property tax may mean either (a) that it is a tax on the income itself as property, or (b) that it is a property tax on the property producing the income in question. The former position could apply to all income regardless of its source; the latter could apply only to income from property sources. There are cases that have adopted the former theory, and others sustaining the latter position. The absolutist tendency of the legal mind tends to employ these holdings as premises in dealing with problems other than those involved in the decisions in which those theories were developed. It is highly desirable to avoid this tendency in dealing with the constitutional aspects of our state income tax act because the history of our constitutional provisions may reveal an absence of those very features that were decisive in construing the provisions of the constitution of some other state in which an income tax has been held a property tax. It is for this reason that the recent Illinois decision holding an income tax a property tax in both of the senses above referred to has practically no bearing on its position under our own constitution. It is certainly a highly proper legal procedure to proportion the persuasive force of decisions from other jurisdictions according to the degree to which the constitutional provisions involved in them resemble those in our own constitution under which the issues arise. The questions, therefore, arise as to what are the provisions of our constitution on which those objections to the state income tax are likely to be based whose disposition may raise an issue as to the nature of that tax, and what are those objections.

The provisions likely to be invoked are both found in article 9,

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That requires taxes to be "uniform upon the same class of subjects," and, by specifying the property exempt from property taxes, impliedly prevents our legislature from exempting any other property from property taxes. The important general principles embodied in the statute on which the uniformity clause has a bearing are the system of progressively graduated rates, the grant of personal exemptions by section 27, and the exemption of certain groups under section 5. The implied prohibition on the legislative creation of exemptions from property taxes has an important bearing on the validity of the personal exemptions just referred to and the other credits allowed by section 27, and on the exemption of those organizations under section 5 which, but for it, would be subject to a tax directly on their net income; it might by an exceedingly tenuous argument be claimed to be pertinent in determining the validity of some of the exclusions from gross income under section 12, and even of the deductions authorized by section 13. The first problem is what effect, if any, the character of the tax has upon the constitutional issues raised by our uniformity clause. Since that clause applies to all taxes, it applies to an income tax whether that be a property tax or another type of tax. The uniformity provision requires only that classifications for tax purposes be reasonable. The application of progressively graduated rates to ad valorem property taxes would be so contrary to past and present practices that it might well be held to offend against our uniformity clause. There is no logical reason requiring the extension of such view to an income tax, even if that should be held a property tax, for the progressively graduated rate feature is in accord with both past and present income tax practices. Moreover, the factors that are most significant in determining whether a given classification for tax purposes is reasonable cannot rationally be said to depend for their force upon the legal nature of the tax. The fact remains, however, that the only decision in which the system of progressively graduated income tax rates has been held to violate a uniformity

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13 This applies to the exemption of all such groups, but the character of an income tax would not enter into the problem so far as any of such organizations would, but for the exemption, be subject to the privilege tax imposed on corporations.

14 The exemption under section 5 of those organizations that, but for it, would be subject to the privilege tax on corporations raises no difficulty in this connection, since the implied prohibition extends only to the legislative creation of exemptions from property taxes. See Le Duc v. Hastings, (1888) 39 Minn. 110, 38 N. W. 803.
clause very like our own reached that result solely because an income tax was held to be a property tax. On the other hand, some of the decisions holding that a progressively graduated income tax does not violate a uniformity clause, practically identical in language with our own clause, have come from states that treat an income tax as not a property tax. The reasoning in the opinions supporting these decisions shows that the legal nature of an income tax did not enter as an element in determining whether the system of progressively graduated rates was permissible under such uniformity clauses, but functioned solely as the basis for holding that such a system of taxation did not violate constitutional provisions requiring property taxes to be proportionate to the value of the property taxed, since an income tax was not a property tax. The Oregon supreme court has held that a progressively graduated income tax did not violate a provision requiring taxes to be uniform upon the same class of subjects, but nowhere in its opinion discusses the legal nature of the tax. In a later case, however, it seems to consider an income tax as one on property, but that case involved a gross income tax. The cases relied on are, however, those holding a net income tax to be a property tax. In view of its specific statement that this case must not be taken as overruling the case in which it sustained a progressively graduated net income tax, it can be said that its position is that a net income tax, though a property tax, may be made progressively graduated without violating a uniformity clause identical with our own. It is apparent, therefore, that, on the basis of authority from other jurisdictions, a progressively graduated income tax may be held valid under our uniformity clause even if an income tax is held to be a property tax whether on the income as property or on the income producing property. The Illinois decision invalidating the progressively graduated rates of the Illinois income tax act has no bearing on our problem since that case held that system violative of a constitutional provision requiring property taxes to be by valuation. It is certain that, if our court should hold an income

Culliton v. Chase, (Wash. 1933), 25 P. (2d) 81. The Washington constitution required all taxes to be "uniform upon the same class of property" whereas ours requires uniformity "upon the same class of subjects."


Standard Lbr. Co. v. Pierce, (1924) 112 Or. 314, 228 Pac. 812.

Redfield v. Fisher, (1930) 135 Or. 180, 292 Pac. 813.

tax to be something other than a property tax, the graduated rate structure will be sustained as valid under our uniformity clause. It is also well established by decisions in other jurisdictions that the grant of personal exemptions and the exemption of all the income of some groups would not conflict with our uniformity clause if an income tax is not a property tax. And since, as far as clauses of that character are concerned, classification is as permissible in connection with property taxes as with other taxes, the decisions just referred to holding such exemptions reasonable are in point even if an income tax should be held to be a property tax. This has reference to the general principles only. The validity under our uniformity clause of the exemptions made by section 5 involves a separate problem as to each of the exempted groups. The limits of this discussion prevent such detailed consideration of that section.

There is, however, one possible problem under our uniformity clause that is likely to be affected by a decision as to the nature of the income tax. The tax act includes income from property in gross income. If an income tax is held to be a property tax on the income producing property, there will be a double tax on such property unless it is relieved of other forms of property taxation. This will be true of all income producing property whose income is within Minnesota's taxing power except income producing property of organizations exempt under section 5, obligations of Minnesota and its political subdivisions the interest on which is excluded from gross income (sec. 12 (b) ), and property occupied by its owner the rental value of which is excluded from gross income (sec. 12 (h) ). Our supreme court has not yet held that double taxation violates our uniformity clause, although it has indicated that the double taxation of some property while other property was subject to but a single tax would violate said clause. The cited case involved such double taxation through two distinct types of property taxes, the ad valorem and the gross earnings methods. This case, however, is far from deciding that the uniformity clause is violated by excepting from a system of double property taxes cases that can be justified by the usual principles governing the validity of tax classifications under that clause. The exceptions mentioned above would undoubtedly be

held reasonable under those principles. So far as concerns the exemption of the income of organizations under section 5, derived by them from property itself exempt under our constitution, the exemption merely carries over to income the policy embodied in the exemption of their property from ad valorem taxation. It is quite certain that our court will not find a violation of our uniformity clause merely because there may be years in which some of the income producing property either produces no income or an amount insufficient to result in a tax which would mean but one tax on it, while other income producing property produces sufficient income to result in a tax which would mean a double tax on that property. The discussion in this paragraph has assumed, for the sake of the argument, that an income tax is a property tax on the property producing the taxed income. It is clear, however, that the whole issue of a possible violation of the uniformity clause by a non-uniform system of double property taxes as a result of an income tax that taxed income from property sources will be obviated if an income tax is held not to be a property tax.

It is in connection with the implied constitutional prohibition against the legislative creation of exemptions from property taxes that the legal character of an income tax is a decisive factor. If it is a property tax on the property producing the income, then exemptions of income from non-property sources would be valid, but the tax act does not limit the personal exemptions and credits authorized by section 27, and the exemptions of all the income of certain groups by section 5, by any such principle. If, however, an income tax be held a property tax on the income itself as property, then the exemptions and credits above referred to are invalid except as to income received by institutions whose property is exempt from tax under article 9, section 1, and it is even possible that certain of the exclusions from gross income found in section 12 would be invalid. The issue, of course, is whether the people of Minnesota in specifying the property to be exempt in article 9, section 1, intended to impliedly prohibit personal and other exemptions if the state should ever adopt an income tax. They probably had in mind only exemptions from ad valorem property taxes. That alone should suffice to show that an income tax is not that kind of property tax to which the provisions of article 9, section 1, now in issue, had reference. In any event, however, the validity of these exemption provisions of the income tax act will be more assured if an income tax be held not a property tax.
The writer has in a previous article analyzed the cases in which the character of an income tax had been considered up to the time of the publication of that article. In none of the cases therein analyzed in which it was held to be a property tax were the constitutional issues in any degree similar to those under our constitution. There have been several decisions since that time. The Illinois court has held that an income tax is a property tax within a constitutional provision requiring taxation of property to be by valuation, and that graduated rates violated said provision. The argument was almost wholly historical. The history of our article 9, section 1, is wholly different. Moreover, our constitution contains no such provision. The recent Washington decision has held that an income tax is a property tax, and that the system of graduated rates violated a provision requiring taxes to be uniform upon the same class of property. The reason the Washington court held an income tax to be a property tax was another provision in the same section of the constitution defining "property" as including "everything, tangible or intangible, subject to ownership." No such provision is found in our constitution. At practically the same time the Montana court reached the conclusion that an income tax was an excise although the Montana constitution contained at least as sweeping a definition of property as that of Washington. The only court that has specifically passed on the issue of whether a prohibition of the legislative creation of exemptions from property taxes prevented exemptions in an income tax is that of Missouri, which sustained the exemptions by holding an income tax to be an excise. There are many cases that have held an income tax to be an excise and have sustained graduated rates, personal exemptions and the exemption of all the income of certain groups. These were the cases that involved uniformity clauses identical with our own or very similar to it. The

27Ludlow-Saylor Wire Co. v. Wollbrinck, (1918) 275 Mo. 339, 205 S. W. 196.
conclusion is, therefore, warranted that the cases in which the constitutional issues were either similar or closely similar to what they are under our constitution have held an income tax to be an excise, while those in which such tax has been held a property tax involved issues under constitutional provisions very dissimilar to the relevant provisions of our own constitution. This is true with respect to both the graduated rate and exemption features of our income tax act. Authority, therefore, supports the theory that the tax imposed by section 3 directly on net income is not a property tax either on the income as property or, so far as income from property is involved, on the property producing the income, but that it is an excise. A common sense view would treat it as a tax in a class by itself, but, if it must be subsumed under an already established legal category, then treating it as an excise seems the more reasonable position as well as that supported by the better reasoned of the decided cases.

**Taxable Persons**

The taxes imposed by the statute are imposed on the exercise of a privilege, or the receipt of income, by designated taxable persons. The taxable person, which term as herein used includes corporations, is not necessarily the person required to make the return and pay the tax, although in most instances the two will be identical. The case of an infant may be cited as an instance in which the two may not be the same. The infant himself is the taxable person, but his guardian is made responsible for a return of his income (sec. 33), and for the payment of the tax thereon (sec. 41). The first class of taxable persons is comprised of corporations. It includes both domestic and foreign corporations. As has already been stated, the tax imposed on some of them is a privilege tax measured by net income, and that imposed on others of them is a tax directly on their net income. The general factors that determine to which of these taxes a corporation is subject for any given taxable year are whether it is a domestic or foreign corporation and the character of its business operations within Minnesota during such tax year. A domestic corporation, other than one whose business within Minnesota during the tax year consisted exclusively of interstate commerce, is taxed on the privilege of existing as a corporation during any part of such year. It

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would be subject to such tax even if it transacted no business whatever within this state during the tax year, or if its business within the state during that year consisted exclusively of foreign commerce or exclusively of interstate and foreign commerce. If its operations within Minnesota during the tax year consisted exclusively of interstate commerce, it would be taxable directly on its net income. The case of a foreign corporation is somewhat different. Minnesota cannot impose a privilege tax on it for engaging within it exclusively in interstate commerce, or exclusively in foreign commerce, or exclusively in interstate and foreign commerce. It can tax it only for the grant of the privilege to engage within it in local business or for the exercise of such privilege. By the statute the privilege tax measured by net income applies only to such foreign corporations as transact some local business within it during the tax year. If it is also during such year engaged within Minnesota in interstate or foreign commerce or both, it is still subject to the privilege tax for that year. Section 3 specifically provides, however, that if such foreign corporation's business within Minnesota during a tax year consists exclusively of interstate commerce, then it shall be subject to a tax directly on its net income. The statute fails to provide for the taxation of a foreign corporation whose business within Minnesota during a tax year consisted exclusively of foreign commerce or of interstate and foreign commerce. This seems to be a casus omissus that should be remedied by proper amendment.

The provisions governing the taxation of corporations apply not only to corporations proper but to certain other types of business organizations frequently resorted to in substitution for the corporate form of doing business. This result is secured by defining the term "corporation" to include certain limited partnerships, associations and common law trusts organized or conducted for profit (sec. 1). The aim seems to be to conform the treatment of such organizations to that which they have been accorded in the federal income tax system, although the language of the statute is

32This discussion, so far as it relates to privilege taxes, does not apply so far as corporations are taxable under the provisions of section 8 directly on their net income.
more specific than that found in the federal acts. There is no doubt as to Minnesota's power to treat such organizations as taxable persons. A question might be raised as to its power to subject organizations that are not technically corporations to the system of privilege taxes imposed by section 2. The various federal capital stock taxes which are taxes upon the doing of business have been held to be associations within these acts. It has also been held that a state may exclude a foreign business trust from conducting within it a local business unless it qualified in the same manner as a foreign corporation, and that to impose such requirement did not violate the interstate privileges and immunities clause nor any other provision of the federal constitution. It would seem, therefore, that there is no constitutional objection to treating such organizations as separate legal entities for purposes of applying to them the tax and other requirements imposed on corporations. A state would be held to have at least as much control over such organizations formed within it as over those elsewhere organized. The probabilities are, therefore, that the application to these organizations of the privilege tax system applied to corporations is constitutionally unexceptionable.

