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THE REVENUE ACT OF 1942

By Henry Rottschaefer* 

The part of the public which has thus far borne the bulk of federal taxes since the adoption of the Sixteenth Amendment has become accustomed to the appearance of a new revenue law about every second year. There have been few revenue laws that have made such important changes in measuring the federal taxpayer's liability as the Revenue Act of 1942. The sharp decrease in the individual's credits against net income is expected to add millions to the class of those liable to federal income taxation. This alone would justify an exposition of the important changes made by the latest Revenue Act. There are, however, additional reasons of considerable importance for such exposition. Long hallowed principles for computing federal estate and gift taxes have been extensively modified. It is the purpose of the following discussion to survey the more important amendments of the Internal Revenue Code made by the Revenue Act of 1942. Its scope will be limited to those changes that affect the estate tax, the gift tax, and the income tax. The changes will, whenever necessary, be discussed against the background of the prior law as found not only in the earlier Revenue Acts and the Internal Revenue Code but also in their administrative and judicial interpretations and applications.

THE ESTATE TAX

The amendments made to the estate tax provisions of the I.R.C. are expressly made “applicable only with respect to decedents dying after the date of the enactment” of R.A. 1942.

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1The Internal Revenue Code will be designated hereinafter as I.R.C.

2The Revenue Act of 1942 will be designated hereinafter as R.A. 1942.
except as otherwise expressly provided. The date of the enactment of R. A. 1942 is October 21, 1942. The principal changes relate to (a) inclusions in the gross estate, (b) deductions from the gross estate in arriving at the net estate, and (c) credits against the tax. These will be discussed in that order.

**Powers of Appointment**

The estate tax was introduced into the existing federal tax system in 1916. The first Act did not expressly include in a decedent's gross estate the property with respect to which he had at the time of his death a power of appointment, nor property passing under his exercise of any such power. An early attempt to include therein property passing under a decedent's exercise by will of a general power held by him failed. The Supreme Court took the position that the donee of a power of appointment, even a general power, had no estate in the property with respect to which he held such a power. The defect was remedied by the Revenue Act of 1918. This required the inclusion in a decedent's gross estate of property passing under a general power of appointment exercised by decedent by will or by certain kinds of inter vivos transfers of a testamentary character. Later amendments merely added other classes of inter vivos transfers to those specified in the 1918 Act. The provision became a part of the I.R.C. in this amended form in 1939.

There were three conditions that had to be satisfied if property with respect to which a decedent held a power of appointment were to be included in his gross estate. The power had to be a general power, and what was a general power was a question of federal law. Second, the power had to be exercised by the decedent by one of the methods specified in the statute. Lastly, the property had to pass as a result of his exercise of the power. The donor of a power could effectually prevent the property from being included in the gross estate of the donee by conferring a special power upon him. A donee, content to have the property pass to those who would take in default of his exercise of his power, could reduce his estate tax by refusing to exercise any general powers.

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3 R. A. 1942, sec. 401.
5 Morgan v. Commissioner of Internal Revenue, (1940) 309 U. S. 78, 60 S. Ct. 424, 84 L. Ed. 585.
power held by him. Even his exercise of it would not bring the property within his gross estate to the extent that the effect of his exercise thereof resulted in the same disposition of the property that would have occurred had he not exercised it.\(^7\) The possibilities for reducing the frequency with which a given property would enter into the computation of some decedent's federal estate tax that these limitations afforded went unnoticed by neither taxpayers nor tax gatherers.\(^8\) The amendments made by R. A. 1942\(^9\) are the Treasury's response to that situation.