The next class of taxable persons consists of natural persons who are taxable with respect to their own annual net income. The tax is imposed on both residents and non-residents. The latter can constitutionally be taxed only on their income from Minnesota sources. The statute expressly exempts from the tax the compensation from personal services or labor earned by a non-resident within this state unless he has been engaged in work within it for more than 150 working days in a tax year (sec. 3 (b)). No comparable exemption is made with respect to other types of income derived by a non-resident from local sources. Section 1 defines a resident as an individual domiciled within this state and any other individual maintaining an abode therein during any por-

tion of a tax year who shall not during the whole of such tax year have been domiciled outside this state. The latter of these provisions thus correlates domicile outside the state during the whole of the tax year with non-residence for purposes of this tax. This will prevent taxing as residents those who are within Minnesota merely temporarily even though they may maintain a summer home within it. That provision also performs another function. It covers cases in which an individual has had a domicile within this state during a part only of a tax year and makes such person taxable as a resident. It should be noted that nothing in the definition determines for what part of a tax year any individual is to be treated as a resident for tax purposes. The case of the person domiciled in Minnesota during the whole of the tax year offers no problem since he can be, and is, taxed as a resident with respect to his income for the whole of such year. The person who has had no Minnesota domicile during any part of a tax year must be, and is, taxed as a non-resident with respect to all his income for the whole of such tax year. The problem arises in the case of one who has been domiciled within this state for a part only of a tax year. In view of the fact that section 4 (a) makes the liability for the tax on individuals arise concurrently with their receipt or accrual of income during a tax year, and that the only liability that Minnesota can impose while an individual is domiciled outside it is the liability for a tax on non-residents, the conclusion follows that a person can be taxed as a resident only while domiciled here. Hence a person who becomes domiciled in Minnesota subsequent to the commencement of his tax year, or who before the end of a tax year loses his Minnesota domicile, can be, and is, taxed as a resident only with respect to income received or accrued during the period of his local domicile, and must be, and is, taxed as a non-resident with respect to income received or accrued during the remainder of the tax year.\(^3\)

The case of a married woman living with her husband affords a special case. The statute in general charges income items to their recipient. The married woman living with her husband is permitted, but not required, to combine her income with that of her husband by making a joint return (sec. 34). It would violate the due process clause of the fourteenth amendment to require her

husband to return her separate income as his own. Various cases are possible. The married woman who has lived with the same husband during the whole of a tax year clearly can elect to be separately taxed or to include her income in her husband’s return. The woman who was married during the entire tax year to the same husband, but lived apart from him during a part thereof, is accorded the same election, but cannot elect to include in her husband’s return the income received while living with him and in a separate return that received while living apart from him. The election must be for the income for the whole tax year. This is also true of the woman who was unmarried during a part of a tax year and married and living with the same husband during the remainder thereof. A case is conceivable in which a woman may have been married to and living with two husbands during a single tax year. No question would arise if she elected to file a separate return for such year. One might arise if she should wish to file a return with her husband. The statute would undoubtedly be construed as requiring her in such case to file a joint return with the husband with whom she was living at the close of the tax year, or, if she were by that time already living apart from the last in the series of husbands for such year, to file the joint return with such last husband. It is quite improbable that cases of this kind will ever arise.

The tax imposed on individuals is also imposed on the estates of decedents during the period of their administration and settlement. The real taxable person in such case is the executor or administrator in his official capacity (sec. 3 (b) ). The position of such executor or administrator in this connection must be carefully distinguished from his position as the person on whom the statute casts the obligation to file a return covering the decedent’s income for the period during which he was alive, and to pay the tax due on the basis thereof (secs. 33 and 41). The decedent ceases to be a taxpayer at his death, but income that might thereafter have been received by him had he lived becomes the income of a new and distinct taxable person, briefly designated in the statute as his estate. There is no combining the income received by him while alive and that received by his estate after his death. The tax is imposed as well upon the estate of a non-resident dece-

dent as of a resident decedent, but in the former case it is treated for tax purposes as a non-resident even though the executor or administrator might be a resident of this state or a domestic corporation. The statute does not explicitly so provide, but lends itself to this construction which is that most in accord with the general policy of the statute in taxing such estates. That policy is to reach the income which, but for the former taxable person's death, would be taxable as his income. That policy can only be carried out by making the decedent's residence or non-residence the factor that determines whether his estate shall be treated as a resident or non-resident for tax purposes.

Another important group of taxable persons consists of trusts other than those taxable as corporations. The real taxpayer is the trustee holding the property in trust. Such trusts are taxed in the same manner and by the same rules applicable to individuals. The trust is a taxable person whether created by a resident or non-resident individual, and also whether created by a domestic or foreign corporation. An important problem arising in this connection is what is to determine whether a trust is to be treated as a resident or a non-resident. The state could constitutionally treat the trust as a resident if the sole trustee is a resident or domestic corporation, or if the principal place of administration is within this state; it could probably do so also if any one of several trustees were a resident or a domestic corporation. It would probably be unconstitutional to tax as a resident a trust whose sole trustee was a non-resident or a foreign corporation not doing business within Minnesota; it is not so certain that due process would prevent this state from treating as a resident a trust merely because its principal place of administration was outside this state, or because one of several trustees was a non-resident or foreign corporation not doing business within Minnesota. This state is probably prevented by the due process clause of the fourteenth amendment from treating as a resident a trust merely because the settlor is a resident or domiciled within it, or because a beneficiary is such, or because both settlor and a beneficiary are such. The statute does not specifically indicate by what principle the residence

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40The mere fact that Minnesota may be constitutionally unable to tax the income of a trust to the trustees does not prevent it from taxing that income when received by a resident or domiciled beneficiary. See Maguire v. Trefry, (1920) 253 U. S. 12, 40 Sup. Ct. 417, 64 L. Ed. 739.
or non-residence of a trust is to be determined. The sensible thing, but for the existence of the constitutional jurisdictional factor, would be to make the residence of the settlor the conclusive determinant. This, as has been intimated, would probably be held to violate due process. Giving the statute an interpretation that would avoid grave constitutional issues, it seems fair to construe it to make the residence or non-residence of a trust as a taxable person depend on the residence or domicile of the trustee, treating it as a resident whenever any trustee is a resident of, or domiciled within, Minnesota. Such loopholes for tax avoidance as this entails will have to be charged to constitutional inhibitions on state power.41

The only remaining problem concerning taxable persons is raised by certain exemptions from the tax. The principal exemptions are the corporations and organizations enumerated in section 5. The exemption in most of the cases within that section extends to all the income received by such corporations or organizations, and is, therefore, distinguishable from the mere exclusion of certain items of income from gross income made by section 12. The exemption of corporations engaged in the business of mining or producing iron ore, however, extends only to their mining or producing operations, and royalties are specifically excluded from income from such operations. The most important of the exemptions made by section 5 are national and state banks, insurance companies of every character, and various kinds of co-operative business enterprises. It is quite impossible to discuss these exemptions in detail. The grant of some of them will probably be assailed as violative of various state and federal constitutional provisions such as our uniformity clause and the equal protection clause of the fourteenth amendment. It would appear that most of them lie well within the permissible limits of the legislative power to make classifications for tax purposes. It may be pointed out, however, that section 58 specifically provides that, if any such exemption is held unconstitutional for any reason, the group whose exemption is thus held invalid will become taxable.

Although not technically an exemption, the case of partnerships can most conveniently be disposed of at this point. A partnership is not generally considered or treated by the law as a legal entity distinct from its members. The income tax act has ac-

41 The special provisions for computing the taxable net income of trusts will be hereinafter considered.
cepted that view and accordingly does not treat it as a taxable person. It is treated as a mere conduit for transferring income to its members who are required to take into their annual income their respective distributive shares in the partnership net income for the partnership tax year ending within their own tax years. It is immaterial whether the partnership net income has or has not been actually distributed. This "conduit theory" is carried through consistently so that partners are allowed to take their proportionate share of credits against net income on account of contributions and dividends made or received by the partnership (section 30). The failure to treat a partnership as a taxable person while other organizations, such as business trusts, and businesses conducted in corporate form are taxed as entities, follows the consistent federal practice. This alone would warrant the conclusion that this differentiation involves no unconstitutional application of the legislative power to classify for tax purposes. It should be noted that the provisions of section 30 do not apply to partnerships that are included in the class of corporations by section 1 (c).

The "conduit theory" is also applied in such a way as to create a practical exemption of certain classes of trusts. These are trusts created by an employer as part of a stock bonus or profit-sharing plan for the exclusive benefit of some or all of his employees, and trusts created by an employer to provide a system of unemployment insurance or old age pensions for his employees (sec. 29 (a) ). The existing federal tax act makes similar provision for stock bonus and profit-sharing trusts, but not for unemployment insurance and old age pension trusts. The treatment accorded by our statute to distributions from these trusts will be hereinafter discussed.

**Net Income — General Considerations**

The taxes imposed by the statute are either directly on or else measured by what the statute describes as taxable net income adjusted by certain credits. The allowance of credits against taxable net income raises few questions, but the computation of taxable net income involves numerous and diverse problems. It has already been stated that the due process clause of the fourteenth amendment restricts the taxation of the income of non-residents to that derived from local sources, and similarly limits the measure of the tax on foreign corporations for the privilege of transacting
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local business within the taxing state. It is not improbable that future decisions of the United States Supreme Court may exclude from Minnesota's jurisdiction some income received even by residents and domestic corporations. The computation of the taxable net income in the case of non-residents and foreign corporations, therefore, involves not only determining what shall constitute net income but also the problem of how much thereof can constitutionally be assigned to Minnesota. The legislature, recognizing its limited jurisdiction over these groups of taxpayers, proceeded to subject all taxpayers, residents and non-residents, and domestic and foreign corporations, to the same general rule of liability by providing in section 27 that the taxes imposed by the statute should all be on, or measured by, the taxable net income which is defined by section 22 as the net income assignable to Minnesota under principles defined in sections 23 to 26, inclusive. The result is that the computation of the taxable net income for all taxable persons involves the two major problems of defining net income in general and of selecting principles for determining the amount thereof assignable to Minnesota. Clarity of exposition will be served by first treating the former of these problems.

The statutory definition of net income follows the general lines of that embodied in federal income tax acts. Income is a function of time in the sense that it is the resultant of certain classes of additions to and subtractions from a person's wealth occurring during a period of time. It thus differs from the conception of capital which is concerned with the state of a person's wealth as of a given instant of time. It follows that an income tax statute must select some time period as that whose income producing transactions shall determine the extent of the tax liability. The state statute has selected a twelve month period ending on the last day of a month. This is not only the period whose income fixes the amount of the tax, but is also the taxable year for which the tax is imposed although the discharge of the tax liability by payment is deferred until the next taxable year (secs. 1 (h), 9, 37, 39 and 42). If the twelve-month period ends on December 31st, the year is described as a calendar year; if on the last day of any other month, it is described as a fiscal year. The taxpayer is required to report his income for the same accounting period on the basis of which he reports for federal income tax purposes or would

have to report were he required to report under the federal income tax act. He cannot, however, change his accounting period merely because federal authorities have consented to such change for federal tax purposes. The consent of the Minnesota Tax Commission is required before he can change it for purposes of the Minnesota income tax (sec. 9 (b)). There are likely to be many taxpayers who have no annual accounting period, and some taxpayers having one that ends on some day other than the last day of a month. All such taxpayers are required to report on a calendar year basis (sec. 9 (a)). This, however, applies only to such taxable persons as are neither making, nor required to make, returns under the federal income tax act.

There are several situations in which the taxable year, and consequently the period for which income must be returned, is less than a full twelve-month period. One of these has only temporary importance. That is the case of taxpayers reporting on a fiscal year basis with respect to their first taxable year which would end some time prior to December 31, 1933. The other situations constitute permanent features of the statute. Any taxpayer, corporate or otherwise, may have been in existence during a part only of a twelve-month period. He is permitted to report for the fractional part thereof during which he was in existence (sec. 37). A taxpayer who has been permitted to change his accounting period is required to file a return for the fractional part of a year between the close of his last taxable year and the date designated as the close of his newly adopted taxable year, and to pay a tax for such period. This is to prevent the income of such period from escaping the tax. The method for computing the tax for such fractional year periods is not the same for all of these cases. In the first two cases the tax is computed solely on the basis of the taxable net income arising during such periods with no apportionment of the personal and dependents credits against net income on a time or any other basis (secs. 7 (b), 31 (a), 37). The federal income tax act requires such credits to be apportioned on the time basis in the second of these cases, and the first does not arise thereunder. In the last case the computation of the tax is more complicated. The taxable net income for the period is first put on an annual basis by multiplying by twelve and dividing by the number of months in the fractional period. A tax is then computed on the taxable net income resulting from that computation after adjusting for the credits against taxable net income permitted by section 27. This
may be called a tentative tax. The tax payable for the period is that proportion of such tentative tax which the number of months in the period bears to twelve months. The result is an apportionment of the credits against taxable net income on the time basis. The method is the same as that followed in the federal tax act in the like situation. The difference in treatment between this case and the other two is justified in order to prevent a change in accounting period from conferring an advantage upon the taxpayer making such change, while it is quite unlikely that taxpayers will be in existence during a part only of a tax year merely to gain the slight tax advantage resulting from the non-apportionment of the personal and dependents credits.

There are various ways of assigning income and deduction items as between different taxable years. The first of these is the cash receipts and disbursements method. This requires that an income item be reported in the year of its receipt, and deduction items that involve payments to others be reported in the year in which payment is made. For the purpose of applying this method an item is deemed to have been received when either actually or constructively received; it is not deemed to have been received merely because one has acquired a claim to receive it at some future time or even on demand. It is not necessary, however, that the item received be cash; the receipt of any property having value, other than an account or bill receivable, is sufficient. Section 11 specifically provides that gross income items shall be deemed such regardless of the form in which received. While this provision is not specifically concerned with the time when income must be reported, it does so indirectly for those reporting on a cash basis. The cash method of reporting is in practice that adopted by most of the smaller taxpayers, although it is not strictly correct in any case in which the taxpayer has income from a business requiring the use of inventories. Another method is that known as the accruals method. In it an income item is required to be reported when a definite claim thereto comes into existence, and deduction items involving obligations to others are required to be reported in the year when the liability therefor becomes definitely fixed, even though in some cases the amount thereof cannot be exactly fixed during that year. It amounts in substance to treating accounts or bills receivable originating in income, as distinct from capital transactions, as though already received, and accounts or bills payable, if due to transactions of the kind for which deduc-
tions can be taken, as though already paid. It involves other things as well, as in the case of accruing taxes. An illustration may make plain the difference between the cash and the accruals methods. A person receiving an annual salary and reporting on a calendar year basis receives his December, 1933 salary on January 2, 1934. If he reports on a cash receipts basis, that salary will be treated as 1934 income; if on an accruals basis, as 1933 income. If now that payment be viewed from the point of view of the employer, who will be assumed to report on a calendar year basis, then, if he reports on the cash disbursements basis, the payment will be a deductible expense for 1934, but, if he reports on an accruals basis, then it will be a deductible expense for 1933. The accruals method is a device that assigns income and expense items more nearly to the taxable years in which the economic facts creating the income or causing the expense have occurred.48

The whole purpose of any method of accounting in connection with this tax act is to get a clear and fair determination of the taxpayer's net income and his net income taxable under the statute.44 This is the reason for giving the tax commission ultimate control over the matter. Section 9 (a) requires the taxpayer to determine his net income in accordance with the method of accounting regularly employed by him in keeping his books. This, however, is only the beginning of his duty and right in the premises. It is the measure of his right only if that method clearly and fairly reflects his net income and his net income taxable under the statute. If it fails to come up to that standard, he is required to employ such method as in the commission's opinion will accomplish those results. The commission's powers in this matter are not unlimited. Methods prescribed by it must be such as reasonably tend to achieve those results. Furthermore, neither the taxpayer nor the commission can run counter to the specific requirements of section 11 that amounts transferred to surplus from reserves built up through deductions in prior years be included in gross income in the year when the transfer is made, and that refunds of taxes deducted in computing net income be returned in


44 See, e.g., sections 9, 11, 13(1), 15 and 26.
the year of their actual receipt. A taxpayer keeping no regular books of account is required to report his income on the basis which, in the commission's opinion, will clearly and fairly reflect his net income and the net income taxable under the act. The limitations on the commission's power referred to above apply to this case also. Taxpayers in this group will in general be expected to report on a cash basis.