The first important change relates to the kind of powers whose possession, exercise, or release, entails tax consequences. It is no longer necessary that the power be general. The test is whether it is exercisable by the decedent alone or in conjunction with any person. There are certain powers which a decedent may possess, exercise, or release without subjecting the property to which they relate to inclusion within his gross estate. If he is limited to appointing persons belonging to a class including only his spouse, the spouse of the creator of the power, descendants of the decedent or his spouse, descendants (other than the decedent) of the creator of the power or his spouse, spouses of such descendants, or donees devises or bequests to whom are deductible in computing the decedent's net estate, the power has no significance for estate tax purposes. The same applies where the decedent did not receive from the creator of the power any vested or contingent beneficial interest in the property subject to the power, "or did not thereafter acquire any such interest." The significance of the quoted part is not wholly clear. It undoubtedly refers to the decedent's acquisition of a beneficial interest in the property by a transaction subsequent to the creation of the power. It is also practically certain that it refers only to donative acquisitions. It is probable, but not certain, that it refers only to cases in which the decedent's subsequent acquisition of such beneficial interest is from the creator of the power. It is also essential to the exclusion of such power from the statutory definition of powers of appointment that it be one to appoint within a "restricted class." The statute gives no clue as to what will be held to constitute a "restricted

\(^9\) R. A. 1942, sec. 403(a).
It is practically certain that it will cover a class which includes only such members as are specifically enumerated in defining the other class of excludible powers. It is also probable that it covers classes whose members are defined by a factor other than family relationship to either the creator of the power or the decedent. In any event the requirement will be satisfied if the decedent has the power to appoint within a class no broader than the members of the creator's family and his or their spouses and descendants. Judicial decision alone can resolve doubts as to when a power will be deemed to be one to appoint within a "restricted class." There is one further test for excluding such a power from taxable powers of appointment. It must not be "exercisable to any extent for the benefit of the decedent, his estate, his creditors, or the creditors of his estate." The effect of making it exercisable to any extent for the benefit of any of these four classes makes it a power whose possession, exercise, or release would render all the property subject to the power includible in the decedent's gross estate, not merely that part thereof which decedent could divert to the defined-classes. Furthermore, the decisive factor is the decedent's privilege of exercising the power in that manner, not the fact that he does so exercise it.

The exemption from the class of taxable powers of the two classes of powers last considered is a privilege that is lost to the extent that the decedent exercises his power by creating another power to appoint. Assume, for example, that A devises and bequeaths property to B for B's life, with power in B by will to appoint within a class including only descendants of A. If on B's death he exercises the power properly, the property subject to the power is not includible in his gross estate. If, however, B dies and by his will exercises his power by devising and bequeathing the property to C, a descendant of A, for C's life, with power to appoint by will within a class including only descendants of A, then the value of the property subject to C's power is includible in B's gross estate. It is immaterial that C's power of appointment belongs in one of the exempted classes. Had B exercised his power by giving C the whole remainder interest in half of the property, and a life estate in the remaining half with power to appoint by will within a class including only descendants of A, the value of the latter half of the property would be includible in B's gross estate. The net result is a drastic reduction in the efficiency of powers of appointment as a device for reducing federal
estate taxes over a period involving successive transfers of property. It should be noted that the value at which the property subject to the power created by B enters his gross estate is its value undiminished by any precedent or subsequent interest not subject to such power to appoint. That would mean, in the case of the above example, its value at the date of B’s death (or as of the optional valuation date if B’s executor chose that date) undiminished by the present value of C’s life estate as of the same date.

The second important change affecting powers of appointment abolishes the prior rule that property subject to a power is includible in a decedent’s gross estate only to the extent that it passes by his exercise thereof. It is now merely necessary that he have the power at the time of his death. This puts the federal provision in line with that in the inheritance tax laws of many states under which a failure to exercise a power effects a taxable transfer as much as does an exercise thereof. To prevent the development of certain avoidance devices the new Act provides that a power shall be considered to exist on the date of decedent’s death even in cases in which it is exercisable only on giving notice thereof whether or not such notice has been given on or before said date, and also in cases in which its exercise takes effect only after the expiration of a stated period thereafter whether or not it was exercised before said date. The prior law included property subject to a power in a decedent’s gross estate if it passed as a result of his exercise thereof by will or certain types of inter vivos transfers of a testamentary character. The amended provision includes property in the gross estate if the decedent has exercised or released a power with respect thereto by the same types of inter vivos transfers as were described in the provision prior to its amendment.