There are certain deductions with respect to which it is immaterial whether the taxpayer is on a cash or accruable basis. Such are losses deductible under section 13 (d), which are required to be taken in the year in which the loss is sustained or, in the sole case of loss resulting from theft, in the year when the theft is discovered by the taxpayer. The deduction for bad debts (sec. 13 (e) ) must under both methods be taken in the year in which the debt is ascertained to be bad in every case in which the taxpayer selects that method for treating that item. This item is also treated the same under both methods whenever partial write-offs are permitted by the commission, and whenever it is taken care of by additions to a bad debt reserve. The deductions for depreciation and depletion (sec. 13 (f) and (g) ) depend upon factors whose effects within a taxable year do not vary with the method of reporting followed by the taxpayer, and hence are similarly treated regardless of which of these two methods is adopted. Strictly speaking, the use of the term "cash basis" is a misnomer as applied to the kinds of deductions discussed in this paragraph, as they may not and, in most cases, do not involve any cash outlay during the period when deductible, and their deductibility, being specifically authorized, is not dependent upon the taxpayer having made any cash outlay during the period of their deductibility.

The preceding discussion has been concerned with the two most commonly employed methods for computing net income. The tax commission is specifically authorized to permit the so-called installment method in the case of taxpayers regularly disposing of property on the installment plan, and of those who make a casual disposition of property on terms under which the initial payment in cash or other property (excluding the purchaser's evidences of indebtedness) does not exceed 40 per cent of the purchase price. The installment method aims to secure a distribution of the net income from such transactions over the years during which they are outstanding. The Minnesota statute does not, as does the Revenue Act of 1932, prescribe the exact technique to be fol-
allowed where this method is permitted. The commission, however, is likely to follow the federal method. The presence of this provision (sec. 9 (c) ) does have the following results. It puts this method in a separate class requiring commission permission before it can be used, and thereby limits the scope of the provision in section 9 (a) requiring taxpayers to report on the basis on which their books are kept. Furthermore, it prevents even the commission from granting permission to use this method in cases other than those specified, and thus limits its discretion in permitting or requiring a method of reporting that will clearly and fairly reflect net income and the net income taxable under the act.

The question arises whether the three methods thus far described exhaust those available for reporting net income. The answer must be in the negative. Section 11 requires gross income items to be accounted for in the year of their receipt unless properly to be accounted for as of a different year under methods permitted by section 9. Section 9 (a) permits the commission to require or permit any method that will clearly and fairly reflect net income and the net income taxable under this act. The few limits on its discretion in the premises have already been stated. Section 13 (i) requires deductions to be taken in the year of payment or accrual, unless in order to clearly reflect income they should be taken as of a different year. This applies to all deductions. It furnishes a standard that the commission can employ in exercising its powers under section 9 (a). It follows, therefore, that the commission may, subject to the limitations heretofore referred to, require or permit other methods of reporting net income than on the cash, accruals, and installment bases. It could, in the case of income earned under long-term contracts, follow the federal method of permitting it to be returned by either the completed contract method or the percentage of completed contract method. Under the former the income is reported in the year of completion and acceptance of the work; in the latter it is distributed over the years of the contract on the basis of the percentage of the work completed in each of such years. The commission could also require either of these methods in a proper case, although the federal government has not done so.

There is one question that is likely to arise quite frequently. That is whether a person whose income is in whole or in part de-

45See Rice, Barton & Fales, Inc. v. C. of I. R., (C.C.A. 1st Cir. 1930) 41 F. (2d) 339.
rived from a business in which the buying and selling of goods or securities is a material factor will be permitted to report on a cash basis as to such income. It is practically impossible to determine the net income in such a case without using inventories. The use of an inventory might transform an apparent profit into an actual loss, or an apparent loss into an actual profit. Under section 15 the commission could require, and it clearly would require, the use of inventories in such case. But the combination of the cash method with inventories would, except in a very unusual case, distort the income accounting as between different taxable years. It is quite likely, therefore, that the commission will require the use of the accruals method in the case posited at the beginning of this paragraph. This would agree with federal practice.

GROSS INCOME — GENERAL CONSIDERATIONS

The discussion in the preceding section was concerned with the problem of the year in which income and deduction items were required to be returned. It did not deal with what items had to be treated as income and what items could be deducted. The net income that enters into the computation of the tax is a statutory concept. The principles governing its determination are defined in sections 10 to 21, inclusive, of the statute, while modifications thereof applicable to estates and trusts are described in section 28. The present discussion will deal only with issues raised by the former. Two kinds of problems are involved. These are the determination of gross income and the definition of deductions permitted to be made in arriving at net income. The statute defines gross income in broad terms (section 11). There are five distinct classes of income items mentioned in the definition. These are income from personal services, income received by an owner of property because of its ownership, profits from the disposition of, or dealing in, property, income from trade or business, and income from any source whatever. This broad definition is limited by the specific exclusion of certain items found in section 12. The items excluded include many of those excludable in computing gross income for federal income tax purposes. There are certain respects in which the state and federal exclusions vary. The state, for instance, is prohibited by the federal constitution from taxing the salaries of federal officers and employees, on which the federal government could and does levy its income tax. Such income
is excluded in computing the state tax. Then there are certain differences based on differences in policy. The state statute specifically excludes amounts distributed as patronage dividends from the gross income of co-operative buying, selling or producing associations, however organized. This, of course, would operate only in the case of cooperative associations not wholly exempt from the tax under section 5. The federal act has no such provision, although there may be instances in which such income is wholly exempt under federal law because belonging to a corporation exempt from the federal tax. Enough has been said to indicate that there are sufficient differences between what is excludable from gross income under the state and federal acts to warn the taxpayer that he cannot exclude an item under the state act merely because he is permitted to do so in computing his federal income tax.

It is beyond the purview of this article to give a detailed exposition of all the provisions of the Minnesota income tax act. There are, however, certain problems of gross income to which attention should be directed. The salaries of officers and employees of the state, its political and other subdivisions, its instrumentalities and its agencies, are required to be included in gross income. The act makes no exception in this matter. Our state constitution provides that the salaries of our supreme and district court judges shall not be diminished during their continuance in office (art. 6, sec. 6). The inclusion in gross income of the salary of a federal judge who had become such before there was any federal income tax was held to violate a provision of the federal constitution prohibiting a diminution in a judge's salary during the term for which he had been appointed. The same result has been reached in the case of a federal judge appointed after the enactment of the tax act under which the tax was imposed. The theory of these decisions is that the imposition of an income tax on the salary operates as a diminution thereof. There are state decisions that have reached the contrary result. The inclusion of state judicial salaries in gross income under the state act raises a question of state constitutional law.

It is not inconceivable that there may be persons employed

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under the authority of the state, its subdivisions, or agencies, who are paid in effect out of funds supplied by the federal government. Their salaries will undoubtedly be held taxable by this state, and not entitled to the immunity from state taxation of salaries received by federal officers and employees. The courts are not likely to look beyond the factor that the salaries of such persons are derived under a contract with the state, its subdivisions, or agencies. There are at least some instances of this situation among the members of the faculty of the University of Minnesota. Another situation meriting consideration is that of a contractor carrying out a contract for the United States. Amounts received thereunder would be taxable. The state act excludes from gross income amounts received from the United States, its agencies and instrumentalities only so far as immune from state taxation under federal law (section 12 (g)). The income of such contractor under such contract is not so immune. The same principles require the inclusion in gross income of the gains derived from the sale of United States bonds and other securities, the interest on which is immune from state income taxation. It should also be noted that, until Minnesota changes the laws applicable to the taxation of national banks, dividends on national bank shares cannot be included in gross income for state income tax purposes. The dividends on state bank shares are, however, includable, as are those of the various holding companies owning bank shares, even national bank shares.

The exclusions from gross income are likely to give rise to certain problems. An important exclusion is that of the capital value of property acquired by gift, devise, bequest or inheritance. It is specifically provided, however, that if the gift, etc., is of a right to receive income, the income received under such right is includable in gross income. The income received by a life tenant of a life estate acquired by gift, etc., would thus be includable in his gross income. This accords with the judicial construction of the comparable provision in the federal tax act. The same rule would apply if the period during which the income was to be


received were a term less than a life estate. The rule is different when the gift or bequest is of a definite sum to be paid the donee or legatee for a term of years or for life which is not required to be paid out of the income of some fund. This is treated as a gift or bequest of capital payable in installments, and is not includable in gross income even for a tax year when in fact paid out of income. Another case that has caused considerable litigation under the federal act is that in which a surviving spouse surrenders her or his rights in the property of the deceased spouse and takes under the latter's will in accordance with an election therein provided. If the bequest made by the will would be excludable from gross income under the principles just discussed, no problem arises. If, however, the bequest takes the form of a right to receive a future series of income, an important issue arises. The statute states that income received under the bequest of a right to receive income shall be includable in gross income (sec. 12 (a)). The federal income tax acts, although containing no such provision, have been construed to reach that result. Despite that fact, the federal courts have held that a bequest of income of the kind under consideration, is to be treated as though the surviving spouse had purchased that right at a price equal to the value of the surrendered interest in the deceased spouse's property, and that no income is received which is required to be included in the surviving spouse's gross income until that received exceeds the value of the interest surrendered by him or her. This is a fair practical solution, though not wholly justified by sound theory since it would be more proper to treat a part of each amount received as a return of capital and the remainder as income. The difference between our statute and the federal acts above referred to is no reason for construing our provision in any manner varying from the accepted construction of the federal provision. Our provision is, therefore, likely to receive the construction already given the comparable federal provision in dealing with the problem last raised in this paragraph.

The provisions relating to the treatment of the proceeds of life insurance and annuity contracts follow closely the federal act. A few differences should be noted. Amounts payable on the death

54United States v. Bolster, (C.C.A. 1st Cir. 1928) 26 F. (2d) 760; Allen v. Brandeis, (C.C.A. 8th Cir. 1928) 29 F. (2d) 363; under state law, see People v. Lynch, (1931) 255 N. Y. 323, 174 N. E. 696:
of the insured are sometimes left with the insurer who pays the beneficiary interest thereon. The beneficiary is required to return as income only the interest accruing after December 31, 1932. This provision will apply only to cases in which the insured died prior to January 1, 1933, since interest accrued during his life would become part of the amount payable under the policy on his death. The interest provision in section 12 (b) applies, that is, only to interest accruing after the insured's death. The amount due on an insured's death is sometimes payable in the form of an annuity to the beneficiary. Amounts received by a beneficiary under such an agreement are in theory in part return of capital and in part interest. If the amount of the policy had been received in a lump sum, it would not constitute gross income, and resort to this substitute method can be considered as the purchase of an annuity for the lump sum due under the matured policy. It should be treated in the same manner as annuities purchased by the surrender of a surviving spouse's interest in the deceased spouse's property, which has already been discussed. The provisions of the state statute concerning amounts received under life insurance contracts, other than amounts paid on the insured's death and interest payments thereon, vary from the provisions of the federal act only in that interest accrued prior to January 1, 1933, is receivable free from the burden of being included in gross income. These provisions apply to amounts received under matured endowment policies. The effect of this provision may be illustrated by the following example. A has taken out an endowment policy on December 31, 1913. His total net premium payments prior to January 1, 1933 amount to $600. The face of the policy, $1000, is payable to himself on December 31, 1933. He receives it on said date. The interest, which presumably means the earnings credited to his policy so far as not distributed to him in the form of policy dividends, may be taken as $360. A is then required to include $40 of the $1,000 he receives on December 31, 1933, in his 1933 gross income. These principles would apply even though the amount had been paid to a donee beneficiary, since the language of the statute is general and not restricted to amounts received by the insured. These provisions also apply to amounts received under annuity contracts. Assume a case in which B purchased an annuity for $10,000 on December 15, 1922, entitling him to receive $1,000 on each December 15th, commencing December 15, 1923. Assume that B is still alive on December 15,
1933. He will then have received during the life of the contract $11,000. Each annual payment will have consisted of part interest and part return of capital, the interest item becoming smaller and the capital-portion increasing with the lapse of time. If the existing act had been in force when B purchased the annuity, he would have had to return $1,000 in his 1933 gross income despite the fact that part only of that was interest. The justification for that, and the theory underlying it, are that during the earlier years he was excused from reporting the interest item in the annual payment as income. In other words, under the statutory rule the taxation of the interest in such payments is waived until the total receipts of the annuitant exceed his original investment, but, once that has occurred, he pays as the price of his earlier advantage having that treated as income which is not such on sound theory. But where, as in the hypothetical case, the annuity was bought years before the law was enacted, a different situation arises. The interest item in annual payments prior to January 1, 1933, never was subject to this tax. The price the state pays for the privilege of taxing in later years what is not income in the light of correct economic theory is thus not paid in the case of the annuity purchased before the law went into effect. The result of the general statutory rule is obviated in this case by adjusting for the interest accrued prior to January 1, 1933, the date as of which this tax applies. The term "accrued interest prior to January 1, 1933" may mean either the sum of the interest items in the annual payments prior to said date plus interest accrued between the date of the last payment previous to January 1, 1933, and said date, or the amount thereof standing as a credit to the contract as of said date which would be the sum just referred to minus amounts already paid to the annuitant in the former annual payments to him. The latter view would in effect put him in exactly the same position as if the annuity had been purchased after this law came into force except as to interest accrued between the date of the 1932 payment and January 1, 1933 (in our illustration, the interest accrued between December 15, 1932, and January 1, 1933). This would to that extent defeat the purpose of the "accrued interest" provision in section 12 (c). Hence it follows that the most reasonable interpretation thereof as applied to annuities purchased prior to January 1, 1933 (and it has no application to those purchased on or after said date) is to adjust by the whole of the interest accrued prior thereto. The
interest, however, must be computed on an annually decreasing capital sum to take account of the fact that each annual payment involved a return to B of part of his original capital. The result of this interpretation is that only the capital items in annual payments prior to January 1, 1933, are added to amounts received thereafter in determining whether any amount received by B thereafter is to be included in his gross income, and how much thereof is to be thus treated. Reverting to our illustration, if the sum of the interest items in the annual payments to B prior to January 1, 1933, plus interest accrued up to said date since the last payment prior thereto, be taken as q, then B will have to include in his gross income for 1933, when he received the eleventh annual payment of $1,000 ($11,000—q) — $10,000. If the result of this computation is a positive algebraic number, it indicates the amount B will have to include in his 1933 gross income. If it is equal to zero or is a negative algebraic number, B will have no 1933 gross income so far as this transaction is concerned.