The new Act contains several provisions intended to give limited protection to certain classes of powers created before October 21, 1942. The amendments made by R. A. 1942 apply to them only if the power is exercised after that date. This means that property subject to a general power created before that date is includible in decedent’s gross estate only if exercised subsequent thereto. The property need not, however, pass under its exercise, and in that respect the rule differs from what it would have been had the law remained unamended. The provision has further consequences. Property subject to a special power created prior to
October 21, 1942, also enters decedent's gross estate, but only if the power is exercised after that date. Such property would not have entered his gross estate had the law remained unamended. The exemption from the application of the amendments does not extend to a power exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. However, even as to it, the amendments become applicable, in cases in which the donee is under a legal disability to release it on that date, six months after the termination of such disability. A person in the military or naval forces of the United States is considered to be under such disability until the termination of the present war. The effect of this provision is to postpone the time when such power becomes subject to the amendments. It does not keep the prior law permanently in force as to it. However, a way is left open to enable every donee of a power created prior to October 21, 1942, to avoid the effects of the amendments upon his gross estate. This requires him to release the power within a prescribed period. That period expired on December 31, 1942, with respect to all powers except those exercisable in favor of decedent, his estate, his creditors, or the creditors of his estate, where the donees were under a legal disability to release them on October 21, 1942. In the excepted cases the release must be effected within six months after the termination of the disability. Furthermore, the amendments are expressly made inapplicable to powers created prior to October 21, 1942, if the donee dies prior to January 1, 1943, or, in the cases to which applicable, within six months after the termination of his legal disability to release the power. That is, the escape period is the same whether death of the donee or his release of the power be the generating cause of his avoidance of the effects of the amendments upon his gross estate. It should be noted that R. A. 1942, expressly provides that the release of a power to appoint before January 1, 1943, shall not be deemed a gift of the property subject to the power, and that said amendment shall apply to all calendar years prior to 1943. No comparable change is made to take care of those who benefit from the extended period for releasing a power because they were, on October 21, 1942, under a legal disability to release it.

10R. A. 1942, sec. 511, amends I.R.C., sec. 3797(a)(15) to read as follows: "The term 'military or naval forces of the United States' includes the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, the Women's Army Auxiliary Corps, the Navy Nurse Corps, Female, and the Women's Reserve branch of the Naval Reserve."

11R. A. 1942, sec. 452(c).
Insurance Proceeds

The 1916 Estate Tax Act contained no express provision dealing with the treatment of the proceeds of insurance policies payable by reason of the insured's death. The 1918 Act remedied this omission by requiring the inclusion in a decedent's gross estate of "the amount receivable by the executor as insurance under policies taken out by the decedent upon his own life; and to the extent of the excess over $40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life." It was incorporated in the I.R.C. in 1939 in this very same form.12 The changes made by R. A. 1942 are the first since the provision was introduced into the federal estate tax system.13 The rule applicable where the insurance is payable to the insured's executor is left as before. The clue to the amendments is to be found in the confusion that grew out of administrative and judicial attempts to determine when insurance had been "taken out by the decedent upon his own life." Space limitations prevent any adequate review of these attempts. It is sufficient for present purposes to state that the tests applied at various times by the Treasury, and sustained by the courts as valid interpretations of the statutory language, were first the payment of premiums, later the acquisition and possession at death of any incidents of ownership, and finally a return to the first of them although in a somewhat modified form.14 The new provisions conform most nearly to the principles stated in Treasury Decision 5032.