The only other provisions concerning exclusions from gross income requiring consideration are section 12, subdivisions (h) and (i). Section 11 provides that items of gross income included within the general definition of gross income shall be deemed such regardless of the form in which received. This makes specific what is implicit in the federal act. The person who is employed by another in return for room, board and clothes, is receiving income from wages just as fully as though he were paid in money sufficient to buy those things, and would have to include the value of such things in his gross income. The person who receives a salary partly in cash and partly in the form of a dwelling house is receiving a total income equal to the sum of the cash salary and the rental value of such house. Similarly a person owning a plot of ground utilized exclusively as a subsistence farm would be receiving income equal to the money value of his produce, derived by him as laborer, capitalist, and landowner. Similarly, the person who owns his own home, which he uses as such, is deriving an income therefrom whose money measure is the rental value of that property. Taxation, however, is a practical matter that can well afford to ignore certain theoretical refinements. Hence section 12 (i) specifically excludes from income the value of foods and goods produced by the taxpayer and consumed or used by his immediate family. And section 12 (h) excludes the rental value of premises occupied by the taxpayer as his home, or for his business, except
that, when such occupancy is the consideration received in connection with a transaction such that, had such consideration been received thereunder in cash or other property, the amount thereof would have been required to be included in gross income, then the rental value thereof is required to be included in his gross income. An example will suffice to make the meaning clear. A minister of the gospel receives as compensation a cash salary plus a dwelling house. The use of the latter is part of the consideration received by him under a contract of service. If received in cash, the amount thereof would be includable in his gross income. Hence, it is so includable under the statutory provision now in question. The federal act specifically excludes the rental value of a dwelling house furnished a minister of the gospel as part of his compensation from his gross income, but does not accord the like privilege to any other group or person receiving compensation in that form. The exclusion from gross income of the rental value of premises owned and occupied by a taxpayer does effect a discrimination against the person who rents in every case in which the latter is not permitted to deduct the rents paid in computing his net income. An objection to this feature of the federal income tax system based on its arbitrary character was brushed aside with practically no argument in the Brushaber Case.55

The duty of a taxpayer to include a receipt of money or other property in his gross income arises only if it is income as distinct from capital, and then only if it is income of the kind includable in the statutory definition of gross income. In the case of a federal income tax the distinction between income and capital is important because a tax on the receipt of a capital item would be considered a direct tax which would have to be apportioned among the several states on a population basis. It is conceivable that an attempt to levy our state income tax on capital receipts might be held to be a tax on capital values, that is, an ordinary property tax, and, therefore, subject to a somewhat more rigid application of our state uniformity clause than similar clauses have elsewhere received in their application to taxes on income. It is not improbable, therefore, that our courts may have to develop a legal theory for distinguishing income from capital receipts. There is a goodly body of federal authority on this distinction so far as federal taxation is concerned. Those decisions constitute a persuasive body of

doctrine to which our courts can refer if, as and when the distinction becomes relevant to an issue raised by our state income tax act. An example must suffice to illustrate the problem. Assume that a corporation issues its stock at an amount in excess of par. The result is a paid-in surplus. Is that paid-in surplus a capital receipt or income to the corporation? Probably the former.

**GROSS INCOME — CAPITAL GAINS**

The Supreme Court of the United States has decided that capital gains are income, and not capital, within the meaning of the term “income” as used in the sixteenth amendment. There is no doubt but that the inclusion of capital gains in income under the state law violates no provision of either the state or federal constitutions. The computation of the gain derived from the disposition of property is subject to rather detailed provisions found in sections 16, 17, 18 and 19 of the state act. This discussion will be limited to outlining the principles embodied in those provisions.

The legislature could have treated every inter vivos transfer of property, other than by gift, as the occasion for requiring the transferee to account to the state for any gain derived by him therefrom, regardless of whether he received in consideration for the transfer cash or other property. The only possible doubt would arise in case the property received by him in the exchange had no readily realizable market value. This was the practice of the federal government under the early income tax acts. This frequently involved taxation of profits tied up in property other than cash or assets of equal liquidity. It was to reduce the number of situations of this character that led to the gradual development of the present federal practice of non-recognition of gain or loss on certain specified classes of exchanges of property for property. A person transferring property for a consideration may receive therefor cash, or other property, or both cash and other property. If

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the whole consideration received is cash, the transaction is closed, and the gain or loss, if any, will enter into the taxpayer's account with the government for the taxable year during which the transaction occurred. If the whole consideration received is property other than cash, the transaction may be either closed in the above sense, or non-closed. A non-closed transaction is one the gain or loss from which, if any, does not enter into the transferrer's income account with the government during the year of the exchange merely because the exchange occurred during that year; reporting the gain or loss is deferred until such time as the property received in the exchange, or other property received for it under a non-closed transaction, is disposed of by a closed transaction. An illustration will make this plain. Section 17 (a) (1) provides that no gain or loss shall be recognized if stock of a given class in a corporation is exchanged solely for stock of the same class in the same corporation. During the heyday of our recent speculative era, it was not an uncommon thing for corporations to multiply the number of their shares through so-called stock split-ups. Assume that A was the owner of 100 shares of the common stock of B Corporation; that said corporation during 1933 split-up its stock so that each shareholder was entitled to receive two shares of new common stock for each one share of the old; and that this exchange is completed during 1933. As a result A acquired 200 shares of the new common for his 100 shares of the old. Even though the market value of the 200 shares of the new common is in excess of the gain basis applicable to A in disposing of his 100 shares of the old common, he need report no gain from the exchange; nor, if such market value were less than the loss basis applicable to A in disposing of said 100 shares of old common, can he take any loss incident to the exchange. This does not mean that he may not have a 1933 gain or loss with respect to his disposition of his original shares of old common; it means only that the aforesaid exchange involves neither gain nor loss. If, however, A should during 1933 sell the 200 shares of the new common for cash, then

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60This must not be construed to mean that the whole gain will necessarily have to be returned during such taxable year. It would mean that, except in so far as the taxpayer would be permitted or required to report the transaction on the installment basis provided for in section 9(c). The statement in the text, as applied to such a case, would mean that the year in which the transfer was made would mark the beginning of the period over which the gain therefrom would have to be returned on the installment basis.
The situations thus far discussed have involved sales of property for cash, and certain specified exchanges of property for property other than cash. If an exchange of property for property does not belong to one of the classes specified in section 17 (a), then it is in general treated as a closed transaction, exactly as though the property had been transferred for cash. This would apply to exchanges of property in consideration for other property plus cash, including exchanges that, but for the receipt of cash in connection therewith, would be treated as non-closed in the sense above discussed. It would also apply to a case in which the party, disposing of property by what would otherwise be a non-closed transaction, receives as part consideration property which is neither cash nor property of the kind the receipt of which would make it a non-closed transaction under section 17 (a). An example may make the meaning clearer. Assume that A Corporation and B

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61 Care must be exercised in arguing from decisions interpreting this method as employed in the federal income tax acts, since the provisions relating thereto have varied in the different acts.

62 The statements in the last two sentences do not apply where cash, or such other property, is received in connection with involuntary conversions of the kind covered by section 17(a) (6). That case is separately discussed.
Corporation are merged, and that C, a stockholder in the former, receives in exchange for his 100 shares 200 shares of B Corporation plus $1,000. But for the receipt of said $1,000, the exchange would be a non-closed one under section 17 (a) (2). The receipt of that $1,000 puts the exchange into the class of closed transactions. The result would be the same had C received a bond of D Corporation worth $1,000 instead of that $1,000 cash. This treatment differs from that accorded such transactions under the existing federal act. That act puts them in a separate category which may be called mixed transactions. The rule applicable to them is that gain is recognized on their occurrence, but not in excess of the cash or value of the property received other than that which could be received without recognition of gain. If, for example, the gain to C on the exchange of his shares in A Corporation in the last example had been $1,100, the gain would be recognized only to the extent of $1,000, that is, the cash received by him, or the market value of the D Corporation bond, as the case may be. The duty to account for the other $100 gain is deferred. There is no immediate right to take a loss in these cases, if the transaction involves a loss. As stated, the state statute has not incorporated this principle as applied to five of the six non-closed transactions specified in section 17 (a). It has, however, adopted it for the case of the involuntary conversion of property specified in section 17 (a) (6). The scope of this provision is readily determinable from the language used. The only thing that requires comment is that it is that part of the money received in connection with any such conversion which is not within one year expended to replace the converted property that sets the limit to the amount of gain required to be recognized, rather than the whole amount of the money received on any such conversion.

There is one other class of transfers that are specifically treated as dispositions from which neither gain nor loss shall arise for purposes of computing income. These are dispositions made by gift, devise, bequest or inheritance, and the passing of property from a decedent to his estate (sec. 16 (d) ). A donative inter vivos transfer in trust is treated as a gift, except where the donor reserved a life estate and a power to revoke, in which case it is treated as a disposition by will by the donor (sec. 18 (c), (d) ). The significance of these provisions will be hereinafter considered.

It becomes necessary now to determine how to compute the
amount of gain on the disposition of property by a transaction in
collection with which gain is recognized under the principles just
discussed. The three most important factors that determine the
applicable rules are (a) how did the party now disposing of the
property acquire it; (b) when did he acquire it; and (c) what
adjustments have to be made in the gain basis because of past
transactions affecting the property or the property for which it now
stands. The last of these will be first discussed.

Section 16 (a) defines the gain as the excess of the amount
realized on the disposition of property over the gain basis pro-
vided in sections 18 and 19. Section 18 lays down the gain basis
when the property disposed of was acquired by the person dispos-
ing thereof on or after January 1, 1933; section 19 defines the gain
basis in connection with the disposition of property acquired by
the transferror prior to said date. That date was selected because
the income tax act is in substance effectively operative as of said
date. The reason for making the applicable rule dependent upon
the time of acquiring the property disposed of was to accord at
least a limited protection to what might be considered as capital
acquired prior to the time as of which the tax became effective.
Under section 16 (c) the amount realized on the sale or other dis-
position of property is made to include the money received plus
the fair market value of other property received by the transferror.
This requires no comment. Section 16 (b), however, is very im-
portant. An example will show this. Assume that A has bought
a rental property on January 2, 1933, for $10,000; that he made
improvements thereon at a cost of $2,000; that the amount of the
depreciation thereof for 1933 was $100 which A could have de-
ducted in computing his 1933 net income; and that he sold the
property during 1934 for $13,000. Since the property was acquired
by purchase after January 1, 1933, the starting gain basis is its
cost, $10,000. Section 16 (b), however, requires that basis to be
adjusted in two respects: first, by way of addition on account of
added capital expenditures, viz., $2,000; and second, by way of
deduction on account of depreciation that A would have been enti-
tled to deduct for 1933, which amount of capital he has in a sense
recovered free from tax. Hence, in the illustration in question the
gain basis equals $10,000 plus $2,000 minus $100, that is, $11,900.
The gain equals $13,000 minus $11,900, or $1,100.

The factors for which adjustments in the gain basis are re-
quired to be made are specified in section 16 (b). They follow the general lines embodied in the corresponding provisions of the federal income tax act. Their general aims are to reflect capital changes, whether of addition or subtraction, affecting the property in question, and to prevent deductions once allowed for from being used more than once. The former aim appears in the requirement that capital expenditures are to be added to, and capital receipts to be deducted from, the applicable basis; the latter aim appears in the requirement that the basis is to be reduced by the depreciation that might have been taken in prior years in computing the tax due under this statute. Certain of the provisions of this subsection require brief explanation. If a taxpayer has acquired the property prior to January 1, 1933, its value of that date will reflect the accrued depreciation up to that time (assuming it is depreciable property). If, however, the applicable basis on the disposition of that property is not its value on said date, then it is necessary to adjust for the prior accrued depreciation in order to determine the capital investment remaining intact on said date, so far as that can be measured by anything other than the value as of said date. Hence the requirement for an adjustment on this account in this situation.

The theory of the non-closed transaction has already been described. Its whole purpose is to defer the time when gain is required to be returned; its aim is not to permit any gain to escape untaxed. In order to prevent this latter, the statute provides that when a taxpayer disposes of property acquired by him in a non-closed transaction, the gain must be computed exactly as if he were disposing of the property given in the exchange. An example will help to make this clear. Assume that A in 1933 bought a share of B Corporation stock for $100; that he exchanged it for a share of C Corporation stock as an incident to a merger of these two corporations; that the C Corporation share at the time of the exchange had a market value of $150; and that thereafter A sold his C Corporation share for $175. The law treats A, for purposes of computing the gain on the sale of the C Corporation share, as though he were selling his original B Corporation share. That is to say, the C Corporation share is treated as a mere substitute for the original B Corporation share. This is the principle of the substituted basis. Assume further that A, while owning the B Corporation share, had received a tax-free distribution of $10 with
Section 16 (b) would require A, if he sold the B Corporation share after the receipt of said tax-free distribution, to reduce his gain basis by $10, so that it would be $90. The provisions of section 16 (b), requiring adjustments of the gain basis on the sale of property acquired in a non-closed transaction to include those which the taxpayer would have to make if he were disposing of the property transferred by him in the non-closed transaction, would, therefore, require A to make adjustment of $10 for that tax-free distribution when he sold his share of C Corporation stock. His gain on its sale would thus be $175 minus $90 or $85. Had he also received a tax-free distribution from C Corporation while he owned its share, a similar adjustment would have had to be made. The adjustments required to be made when disposing of property acquired by gift are somewhat similar, since they include not only those due to factors arising during the donee's ownership but also those due to factors arising during the donor's ownership. There is, in short, a "tacking" of adjustments. This is the significance of the provision in Section 16 (b) which provides that a donee disposing of a gift shall be treated as the owner from the time it was acquired by the last preceding owner who did not acquire it by gift. Assume, for instance, that A had bought a rental property during 1933 for $15,000 which he later gave to B at a time when it had a market value of $20,000; that during the period of A's ownership the property had depreciated $500, which A could have deducted in computing his net income under this statute; and that thereafter B sold it for $16,000. His gain would be $16,000 minus ($15,000 (cost to A) minus $500 (deductible depreciation during A's ownership) ), or $1,500. Adjustments during A's ownership of the kind increasing the basis could, of course, be added to the basis required to be employed in computing B's gain on his disposition of said property. The basis would also have to be adjusted by deductible depreciation accruing during B's ownership.64

The basis to which these adjustments have to be applied varies.

63 The problem of tax-free distributions by corporations will be hereinafter considered. For purposes of the present illustration the distribution will be assumed to have been from B Corporation's capital.

64 Whether B would be required to adjust for the depreciation accruing during the taxable year of the sale up to the time of the sale would depend on how he treated that item in the remainder of his return for that year. So far as he included it in the depreciation deduction for that year, a negative adjustment in equal amount would have to be made in his gain basis; so far as he did not so include it, no adjustment therein would be required.
as has already been stated, with both the time and manner of acquisition of the property disposed of. The significant date is January 1, 1933. The detailed rules governing the gain basis when property is disposed of that was acquired on or after that date are found in section 18. They will be discussed apart from those applicable where the property was acquired prior to said date. The basis is cost of acquisition in the case of all property unless the statute specifically provides another basis. It does so if the property was acquired by gift, devise, bequest or inheritance, and when acquired from a decedent by his executor or administrator. The rule in all these cases except that in which the property was acquired by gift is that the gain basis is the fair market value of the property at decedent's death. The rule under the present federal income tax act is somewhat different. An inter vivos transfer in trust under which the decedent reserved the income and a power to revoke is treated as a disposition by will (sec. 18 (d)). This applies only if the decedent did not exercise the power to revoke during his life, and means that the gain basis to the person entitled to the property after the settlor's death is its value at the time of his death. If the decedent has during his life exercised his power to revoke, the property would revert to him, and this provision would not be applicable. This provision accords with the existing federal rule.

The case in which the property disposed of was acquired by gift has its own rule, a rule framed to prevent gain from escaping taxation through judiciously timed gifts. The donee is required to trace back the title until he reaches a prior owner who acquired it by some method other than gift. The donee's gain basis is the same as it would be were it now being disposed of by such former owner who acquired it by some method other than gift. This rule also applies to donative inter vivos transfers in trust since the basis is what it would be if the grantor were disposing of the property; if such grantor had originally acquired it by gift, the basis applicable to gifts would apply. It seems quite clear that this provision relating to donative inter vivos transfers in trust has reference to dispositions by the trustee. The question is whether it also applies to transfers by the cestuis of their equitable interests. The cestuis under such a trust clearly acquire their equitable interests by gift. Their interests, however, are not exactly the property transferred by the grantor to the trustee. In
a sense, the grantor never had a separate equitable estate in the property that he transferred to the trustee. The equitable interests of the cestuis are, however, property within the definition found in section 1, and they are property acquired by gift. Hence the gain bases on their disposition are governed by the rule applicable to other property acquired by gift. That requires finding the last preceding owner who did not acquire such property by gift. But, in a sense, the equitable interests as such never had a prior owner. This seeming impasse could be resolved either by treating such interests as not within the provisions relating to gifts, or treating as their last preceding owner who did not acquire them by gift the last preceding owner of the legal title to the property in which such estates exist, who did not acquire that legal title by gift. In the former case the gain basis to the equitable owner would be cost, that is, nothing. In the latter case the gain basis for the sum of all the equitable estates created by the trust deed would be the same as that applicable if the cestuis together held the full legal title, provided the equitable estates created by the deed included all possible equitable interests in such property. This latter theory seems the correct one since it involves no discrimination in the matter of the gain basis applicable to donated property disposed of by the donee dependent merely on the legal or equitable character of the donee's acquisition. But this solution gives rise to administrative difficulties where, for example, the trust deed creates a life estate in one cestui, with an equitable remainder in another. Here the gain basis would have to be allocated between these two, presumably on the basis of their respective present values at the date of acquisition. This might be somewhat hard on the equitable remainderman, but no better basis suggests itself. What has been said above does not, of course, apply to the transfer of an equitable estate by one who had received it by gift from a prior holder of that equitable estate. Such a transfer would be clearly governed by the provisions applicable to transfers of property acquired by gift.

The theory of the substituted basis applicable when disposing of property acquired as the result of a non-closed transaction has already been explained. Special problems, however, arise in two cases. If A's rental property is taken from him by the state under the power of eminent domain, there is an involuntary conversion of that property into money. Assume that he had acquired such
property on or after January 1, 1933, at a cost of $10,000, and that the state had paid him a condemnation award of $12,000. Ignoring adjustments in the gain basis, he has then realized a gain of $2,000. Under section 17 (a) (6) this will be treated as a non-closed transaction to the extent that he expends that $12,000 within one year in the acquisition of another rental property. If he spends it all for that purpose within that time, no gain need be returned; that is deferred until he disposes of the newly acquired rental property by a closed transaction, and is then measured as though he were disposing of his original rental property. If, however, he reinvests but $11,000 in the new rental property within the prescribed time, then he is required to immediately report as a gain $1,000, which is equal to that part of the $12,000 which he retained in cash. Assume then that thereafter he sells his new rental property for $15,000. Under the principle of the substituted basis, the basis for computing the gain on this sale would be the same as if he were now selling his original rental property. That basis was $10,000. His original investment of $10,000 has now been transformed into $15,000 received on the sale of the new rental property, plus $1,000, the part of the $12,000 received from the state which he did not reinvest in the new rental property. That makes a total of $16,000. His total gain from this series of transactions is thus $6,000. However, he has already returned a gain of $1,000, which should not again be taxed. A should, therefore, be required now to report only $5,000. Allowance can be made for the gain already reported by adding that $1,000 to the gain basis. Furthermore, since the gain basis is that of the original rental property, account will have to be taken of the fact that $1,000 has already been recovered because only $11,000 of the $12,000 was reinvested in the new rental property. This can be reflected through reducing the gain basis, $10,000, by that $1,000. This is the sole purpose of the adjustments of the gain basis required in this situation by the provisions of Section 18 (e). The gain basis thus becomes $10,000 minus $1,000 plus $1,000, or $10,000. The gain required to be reported on the sale of the new rental property is, therefore, $5,000. It may seem absurd to adjust the basis by both adding and subtracting $1,000, as was done in this case. The plus and minus adjustments of the kind referred to in this section 18 (e) will cancel each other in every case in which the gain required to be returned on the conversion of the old
rental property is equal to the unexpended part of the sum received on the conversion. They will not cancel each other if the gain thus required to be returned is less than such unexpended part, nor if there is no gain. Since such unexpended part is the maximum of the gain thus required to be reported on the conversion of the original rental property, the above enumeration comprehends all possible cases. And they could all be included in a single rule by adopting that actually found in section 18 (e). This seems preferable to formulating separate rules for each of the possible situations.

Section 18 (f) is concerned with another type of non-closed transaction. Assume that A is a stockholder in B Corporation which is engaged in two kinds of business; that B Corporation transfers those of its assets connected with one of those businesses to a newly organized C Corporation in exchange for all its shares; that B Corporation thereupon distributes the C Corporation shares received by it to its own stockholders so that each of them receives one share of C Corporation stock in respect of each B Corporation share; and that all this was done under a plan for reorganizing B Corporation's business. Under Section 17 (a) (3), A can receive the C Corporation share free from tax. He now has one share of B Corporation stock and one share of C Corporation stock. Assume now that A acquired his original B Corporation share for $100 during 1933, and that some time after the reorganization he sold his C Corporation share for $75. How is the gain to A on that sale to be computed? An analysis of the underlying facts will explain the statutory rule. In selling that share A is in substance disposing of part of his original investment in the B Corporation share. It would be unfair to treat him as if he had received the C Corporation share without cost. Hence, a part of his original investment should be allocated to the share he sold. The statute requires that an equitable portion of the gain basis applicable to the B Corporation share be allocated to the C Corporation share. Assume that an allocation on the basis of the proportion of B Corporation's net assets transferred to C Corporation would be equitable, and that 60% of its net assets had been thus transferred. Then the gain basis for computing gain on A's sale of the C Corporation share would be 60% of $100, or $60, and his gain would be $75 minus $60 or $15. If he sold his B Corporation share for $50, then, since the gain basis for it is $40, his gain
would be $10. This is the theory underlying the provision in section 18 (f). Note, however, that the particular method of allocation employed in this example is not specifically prescribed; the statute only requires an equitable apportionment of the gain basis applicable to the old share over the old and the new shares. Practically the same method is adopted in determining the gain basis when a taxpayer disposes of stock with respect to which a stock dividend has been received by the transferror, and when disposing of the shares received by way of stock dividends (section 18 (h)).

Section 13 (d) excepts from deductible losses those resulting from wash sales or transactions likely to be employed to make losses for tax purposes. Assume that A owns 100 shares of stock acquired during 1933 at a cost of $5,000; that he sells them on December 30, 1933, for $4,000; that within 30 days thereafter, say on January 15, 1934, he repurchases 100 shares of the same kind for $4,500; and that thereafter he sells these newly acquired shares for $6,000. Under section 13 (d), he would be prohibited from deducting the $1,000 loss sustained during 1933. When in 1934 he sells the new shares, he is treated as though he were selling the shares originally owned that were sold during 1933. This is another application of the principle of the substituted basis. Hence the gain basis is $5,000. This gives him during 1934 an apparent profit of $6,000 minus $5,000, or $1,000. But this computation overlooks the fact that A had to pay $500 more in acquiring the stock in 1934 than he received on the sale of his formerly owned shares in 1933. His total net investment in this series of transactions which is consummated by the 1934 sale is $5,000 plus $500, or $5,500. His real gain is, therefore, $6,000 minus $5,500, or $500. This factor is taken care of by the statutory rule that the gain basis (which is that applicable to the shares sold during 1933) is to be increased by the excess of the repurchase price of the substituted shares over the selling price of the original shares. Had A's repurchase price in 1934 been under $4,000, say $3,500, the gain basis would have to be decreased by $500 to reflect the fact that his net investment when he sold the shares acquired in 1934 was really $5,000 minus $500 (the amount of the $4,000 realized on the 1933 sale which he was not required to reinvest in acquiring the shares purchased in 1934), or $4,500, which would make his gain $6,000 minus $4,500, or $1,500. This is the aim
and effect of the special rule applicable to the situations covered by section 18 (g). Its application is restricted to cases in which stocks or other securities have been acquired in connection with sales to produce losses for tax purposes of the kind referred to in section 13 (d). There is no reason for applying it to cases in which sales of that character antedated January 1, 1933.

The state act has no specific rule for the computation of the gain on the sale of stock rights, nor on the computation of the gain on the sale of shares with respect to which the seller has received stock rights which he has either sold or exercised. The federal practice with respect to these matters has varied from time to time. The matter is rather complicated, and will be disposed of by referring the reader to federal practice.65

The gain basis when a taxpayer disposes of property acquired prior to January 1, 1933, is defined in section 19. The general rule is that the gain basis is the fair market value of the property as of the above mentioned date. This is the invariable rule when the property now being disposed of (except inventory property) was acquired by the transferrer by any method other than purchase. It follows that the principle of the substituted basis, and the special rule applicable to the disposition after said date of property acquired by gift thereafter, have no application to the disposition of property acquired before January 1, 1933, so far as the transactions, in connection with which the principle of the substituted basis would be employed, or such gift, occurred, or was made, prior to said date. Of course, if a taxpayer should, for example, on or after January 1, 1933, exchange property, acquired by gift prior to said date, by a non-closed transaction, and thereafter sell the property received in such exchange, this is not treated as a case of disposing of property acquired prior to January 1, 1933, and the principle of the substituted basis would apply to it. The gain basis in the case of property acquired on or after January 1, 1933, depends on the way in which the taxpayer acquired it. This is not the case with respect to property acquired prior thereto with the exception already indicated. The January 1, 1933, value is in these cases treated as the taxpayer's capital which he is entitled to recover tax-free on the sale of the property. A question arises as to whether, in those cases in which the gain basis is the

65Miles v. Safe Deposit & Trust Co., (1922) 259 U. S. 247, 42 Sup. Ct. 483, 66 L. Ed. 923; Regulations 77, art. 58.
January 1, 1933, fair market value, any of those adjustments have to be made which are provided for in section 16. It is clear that depreciation sustained prior thereto need not be deducted since that is reflected in the January 1, 1933, fair market value. It is also clear that capital additions, or capital deductions, will also be reflected in that value so that the only proper adjustment to be made therefor would be no adjustment at all. The case of shares of stock requires special consideration. Section 16 (b) requires the gain basis to be diminished by tax free distributions of capital received by the taxpayer in respect of such shares at any time during his ownership thereof. Tax-free distributions are described in section 21. Such capital distributions made prior to January 1, 1933, need be adjusted for only so far as proper. But, if the gain basis is the January 1, 1933, market value, such distributions will be reflected in that value so that the proper adjustment therefor is no adjustment at all. It is clear, therefore, that so far as adjustments of the kind provided for in section 16 (b) arise prior to January 1, 1933, they will be reflected in the market value as of said date, and need not again be accounted for when that value is taken as the gain basis.

The case of property acquired by the taxpayer for a consideration prior to January 1, 1933, is excepted from the general rule just discussed. The method for determining its gain basis when disposed of on or after January 1, 1933, is as follows. First ascertain its value as of said date. Then ascertain its cost, to the taxpayer. Adjust that cost for the factors specified in section 16 (b) so far as any are relevant, and if said adjusted cost is greater than the January 1, 1933 value, use the cost (not the adjusted cost) as the gain basis. If the adjusted cost is less than such value, use such value as the gain basis. This conclusion is not wholly free from doubt. Section 19 says that cost shall be used if cost exceeds January 1, 1933, value, making no reference to using adjusted cost. However, the purpose of this provision was to confer a benefit, not to impose a disadvantage, on the taxpayer by insuring that price level changes between the time of acquiring the property and January 1, 1933, should not prevent him from recovering his depreciated cost up to said date, and to do so without requiring him to pay as the price therefor a surrender of the privilege accorded others of protecting his capital value as of said date. This purpose would be defeated by a narrow con-
struction of section 19. Construing the term “cost” in the expression “if its cost to the taxpayer, etc.” in a broad way to mean “remaining unrecovered costs as of January 1, 1933” will enable treating this case as above outlined. An example will clarify this matter. Assume that A during 1928 bought a machine at a cost of $10,000; that the sustained depreciation thereon up to January 1, 1933, was $5,000; that its fair market value as of said date was $6,000; and that A sold it in 1933 for $6,000. The actual cost thus exceeds the January 1, 1933, value. If the actual cost governs the selection of the gain basis, that would be $10,000, which, adjusted as required by section 16 (b) for sustained depreciation, would give an adjusted basis of $5,000, and a gain of $1,000. If, however, adjusted cost up to January 1, 1933, governs the selection of the gain basis, then the January 1, 1933, value, $6,000, becomes such, and there is no gain. The result of the former alternative would be that a provision intended to secure A at least as favorable a position as he would have had if the January 1, 1933, value were to be his gain basis, produces a contrary result. For this reason, section 19 might well be construed as though it provided for using cost as the gain basis only if the adjusted cost up to January 1, 1933, exceeded fair market value as of said date. Once that is determined, then cost must be adjusted to get the adjusted basis which is to be subtracted from the selling price to get the gain on the sale.

The case of the disposition of shares of stock acquired prior to January 1, 1933, raises the same kind of issue. Section 16 (b) requires the gain basis to be adjusted for tax free capital distributions received with respect thereto by the taxpayer. Assume that A had bought a share of stock during 1931 for $100; that during 1931 and 1932 he had received a total of $25 tax-free capital distributions, i.e., distributions of the kind that would be tax-free if received on or after January 1, 1933 (section 21). The cost, adjusted up to said date, equals $75, which represents his unrecovered cost up to January 1, 1933. If, the share’s market value as of said date is $80, then that is in excess of such adjusted cost basis, and that market value is the gain basis for that share. That need not be adjusted for the tax-free capital distributions prior to said date since that value reflects that factor. If, however, the January 1, 1933, value of the share had been $60, then, since that would be less than the adjusted cost basis up to that date, $75, the gain
basis becomes the cost, $100. But this must then be adjusted to reflect the fact that A has already recovered $25 of his cost through prior capital distributions. The methods herein described are those consistent with the purposes in defining the gain basis in section 19, and in requiring adjustments for capital distributions to the taxpayer with respect to such share.

Inventory property on hand at January 1, 1933, is not subject to either of the rules thus far discussed. The gain basis with respect to it is its January 1, 1933, value or its last inventory value, whichever is the greater.

The date, January 1, 1933, has practically the same significance for the state statute with respect to ascertaining the gain basis that the date March 1, 1913, has for the federal income tax act in connection with the similar problem thereunder. The rules as to the gain basis under the state law are, however, quite different from those found in the existing federal income tax act. The principal differences relate to the gain basis of property acquired on or after January 1, 1933, by bequest, devise, and inheritance (as compared with the federal rule applicable to property thus acquired on or after March 1, 1913), and to the gain basis for property acquired prior to January 1, 1933 (as compared with the federal rule applicable to property acquired prior to March 1, 1913). The federal act also has numerous provisions for special cases that have no counterpart in the state act.

GROSS INCOME — CORPORATE DISTRIBUTIONS

Corporate distributions to members constitute an important type of gross income. They include not only distributions to stockholders by corporations, but also distributions to members by associations, business trusts, and other organizations treated as corporations under the tax act (sections 1, 21 (a)). The principal form of corporate distributions to members is the regular dividend, whether paid in cash or other property. A dividend payable in the bonds of the corporation declaring the dividend is an instance of a dividend payable in property. The test of whether a distribution is a dividend includable in gross income is its source. It is such only if made from accumulated earnings or profits. The federal income tax act defines dividends as distributions from earnings or profits accumulated after February 28, 1913, thus permitting distributions from earnings or profits accu-
mulated prior thereto to be received tax free. This seeming favor, however, is offset by the requirement that such tax-free receipts reduce the gain and loss basis of the share with respect to which such distribution was received. The state act does not differentiate between distributions from earnings and profits accumulated prior to January 1, 1933, and from those accumulated on or after that date, but treats them all as dividends. All distributions are deemed made from accumulated earnings or profits if, and to the extent that, there are any such on the date the dividend is declared, or, if made without formal declaration, on the date of payment or credit thereof to the shareholders or members. In applying this presumption (which is a conclusive one) the net earnings of the year in which the distribution is ordered, or made, are pro-rated on a time basis. The reference is to the total corporate net earnings for such year, not merely to the proportion thereof subject to the state tax. The federal act has somewhat similar provisions, but has further conclusive presumptions. If a dividend is distributed in kind rather than in cash, the state act requires the recipient to include it in his gross income at its fair market value on the date the distribution was ordered, or, if no declaration was made, on the date of the actual payment or credit thereof to him. This will sometimes result if the dividend being returned at a figure which will be either greater or less than the contemporaneous charge on the corporate books. For instance, A Corporation might declare and pay a dividend payable in Liberty bonds which had been acquired, and which were being carried on the corporate books, at a cost of $10,000. If said bonds had a market value of $11,000 on the date said dividend was declared, the stockholders would be required to report dividend income of $11,000, though A Corporation would charge surplus with but $10,000.

A corporation may have a surplus from which dividends may be declared which is not the result of accumulated earnings or profits. This would occur if it had written up its assets on a revaluation thereof. This would, of course, increase its surplus by the amount of the write-up. A dividend declared by this corporation at a time when all its accumulated earnings and profits had already been distributed (as determined by the application of the presumption referred to in the preceding paragraph) would have to be charged against the surplus resulting from said revalu-
ation of its assets (assuming no other transactions affecting its surplus). Dividends received under these circumstances would not have to be included in the recipient's gross income until they exceeded the gain basis applicable to the stock with respect to which they had been received, in which case the excess would be treated as income for the year in which received. In applying this rule dividends of this kind received by the owner of the stock on or after January 1, 1933, must be accumulated in order to determine when their aggregate exceeds the applicable gain basis of the stock on which they were paid; distributions from such a surplus received prior to said date can be ignored, since their effect will already have been reflected in the adjusted gain basis against which receipts of this character are required to be measured in determining when they produce income to the taxpayer. That is, the effect of the references to the "applicable loss and gain basis" in section 21 is to incorporate into the pertinent provisions of section 21 the relevant principles found in sections 16 to 19, inclusive, for computing gains or losses on the disposition of property. This is sound theory, since the transactions referred to in section 21 in connection with which this occurs are substantially analogous to partial or complete dispositions of property. Example: Assume that A had purchased a share of stock in 1931 for $100; that prior to January 1, 1933, he had received $25 in dividends which were required to be treated as charged against unrealized appreciation surplus; that during 1933 he received a $50 distribution of that character, and another equal amount of that kind during 1934; that his gain basis for such share was cost, $100. His adjusted gain basis is, therefore, cost less the distribution received prior to January 1, 1933; that is $100 minus $25, or $75. During 1933 he receives a $50 tax-free distribution. That has no immediate effect on his income. When he receives another tax-free distribution of $50 during 1934, his accumulated tax-free distributions aggregate $100. This is $25 in excess of his adjusted gain basis for said stock. That $25 would have to be treated as part of his 1934 income. It should also be noted that such tax-free distributions from a surplus of this character diminish the gain basis when the shareholder disposes of his share. This is specifically provided for in section 21 (b), but, apart from that, would be required in any event under section 16 (b), since these are one type of tax-free distributions of capital referred to in that section.
Section 21 (d) applies to distributions incident to the complete or partial liquidation of a corporation. The rule is that such distributions shall be treated by the recipient as the price received on the sale to the corporation of the whole or a part of his capital interest in the corporation represented by the shares with respect to which the distributions are made. The taxpayer is entitled to receive tax-free an amount equal to the adjusted gain basis applicable to his shares. As soon as the amounts received by him in liquidation exceed such adjusted gain basis, the excess is taxable. If a distribution is one in liquidation of a corporation, the whole of it is treated as a return of capital to the recipient shareholder, regardless of whether it is charged on the corporate books against capital, a capital surplus, or accumulated earnings or profits. This is the significance of the provision of section 21 (d) that no amount received in liquidation is to be treated as the distribution of an ordinary dividend. It should also be noted that, if the liquidation occurs as an incident to a non-closed transaction (as specified in section 17 (a)), it too is treated as a non-closed transaction. This is the effect of the provision that the gain to the distributee shall be recognized only to the extent provided in section 17. For example, assume that the corporation in which A owns shares transfers all its assets to another corporation in exchange for all the latter's stock, and that the former then liquidates by distributing the new shares received by it to its own shareholders. The receipt by A of his proportion of the shares of the new corporation is in liquidation of his own capital interest in the old corporation, but under section 17 (a) it is, as to A, a non-closed transaction. Hence the provisions of section 21 (d) requiring him to return any gain thereon would not apply. The provision that losses on liquidation are deductible only when the corporation being liquidated has made its final distribution requires some comment. When the final distribution has been made depends upon whether the liquidation was complete or partial; in the latter case the final distribution is deemed to have been made when the partial liquidation is completed. Assume a corporation engaged in two businesses that decides to liquidate one; that it decides to recognize this change by a readjustment of its capital structure by reducing its capitalization by 40%; and that it carries this out by distributing to its shareholders part of its assets in exchange for 40% of the stockholdings of each stockholder. For the purposes of determining
when a stockholder can return any loss he may have incurred on
the surrender of that portion of his stock, the corporation is
deemed to have made its final distribution when the partial liqui-
dation has been completed.

It is only necessary to call attention to the fact that the state act
does not treat stock dividends as income. In this respect it is sim-
ilar to the federal income tax act, and this is also true with respect
to the state statute's provision to prevent the exclusion of stock
dividends from gross income from being resorted to to effect
what are in substance distributions of ordinary dividends. To be
treated as a stock dividend, however, it is not necessary that the
stock received as a dividend be of the same class as that with
respect to which the distribution was made, provided only that the
stock received be that of the distributing corporation.

GROSS INCOME — INCOME FROM ANY SOURCE

Section 11, which defines "gross income," includes "income
from any source whatever." A few examples will suffice to
indicate the scope of this "catch-all" clause. It covers gains from
gambling and any other type of illegal transaction.66 There are
certain to be many cases in which a taxpayer will have taken cer-
tain deductions on the assumption that the facts existed which
under the statute condition the privilege of making such deduc-
tions. Section 11 itself specifically refers to one such case, that in
which a taxpayer has paid a tax of the kind permitted to be de-
ducted in excess of that legally due from him. He will generally
have deducted the full amount thereof actually paid. He receives
a refund of the excess in a subsequent year. This refund could
be treated in one of two ways: either revise the return of the year
when the taxpayer deducted the excessive tax, or include the re-
fund in the income for the year of its receipt, thus correcting a
past under-statement of net income by increasing the net income of
the year the refund was received. Section 11 specifically requires
the latter method. The refund comes within the category of "in-
come from any source whatever." An under-statement of the net
income of a given year is very likely to occur as a result of the
"bad debt" deduction. If a taxpayer should in a given year collect
a debt for which he had made a bad debt deduction in a prior year,

66 United States v. Sullivan, (1927) 274 U. S. 259, 47 Sup. Ct. 607,
71 L. Ed. 1037.
justice requires that an adjustment of some kind be made. One way of adjusting the matter is to treat recoveries with respect to debts deducted in prior years as income for the year of their recovery. Such recoveries come within the class of "income from any source whatever." A more interesting case within it is that in which a taxpayer pays off his own obligation for less than the value he received when he incurred such obligation, where this does not occur as an incident to bankruptcy, receivership, or a composition with creditors. Assume that A issues his bond in return for a loan of $1,000; that he received from the lender $1,000; and that thereafter he reacquired said bond for $900. The original borrowing increased his assets by $1,000, but at the same time increased his liabilities by $1,000, and so left his net asset position unchanged. Now, the discharge of his liability by the payment of but $900 involves a decrease in his assets of but $900, but a decrease in his liabilities of $1,000, and thus an increase in his net wealth of $100. This is income that comes within the category of "income from any source whatever."

DEDUCTIONS FROM GROSS INCOME

Net income means gross income less the permissible deductions. The latter are defined, for nearly all taxpayers, in sections 13 and 13-1. Those permitted by the state act correspond quite closely to certain of those permissible under the existing federal income tax act, but the latter provides for some deductions that have no counterpart in the state statute, and the state act differs from the federal in so far as it permits the deduction of necessary expenses of sickness and accidents to the taxpayer or his dependents (section 13 (k)). If experience under federal income tax acts can be taken as an indication, there will be numerous questions as to whether particular items are deductible under the state statute. It is, of course, quite impossible to discuss them all. The following treatment will touch only the high points.

Business expenses constitute probably the most important single item of deduction. Though the language used in the state

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statute differs somewhat from that employed in the federal act, their scope is sufficiently similar to give decisions interpreting the latter great persuasive force in determining the scope of the provision in the state act. Not all business expenses are deductible; only those are which are ordinary and necessary. Fines paid for violating the criminal law in the course of conducting a business are not deductible; but damages for breaches of contract or infringing patents or copyrights would be. Reasonable salaries only are deductible. A salary, to be deductible, need not be for services rendered during the year for which the deduction is claimed; it is sufficient if the liability therefor first arose during the year it is deducted. If the amount of a salary is contingent upon events that will occur only in a subsequent year, then it is not deductible until that contingency happens.

Interest is another permissible deduction. This includes interest paid by a home owner on loans made to finance the acquisition of his home. Living expenses are deductible to that extent. Interest paid on loans made to finance the acquisition or carrying of securities whose income is excludable from gross income cannot be deducted. The application of this provision involves difficult fact questions.

All taxes paid or accrued within the taxable year are deductible except those imposed by this state statute, special assessments, and inheritance and estate taxes. Income taxes paid to the United States, to other states, or to foreign countries are deductible. The treatment of income taxes paid to foreign countries under the federal income tax act differs from that accorded such taxes paid to other states under our statute. The federal act permits such foreign income taxes to be either deducted from gross income in computing net income or to be credited against the tax due the United States subject to a defined limit. The state statute nowhere provides for any credit against the tax due Minnesota for income taxes paid to other states. There is one other important

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difference between the tax deductions permissible under the federal and state acts. The former permits the deduction of inheritance and estate taxes; the latter does not but treats them as in the nature of capital levies chargeable against capital rather than annually recurring charges properly to be charged against income. Both systems permit a corporation that pays taxes assessed on its shareholders without reimbursement by such shareholders to deduct such taxes, and deny the shareholder the right to deduct such taxes in such cases.

Losses constitute an important group of deductions in both the state and federal acts. The federal and state laws agree in permitting the deduction of uncompensated losses incurred in trade or business and those due to certain specified kinds of casualties. The statutory language is sufficiently plain to need no comment. The federal act also permits the deduction of uncompensated losses incurred in connection with transactions entered into for profit. The state act's provision on this particular matter is different and more liberal to the taxpayer; it permits such losses to be deducted if incurred in connection with any transaction the gains from which, if any, would be includable in gross income. For example, if A builds a home which he occupies as such during the entire period of his ownership thereof, which he sells at a loss, the loss is not deductible in computing his net income under the federal act; it is in computing net income under the state act. Losses are deductible in the year when sustained, but the state act specifically provides that losses due to theft shall be deductible in the year in which the theft is discovered; the federal act has no such provision. With this exception, the federal and state rules determining when a loss is sustained are sufficiently similar to give decisions applying the federal act highly persuasive force in construing the state statute. Both acts also prohibit the deduction of losses incident to wash sales of stocks and other securities, and contain similar definitions of "wash sales." The provisions in the existing federal act for treating losses from wash sales vary greatly from those in the state law. The computation of losses is governed by the same principles already discussed in dealing with the problem of capital gains, and requires no further consideration.

Bad debts represent a kind of loss which receives special treatment under both the federal and state acts. Both acts permit a
bad debt to be deducted in the year when its worthlessness is ascertained, but the state act does not require it to be charged off unless the taxpayer keeps books of account. The worthlessness of a claim is a question of fact. The state statute accords the taxpayer an election to treat bad debts by the method of setting up a reserve for bad debts. If the taxpayer elects that system, the deduction for any tax year is the reasonable addition to that reserve for that year. A taxpayer electing this system must continue to employ it in later years unless consent to a change is obtained from the tax commission.—The federal law permits this system in the discretion of the commissioner of internal revenue. Both state and federal acts permit the authorities charged with administering them to permit partial write-offs for bad debts. Not all uncollectible claims are deductible as bad debts. If A lends $1,000 to B, which becomes uncollectible, in whole, a deduction is permissible, though the original loan was a capital transaction. Uncollectible claims may arise, however, out of transactions the proceeds from which, if collected, would be includable in gross income. A, for instance, has a claim against B for services rendered; this claim becomes wholly uncollectible. Whether A can deduct the amount thereof as a bad debt depends upon his method of reporting his income. If he reports that on an accruals basis, he will have included it in his income, and is, therefore, permitted to adjust for the fact that the claim became uncollectible by taking a bad debt deduction therefor. If, however, he reports on a cash receipts and disbursements basis, then he has never included it in his income, no adjustment is necessary when it becomes uncollectible, and hence no bad debt deduction can be taken therefor. In short, uncollectible income items can be deducted as bad debts only if previously reported as income, except that claims of that character existing as of January 1, 1933, can be deducted as bad debts if they thereafter become uncollectible but only in an amount equal to their value on that date.

Depreciation of depreciable property can be deducted if the property is such that its periodical income would be includable in gross income (the federal act has no such provision), or if the property is used in trade or business (this is the federal rule). The depreciation allowance may cover the obsolescence factor. Questions sometimes arise as to who may take this deduction. This frequently comes up as between life tenant and remainderman,
whether or not the property is held in trust. The state rule for this matter is the same as that embodied in the federal act. The state law also specifically restricts the deduction to the lessee as to structures built by him on leased premises, or the fixtures installed thereon by him. This is also the practice under federal law. It should be noted that the allowance for depreciation is to cover, among other things, the exhaustion of property. This is not limited to tangible property, and can be applied to the exhaustion of such intangibles as a patent due to the mere lapse of time. Closely akin to the depreciation deduction is that allowed for the depletion of wasting assets, such as mines and oil or gas wells. The provisions determining who can take such deduction as between life tenant and remainderman are the same as those applicable to the depreciation deduction. The provisions as to the amount of allowable depletion that can be deducted found in the state act are wholly different from the federal provisions dealing with that matter. Under the state act the basis on which depreciation and depletion are to be computed is the same as would be applicable in determining the gain or loss on the sale of the property that is being depreciated or depleted (section 20).

It has frequently been considered that it is unfair to make the net income of a single year the basis of an income tax, and that it would be fairer to average the net income over a period of years in computing the tax for any given year. The principal argument has been that this would enable losses of one year to be offset against the gains of a succeeding year. The federal acts have for some time dealt with this through the so-called net loss provisions under which net losses for one year could be carried over as deductions in a future year or years. The 1932 Revenue Act contained such a provision. This provision was one of those that incurred Congressional hostility as a result of disclosures in the hearings conducted by the senate committee on banking, and was repealed by section 217 of the National Industrial Recovery Act of June 16, 1933, effective as of January 1, 1933. The Minnesota act incorporates a net loss provision in section 13-1 thereof... A net loss exists only when the gross income used in computing the taxable net income assignable to Minnesota exceeds the deductions permitted to be taken in computing such taxable net income assignable to this state. But such gross income must first be adjusted by adding an amount equal to the interest exempt from
inclusion in gross income under section 12 minus interest not deductible under section 13 because incurred in purchasing or carrying the securities whose income was tax-exempt. The purpose of this is to prevent a net loss existing when, because of the amount of exempt income received by a taxpayer, his real position for the year is one of gain. Furthermore, a taxpayer may have derived income from both business and non-business sources. He will also have certain deductions allocable against the business income and others allocable against his non-business income. Under section 13-1 (a) (1), he can deduct those allocable against his non-business income only up to the amount of his non-business gross income. The reason for this limitation is this. His non-business deductions include such things as taxes on his home, interest on the mortgage on his home, and doctor's bills. These are really living expenses specifically deductible. They do not really represent a loss, but a deficiency of income from certain sources. There is no reason why this deficiency should be charged against his business income, and it is the latter with which the net loss provisions have dealt and with which the net loss provision in the state statute is concerned. Example—Assume that A is a resident whose gross income from business is $50,000, from non-business sources, $5,000; that the gross income from business used in computing the net income therefrom assignable to this state is $35,000; that the corresponding figure as to his non-business income is $4,000; that he also had $500 in tax-free interest; that the deductions allocable against his business income are $60,000, of which $45,000 are chargeable against the gross income used in computing his net taxable income assignable to this state; and that his corresponding non-business deductions are $5,500 and $4,800, respectively. His net loss would be computed as follows: Add to his non-business income assignable to this state $500 tax-free interest, thus making that $4,500; add to that sum his business gross income assignable to this state, $35,000; this makes his total gross income assignable to this state $39,500. His total non-business deductions to be used in computing his taxable net income assignable to this state are $4,800, which is $300 in excess of his non-business gross income allocable to this state. His total business deductions to be used in computing his business taxable net income assignable to this state are $45,000, leaving a business net loss with respect to the income factors used in computing his
taxable net income assignable to this state of $10,000 ($35,000—
$45,000). The algebraic negative merely indicates the existence of
a loss. That is his net loss deductible over the next two succeed-
ing tax years, if not fully taken care of during the first succeeding
tax year. He cannot increase that by the $300 above referred to,
although, but for the limitation now being considered, his net loss
assignable to this state would be $10,300 ( ($35,000 plus $4,000
plus $500) minus ($45,000 plus $4,800) ).

A complication arises in the case of taxpayers whose taxable
net income is assignable to this state through an allocation of net
income. This matter is taken care of by the provisions of section
13-1 (a) (3). The effect and meaning thereof can be illustrated
by the following example. A carries on a single unitary business
in both Minnesota and Wisconsin. The total gross income there-
from is $200,000; the total permissible deductions are $250,000;
this leaves a net loss of $50,000. Had this been net income (which
under the required allocation formula will be assumed to have been
half assignable to this state) the taxable net income assignable to
Minnesota would have been $25,000. If now A’s net income dur-
ing the succeeding taxable year, apart from the net loss deduction,
is $100,000, the question arises whether the whole net loss of the
preceding year is to be deducted from said $100,000 in computing
the net taxable income assignable to this state in such succeeding
taxable year, or may half thereof only be deducted. The proper
way is to deduct the whole $50,000 net loss of the preceding year,
since it is to be deducted from the whole net income of such suc-
ceeding year. This would give a net income of $50,000, one-half
of which (assuming this was the proportion indicated by the ap-
plicable allocation formula) would be the taxable net income as-
signable to this state for the succeeding tax year. To deduct half
only would conflict with the provision that in such cases the net
loss shall be computed as if the entire gross income of A from said
business were assignable to this state. The reason for this is that
A’s entire gross income from this business in the succeeding tax-
able year will also be used in computing his taxable net income
assignable to this state for such succeeding taxable year. The
statute does not specifically provide the rule that would apply if A
was not in that business during such succeeding taxable year, or
conducted it wholly within this state during that year. These
cases will have to be handled by regulations consistent with the
theory on which the net loss deduction is allowed.
Two other points concerning this net loss provision should be noted. The net loss of one year carried over into the next year or years, as the case may be, cannot be treated as a deduction in determining whether a net loss exists during such subsequent year or years. Furthermore, no loss properly chargeable against operations prior to January 1, 1933, can be considered in computing net losses deductible under the statute.

It is proper to call attention to two deductions permitted by the federal act which are not allowed by the state statute. The first of these is charitable and other contributions. The state statute takes care of these by permitting them to be taken as a credit against net income. The reason is that this avoids entangling them in the problems involved in determining the net income assignable to this state. The state provision is more favorable to the taxpayer as long as the credit against net income on this account is limited as it is by section 27 to contributions to local organizations. The federal act permits dividends received by corporations from certain other corporations to be deducted in computing the corporate net income. The state statute does not permit this. Certain dividends can under the state act be credited against the taxable net incomes of both corporate and non-corporate taxpayers.

Section 14 of the state statute lists certain items that are specifically made non-deductible. These are living expenses, capital expenditures, expenditures properly chargeable against a depreciation reserve, insurance premiums, and the shrinkage in value, due to lapse of time, of a life or terminable interest in property acquired by gift, devise, bequest or inheritance. None of these require explanation except the last. If A receives a life estate in Blackacre under B's will, that life estate has a present value equal to the sum of the discounted values of the income series to which A is entitled. The present value of that series decreases with the lapse of time as the number of future payments decreases (this assumes that the discount rate will remain constant in making the successive computations). It is this decrease in value that A is prohibited from deducting with the result that the whole of the income to which his life estate entitles him is treated as includable in his gross income. Note that this does not apply to purchased annuities or life estates. Their treatment has already been discussed.
TAXABLE NET INCOME

It has already been stated that the tax is not on, or measured by, a taxpayer's total net income, but is only on, or measured by, such part thereof as is assignable to Minnesota in accordance with the principles enunciated in sections 23 to 26, inclusive. This is not the place to discuss the extent to which Minnesota can go in assigning income to it without involving violations of the due process clause of the fourteenth amendment to the federal constitution. That clause does impose jurisdictional limits upon it, but their exact line has not yet been fully charted by decisions of the Supreme Court of the United States. Some of its decisions will be hereinafter referred to at appropriate points in the discussion.

There are two principal methods provided for by the statute for determining the taxable net income, which as defined in the statute and as hereinafter used means the net income assignable to this state under the statute. The first is by an allocation of items of gross income and a correlative allocation of deduction items. Sections 23 and 24 provide the principles to be employed for this purpose. The other method is by an allocation of net income. Section 25 is the principal section concerned therewith. It is not necessary that a taxpayer's taxable net income be wholly computed by one method. One method may be applicable to a portion, and the other to the remainder of a taxpayer's income. The test is the character of the transactions producing the income. If the source is business or trade conducted partly within and partly without this state, then the general rule is that taxable net income is determined by an allocation of net income.

The principles assigning gross income items to this state can be easily stated by classifying them on the basis of the kind of income involved. The first of these is income derived by a resident or domestic corporation from personal services, or from a business consisting principally of the performance of personal or professional services. This is treated as Minnesota income regardless of where the services may have been performed. An attorney, a resident of this state, who argues a case before the federal Supreme Court would have to return his fee as local income even though he had been hired to make such argument for a fee directly paid for that single specific service. The case of a non-
resident or foreign corporation is quite different. Income from personal or professional services is allocated to this state only in so far as the services were rendered or performed within it. This represents the constitutional limit of Minnesota's power to tax a nonresident's income of this character. Its power over residents is in this respect much broader, and seems to extend to such income wherever earned. The provisions thus far discussed do not apply to what might be called the salary imputable to the owner of a business for his services to that business (except the kind of business hereinbefore referred to), since that is treated as income from said business for the purpose of allocating such income as between this and other states.

Income from property, whether consisting of the periodical returns thereon or the gains arising on the disposition thereof, constitute another class of income. If the property consists of tangible property not employed in the business of the recipient of such income or gains, the income and gain follow the situs of the property, regardless of whether the recipient is a resident or non-resident. If a resident of Minnesota owns a farm in Wisconsin which he leases for an annual rental of $500, that rent is treated as Wisconsin income, and does not appear as gross income to the resident if his taxable net income is assigned to this state by the method of allocating gross income. The same rule applies to income from tangible property employed in business if that business consists principally of holding that property and collecting the income and gains therefrom. These rules do not, however, apply to the allocation of income and gains from intangible personal property which is not employed in the business of the recipient. Such income and gains follow the domicile of the recipient. Dividends received from a Minnesota corporation by non-resident shareholders afford an instance of this kind of income. The meaning of the rule is not so clear when such property is held in trust since in such case the trustee and the cestui to whom it is immediately or ultimately distributed are both recipients of the income. A trustee is a taxable person. Under the special provisions applicable to trusts (section 28) the trustee is taxable with respect to trust income held on certain terms, while with reference to other income he serves as a mere conduit to transfer the income to others who may be taxable thereon. The trustee is clearly the recipient of income of the

former type (e.g., income being accumulated for future distribution) and is under Section 28 taxable with respect thereto. As to such trust income from intangible personal property held in trust, the allocation is to this state if the trustee is domiciled therein, but not otherwise. The cestui is equally clearly the recipient of the latter type of trust income (e.g., trust income required to be periodically distributed to the cestui) and its allocation depends on the cestui's domicile. This is reinforced by the provision in section 28 requiring cestuis to whom such distributions are made to include it in their own income if they are domiciled in this state. The result is, of course, that a non-resident could appoint a local trust company as trustee of such property without subjecting such income thereon to this tax except in so far as the cestuis were domiciled in this state, and a resident could do the same. These rules also apply to resident cestuis of a trust of intangible personality of which a non-resident or foreign corporation is the trustee, whether or not the settlor was a resident when the trust was created or is such during the year whose income is in question. The cestui's interest is intangible personal property. The income is received as income derived therefrom. Hence it is taxable to him as income from local sources since that income follows the domicile. There is one group of situations in which income from property of this kind held in trust does not follow the domicile of the recipient. Section 29 provides that income from trust property shall be treated as income of the settlor if the trust contains certain provisions. Trust income from such a trust is allocable to this state if the settlor is domiciled within this state during the year whose income is in question, and not otherwise. Income from intangible personal property held by a guardian for a ward is allocable on the basis of the domicile of the ward.

Business income derived from a business carried on wholly within this state is allocable to this state; if the business is conducted wholly without it, it is treated as income from non-Minnesota sources and need not be reported as gross income. These rules apply whether the owner of the business is a resident or non-resident, or a domestic or foreign corporation. Income from business carried on partly within and partly without this state is allocable under section 25. All other income is allocable on the basis of the taxpayer's domicile. For example, a tax refund on account of a tax deducted in the course of computing the tax under this
act is income assigned to this state only if at the time of the refund the taxpayer is domiciled in this state. The result is that, if he was a resident when the tax was deducted and a non-resident at the time of its refund, the refund cannot be treated as assignable to this state.

When, and in so far as, taxable net income is determined by an allocation of gross income, there will have to be a correlative restriction on the deductions permitted to be taken under section 13. This is the purpose of section 24. The basic principle is that such deductions are allowable to the extent that they are connected with and allocable against the production or receipt of the gross income assignable to this state. If a person operates one business in Minnesota, and a distinct business in Wisconsin, he can take the permissible kind of deductions connected with earning his Minnesota income, but not those connected with earning his Wisconsin income since that is not includable in the gross income used in computing his Minnesota tax. There are, however, certain deductions not connected with or allocable against the production or receipt of any income, neither against that assignable to this state nor against that assignable to another state or country. The deduction for medical costs for caring for the health of the taxpayer and his family is an instance. The statute (section 24 (b) ) imposes a limit on the extent to which such item is deductible from gross income assignable to this state in computing the taxable net income. Only that proportion thereof can be deducted which the gross income assignable to this state bears to the taxpayer's gross income from both within and without the state. If, for example, two-thirds of a taxpayer's gross income were assignable to Minnesota, then he could deduct two-thirds of such medical costs in computing his taxable net income. This will frequently involve difficult issues of fact, and is a bit more involved when the taxpayer also has income of the kind allocable under Section 25 (i.e., income from a single business conducted both within and without this state), but the underlying principle is that applied in the illustration just given. The theory back of requiring such apportionment with respect to such deductions is that they are a charge against a person's entire income, not merely that assignable to this state. The effect of this rule is also that non-residents can charge a part of such deductions against their Minnesota income. The only exception to the requirement that such deductions be
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apportioned is in the case of taxes paid to Minnesota or its sub-
divisions if the tax belongs to the kind of tax deductible under
section 13. The tax paid by a resident on his home is an exam-
ple thereof. That is deductible in toto.

Income derived from a single business conducted partly with-
in and partly without Minnesota is in general treated as a unit.
The taxable net income therefrom assignable to this state is de-
termined by an allocation of its net income. No attempt is made
to allocate particular gross income items in such case, with a cor-
relative restriction of deductions. An instance of a business of
this kind is that of a manufacturer who manufactures his products
within Minnesota and sells them both within and without this
state. This method is used for this kind of business income regard-
less of whether the taxpayer is a resident or non-resident, a
domestic or a foreign corporation. The fundamentals of this
method are simple. The gross income from the business as a
whole is determined; from that are deducted deductions of the
kind permitted to be made under section 13 and 13-1; the balance
is the net income from said business. The taxable net income
therefrom is a proportion thereof which is computed by applying
thereto one of the two allocation formulas found in section 25.
These are sufficiently explicit to require no discussion. The provi-
sion that this method shall apply whenever, and in so far as, the
business carried on within this state is an integral part of a busi-
ess carried on both within and without this state requires some
explanation. It defines the only circumstances to which section 25
applies. It is conceivable that the same taxpayer might have sev-
eral businesses conducted both within and without this state. If
they were wholly separate the provisions of section 25 would have
to be applied to each separately. It sometimes happens, however,
that it conducts separate businesses only one of which is carried
on within the taxing state. An actual case will make this clear.
A Co. was a corporation engaged in producing and refining oil,
and selling the refined products. Its only business within State B
was selling such products; all its other operations were conducted
without that state. State B, however, treated all of its various
activities as a unit and computed the net income assignable to it
on that assumption. The result was throwing into it a consider-
able part of the profits of A Co. from its more or less indepen-
dently conducted producing and refining operations. This was
held to violate the due process clause of the fourteenth amendment as an attempt by State B to tax income beyond its jurisdiction. The court held thus because State B had erred in the selection of the income producing unit. State B could have included the net income from its independent selling business wherever carried on and applied its allocation formula thereto, since the business within it was an integral part thereof. It is for this reason that the provision under discussion is an essential element of this method of determining the taxable net income in such cases. It involves in substance an extension to the field of state income taxes of the unit system employed in connection with other kinds of state taxes, and is subject to the constitutional limitations developed for it in those other fields.

No system for determining the taxable net income assignable to this state can hope to meet every conceivable case. The results of any method may be fair as applied to one set of facts and so arbitrary as to violate the aforementioned due process clause as applied to another set of facts. Prudence, therefore, demands that a measure of elasticity be provided for. This can be done by conferring upon the administrative authorities power to permit variations from the statutory rules whenever fairness so requires. This is the purpose of section 26 which authorizes the state tax commission not only to permit such departures but to require them if the facts warrant it. The standard set up for the commission's action in this field is sufficiently definite to meet the requirements of the constitutional principle prohibiting the delegation of legislative authority. It can be stated that such discretion to modify the allocation rules and principles contained in sections 23, 24, and 25 is absolutely necessary in order that a rule based on statute may exist for cases in which the usual statutory rules produce results condemned by the due process clause.

Credits Against Net Income

The tax is based on the taxable net income as adjusted by certain specified credits against that quantity (section 27). A credit against taxable net income has the effect of reducing the amount to which the tax rate schedule is applied for purposes of computing

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75 Standard Oil Co. v. Thoresen, (C.C.A. 8th Cir. 1929) 29 F. (2d) 708.
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the tax due from the taxpayer. These credits were not treated as deductions because they are not really deductions from gross income in arriving at net income in its usual meaning. The credit for charitable contributions, for example, is rather a disposition of income than a deduction from gross income. The credit for dividends is clearly not a proper deduction from gross income in arriving at net income, but is merely a device for preventing the same ultimate income from being taxed twice. The most familiar of these credits against taxable net income are the so-called personal and dependents credits. They are $1200 for an unmarried individual, the estate of a decedent, and a trust; $1,000 for a corporation; $2,000 for a married person, living with husband or wife, and for the head of a household; $250 for each dependent, other than husband or wife. Though a husband and wife who make separate returns may divide the $2,000 credit between them in any proportion, their aggregate credit shall not exceed $2,000. In the case of the dependents credit (which is more liberal than the federal act equivalent), but one taxpayer is entitled to it with respect to a single person. The credit for contributions exists only for contributions to the organizations specified in section 27 (f). This credit requires no further discussion. The last credit is for dividends received if paid from income accruing to the corporation paying the dividend from business conducted within this state. If the dividends were out of income from business done within and without the state, only that proportion thereof can be taken as a credit which the corporation's taxable net income for the year preceding the distribution of such dividends bears to its total net income for such year. This ratio will be determined by the returns of the paying corporation made under this act. If it made no return for such year, it will have to be obtained elsewhere. The law casts the burden of establishing this ratio on the taxpayer as part of the requirement that the burden rests on him to establish that the dividends claimed as a credit were from income arising out of business done in this state.

TAX RATES

The system of rates of taxation employs the principle of progressive graduation (section 6), but the state statute does not embody the method of having both normal and surtaxes as does the federal income tax act. The state rates are applied only to that
portion of the taxable net income which is in excess of the credits against such taxable net income as those are defined in section 27. Such excess is divided into ten units of $1,000 each, and an eleventh unit composed of that part thereof which is in excess of $10,000. The scheduled rates are applied to such units, the lowest rate to the first $1,000 unit, the next lowest to the second $1,000 unit, and so on.

**Special Cases**

There are certain special cases with respect to which the general rules for the determination of the taxable net income are modified in certain particulars. The case of income from property held in trust is one such. The tax is imposed on the income from such property. Its treatment, however, depends upon the disposition required to be made of the income under the terms of the trust instrument. If it is to be accumulated for future distribution, i.e., for distribution in a future tax year other than that in which received by the trustee, it is required to be included in the income of the trustee and taxed to him, and can be thereafter received by the beneficiaries without being required to be included in their gross income (section 28 (g)). If the trust income is to be currently distributed, it is treated as income received by the trustee, but is in effect not taxed to him because the amount thus required to be currently distributed can be deducted by the trustee in computing the trust income on which the tax is required to be paid by the trustee (section 28 (d)). If the trustee is vested with discretion either to accumulate or distribute, then the amount of the trust income for a given year which he decides to accumulate is taxed to him, but the amount thereof which he in fact distributes during such year is in effect not taxed to him because it is deductible in computing the net income on which the trustee is required to pay the tax for such year (section 28 (d)). Amounts distributed to beneficiaries in the last two cases must be included in the distributee’s income for the year of its receipt by them if they are domiciled within this state; if not so domiciled, they can receive such distributions without including it in their gross income. The theory underlying this method of treatment is that the trustee is a mere conduit for distributing the trust income as to all such trust income which is lawfully distributed to beneficiaries during the year when the income was received by the trustee, but is something much more than that as to income being accumu-
lated for distribution in future tax years. There is one exception to the deductibility by the trustee of amounts of current income lawfully distributed by him during such year. If a beneficiary, domiciled in Minnesota, is entitled for any reason to receive such current distributions without being required to include them in his gross income, the trustee is prohibited from deducting them in computing the net income on which the tax on the trustee is based. This case would arise under a testamentary trust to pay the income to a widow for life in lieu of her interest in her deceased husband's property if the court should hold that to be a purchased annuity no part of which would have to be returned as income by the widow until the total received by her exceeded the value of the rights surrendered by her.

The computation of the tax in the case of trust income is also modified in that the credit against taxable net income for charitable, etc., contributions is not subject to the 15 per cent limit, and that it includes trust expenditures or appropriations for purposes of the kind that define the character of organizations to which contributions can be made and be credited against taxable net income under section 27.

There is one further matter that should be noted. Assume that A receives $1,000 from the annual income of property held in trust under a trust instrument requiring the current distribution of the trust income; that A is domiciled in Minnesota; and that $500 of that $1,000 is from dividends received by the trustee from corporations all of whose income was from Minnesota sources. That $500 could be used as a credit against A's taxable net income had he received them from the corporations directly, and the language of section 28 (e) permits him to do the same when he receives that $500 from the trustee. The interposition of the trustee is not permitted to deprive A of that privilege. If the $1,000 received by A equalled half of the taxable net income of the trustee, and the other half was required to be accumulated by the trustee (being thus taxed to the trustee), and if the total of such dividend income of the trustee had been but $500, then half only thereof could have been taken as a credit by A, the other half being required to be thus used by the trustee.

The case of income received by the estate of a decedent during the period of its administration can be briefly disposed of. So far as it is currently and properly paid or credited during such year
to any legatee or heir, it is required to be included in the gross income of such legatee or heir; otherwise it is required to be included in the estate's gross income, and is thus taxable to it. In the latter case it is receivable by the legatee or heir without being required to be included in their gross income. The statute (section 28 (g) ) restricts this to income with respect to which the estate has paid the tax imposed by this act, but it will be deemed to have paid that if it was included in the estate's gross income in determining the tax on the estate's income, even though in a given case no tax may be due for the period covered by the return. This also applies as to distributions by a trustee of income included in reporting the trustee's gross income. The provision above described as to a cestui's privilege of taking a proportionate part of the dividend credit against net income also applies to income received by a legatee or heir from a decedent's estate which such legatee or heir is required to include in his gross income.

It should be observed with respect to all the matters thus far discussed under the present heading that it was concerned only with trust income, and the income of decedents' estates, that are allocable to this state, and within Minnesota's jurisdiction to tax. These matters have already been discussed.

Federal experience has shown that the trust device has been frequently employed to effectuate certain tax advantages to the taxpayer. The existence of a system of progressively graduated rates furnishes a strong incentive in this direction. It was to restrict the opportunities of thus employing that device that section 29(a) and (b) were enacted. The statutory method is to ignore the existence of the trust under certain circumstances and to treat its income as that of the settlor. Assume A transfers property to T in trust to pay the income to B for a designated term, remainder to D; that A reserves a power to revoke at any time. The control resulting to A from that power to revoke makes B's right to the income in fact dependent on A's will. If during any tax year A had such power, he is required to include the income for such year in his own income. The same would be true if the power to revoke were vested in A and another not having a substantial adverse interest in the disposition of the trust res or the income therefrom. If this power extends to a part only of the corpus, the duty to return the income as A's extends only to the income from such part of the trust res which is subject to
such power. A similar provision in the federal act has been held
not violative of the due process clause of the fifth amendment.\(^7\)
A device to circumvent this provision was soon invented. That
consisted of substituting for a power of revoking at any time a
power to give notice which would become effective to revest all
or part of the trust res in the settlor at some time other than in
the taxable year when the notice was given.\(^7\)
The state statute
guards against the use of this substitute device by requiring the
settlor to include the income from trust property in his income if
during the year whose income is in question he has a power to
give notice of revestment of the trust res producing such income in
himself, which revestment will occur at the end of the period pre-
scribed for giving notice. The income during the time succeeding
the year in which such notice is given is also taxable to the settlor,
although this is not so clear, since it may be argued that he no
longer possesses that power after it has once been exercised. The
same principle applies if the settlor has such power in conjunction
with another not having a substantial adverse interest in the dis-
position of the corpus, or the income therefrom, subject to such
power. These provisions of section 29(b) cannot be circum-
vented by the settlor by granting any of these powers hereinbe-
fore mentioned to a stranger, unless such stranger has a substan-
tial adverse interest of the kind already referred to, and in that
case the reason for the principles of this subsection do not apply.

Section 29(b) deals with trusts in which the settlor reserved
certain specified powers over the corpus of the trust, or a part
thereof. Section 29(c) deals with situations in which the settlor
has dealt with the trust income in certain specified ways. The in-
come is taxed to him if by the terms of the trust it is to be used in
certain specified ways or for certain specified purposes. It is so
taxed if it is to be distributed to him or at his direction; if it is
being accumulated for future distribution to him or at his direc-
tion; if it is to be used to discharge any of his obligations or those
of another (this provision, among other things, prevents the use
of this device to secure what would amount to making deductions
of a kind not permitted to be directly made); if it is to be used to
provide a fund to be used for the purposes of either the settlor
or another, if such purposes are such that expenditures therefor
would be non-deductible under section 14 (which specifies the

non-deductible expenditures); or if it is to be applied to paying premiums on insurance policies on the life of the settlor (except where the proceeds are irrevocably payable to organizations, gifts to which would be treated as a credit against taxable net income); or if it is to be applied to pay insurance premiums on the life of another than the settlor if the settlor or any other person designated by him (with the same exceptions so last referred to) is a beneficiary under such policies. The purpose of these last two provisions is to prevent insurance premiums of the kind therein described from being in effect deducted although they would not be deductible if paid directly by the settlor. The exceptions indicated in those last two provisions are defined in terms of the character of the organizations named as beneficiaries in such policies. A settlor can, by creating a trust to finance insurance policies payable to such organizations, in effect make contributions to them in excess of the 15 per cent limit imposed by section 27. Section 29(c) is not limited to cases in which the terms of the trust require any of the above disposition of the trust income. It extends also to cases in which they may be thus used at the discretion of the settlor alone or in conjunction with another not having a substantial adverse interest in the disposition of the income in question, or at the discretion of any other person not having such adverse interest. It will be noted that this subsection applies even to irrevocable trusts. This feature has been assailed so far as it involves trusts to apply the income to paying insurance premiums on the settlor's life where the proceeds of the policy were irrevocably beyond the settlor's control in a case arising under a specific provision contained in a federal income tax act. The argument was that this violated the due process clause of the fifth amendment by taxing one person on another's income, but the United States Supreme Court sustained the provision by a divided court. The similar provision in the state statute is, therefore, equally immune against successful attack based on the due process clause of the fourteenth amendment. Section 29(c), however, is much more sweeping than the corresponding federal provision, and may be expected to give rise to litigation assailing some of its provisions as violative of said due process clause. The same may also be said of the provisions of section 29 (b).

The only other special cases to which attention need be directed are those provided for in section 32. Section 32(a) imposes a

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special tax on corporations formed or availed of to reduce the
taxes due from its stockholders. Section 32(b) and (c) are
aimed at somewhat different objectives than is section 32(a). A
corporation that conducts most of its manufacturing in a state
having an income tax but which sells most of its products in states
having no such tax may resort to a complete rearrangement of its
 corporate structure so as to siphon income out of the state having
an income tax into those having none. Wisconsin has had to deal
with several of such instances. The provisions of section 32(b)
and (c) confer upon the state tax commission power to deal with
such situations by ignoring the devices employed and computing
the taxable net income in such a manner as will reflect a more
correct determination of that part of the net income attributable
to the operations carried on within Minnesota. It is impossible
within the limits of this article to go into details on this matter.
The reader is referred to the cases cited in the footnote.80 Suffice
it to say that courts have shown no hesitation in sustaining any
reasonable policy employed by the taxing authorities to prevent the
corporate device from being used to subvert the true economic
picture in cases of this character.

OTHER PROVISIONS

This article has aimed to deal with those parts of the state
income tax act that define who are liable thereunder, and that state
the principles employed in determining the extent of the tax liaabi-
ity imposed. The act also contains numerous provisions intended
to enable the taxing authorities to enforce these liabilities. The
provisions relating to the making of returns, to the imposition of
interest and penalties, to administrative examinations of taxpay-
ers' accounts, and to the collection of the tax are of this character.
They are all framed in language familiar to lawyers, and, while
they may raise questions of construction, will not be discussed
in this article.

GENERAL COMMENT

There are several features found in the existing federal in-
come tax act that have no counterpart in the state statute. One of

80Palmolive Co. v. Conway, (D.C. Wis. 1930) 43 F. (2d) 226; Buick
Motor Co. v. Milwaukee, (D.C. Wis. 1930) 43 F. (2d) 385. See Magill,
Allocation by Income by Corporate Contract, (1931) 44 Harv. L. Rev. 935;
Breckenridge, Tax Escape by Manipulations of Holding Company, (1931)
9 N. C. L. Rev. 189.
these is the special rate of tax applied to capital net gains, and the special method of computing the tax due where there is a capital net loss. Another is the limitation of stock and bond losses on the sale of such securities if they have not been held for a sufficient length of time to come within the capital gains and losses method of taxation. The last of these is the credit against the federal tax for or on account of income and profits taxes paid to foreign countries, or possessions of the United States. The reason for this credit is that the taxpayers who may elect to take it are required to take into their income that derived from sources in such foreign countries or possessions of the United States. The credit enables them (subject to specified limitations) to deduct from the tax ordinarily payable to the United States income and profits taxes paid to the foreign countries or possessions of the United States with respect to income includable in computing the net income that enters into the computation of the tax due the United States. Since the Minnesota tax is imposed only on income assignable to this state, there will generally be no occasion for resorting to the device of permitting a credit against the tax due this state for income and profits taxes paid to other states or countries with respect to income from sources within those other states or countries. The only possible occasion for its use would be in so far as the principles employed in our statute for assigning income to this state may assign to it some income which may be taxed elsewhere. The principles governing this matter in our law being what they are, about the only instance of that kind likely to arise is with respect to income from certain classes of intangible personal property which may be held to have a tax situs in our state and some other.

Appendix A

There is given below a list of the sections in the Minnesota state income tax act and the sections of the income tax title of the federal Revenue Act of 1932 dealing with the corresponding topics. The comparison extends only to those matters involved in the determination of net income and to those connected with the treatment accorded special cases.
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*National Industrial Recovery Act, June 16, 1933.*