The amended provision15 specifies two alternative grounds for including in a decedent's gross estate amounts receivable by others than his executor as insurance under policies upon his life. Such amounts are so includible, either in whole or in part, if the policies were purchased with premiums, or other consideration, paid directly or indirectly by him. The second basis for inclusion is his possession at death of any of the incidents of ownership exercisable alone or in conjunction with any other person. It is

12I.R.C., sec. 811(g).
14See Treasury Decision 5032, issued on January 10, 1941, amending Reg. 80, Articles 25, 26, and 27, (1942) 36 Treasury Decisions Internal Revenue 15.
15R. A. 1942, sec. 404(a).
clear, therefore, that insurance proceeds receivable by third party beneficiaries under a policy on decedent’s life may constitute a part of his gross estate even though he has completely divested himself of all interest in the policy prior to his death. In such case, however, the inclusion will have to be based on his payment of premiums, or other consideration, and the amount includible will have to be computed in accordance with the rules applicable to such case. It is equally clear that insurance proceeds receivable by third party beneficiaries under a policy on decedent’s life may constitute a part of his gross estate though he has paid no part of the premiums thereon. It is only necessary that he possess at death an incident of ownership. In such case the amount includible in his gross estate would equal the entire proceeds. A mixed case would occur where the decedent has paid part or all of the premiums and also retained until death one or more incidents of ownership. The proceeds would clearly be a part of his gross estate. If he had paid all the premiums the entire proceeds would be includible therein. But, if he had paid part only of the premiums, a question would arise as to how much of the proceeds would be so includible. Since the only reference to apportioning the proceeds occurs in that part of the amendment dealing with the inclusion of the proceeds on the basis of decedent’s payment of premiums or other consideration, it is quite likely that the apportionment formula will be held inapplicable where the inclusion of the proceeds can be based on the decedent’s retention of an interest in the policy until his death. It is, accordingly, likely that in such case the whole proceeds will be held to constitute a part of his gross estate.

It should be noted in passing that the amendment expressly excludes a reversionary interest from incidents of ownership. This settles, in favor of the taxpayer, the attempt to apply to this problem the theory of Helvering v. Hallock.10

The new provision contains very explicit provisions for computing the amount to be included in a decedent’s gross estate where the sole basis for the inclusion is his payment of premiums, or other consideration. The amount then includible is in the proportion that the amount paid by him bears to the total premiums paid for the insurance. Thus, if he paid half of the premiums, half of the proceeds would be includible in his gross estate. The amount paid by him may, however, consist of something more than,  

or other than, the premiums paid by him. Assume a policy taken out on decedent’s life by his wife who pays the premiums out of her own funds for 10 years. Thereafter the insured takes over the policy and reimburses his wife to the extent of \( x \) dollars. The \( x \) dollars would become a part of the amount paid by him to purchase the policy. The new law provides for an adjustment in computing the amount deemed paid by decedent where he transfers the policy. This probably means a transfer completely divesting him of all interest in the policy, or in such part thereof as he is transferring. Any other type of transfer would leave in him an incident of ownership requiring the inclusion of the proceeds in his gross estate on that basis alone. The significance of a transfer also depends upon whether or not it is donative. If decedent transfers a policy on his life, on which he has been paying premiums, to his creditors, and if such transfer is wholly without donative intent, the proceeds thereof do not enter his gross estate even in proportion to the premiums paid by him. If, however, he transfers it by way of gift and receives no consideration whatever, the proceeds enter his gross estate in proportion to the premiums paid by him. If the policy were a fully paid policy at the time of the gift, the entire proceeds would be includible in his gross estate. In applying these principles a transfer is deemed a gift, in whole or in part, if and to the extent that it is such under the gift tax provisions of the I.R.C. (or would have been such had said chapter been in force when the transfer was made). That chapter treats the transfer of property for less than an adequate and full consideration in money or money’s worth as a gift in an amount equal to the excess of the value of the transferred property over the consideration received by the transferor. If decedent makes a donative transfer of a policy on his life in this manner, the amount that has to be included in his gross estate is adjusted to reflect the fact that the consideration received by him reduces his contribution to the production of the asset represented by the insurance proceeds. This is accomplished by reducing the amount deemed paid by him in computing the proportionate part of the proceeds includible in decedent’s gross estate.

Let \( A \) = the amount actually paid by decedent prior to the transfer of the policy, and assume that he made no further payments; and

Let \( C \) = the consideration received by him for the transfer; and
Let $V$ = the value of the policy at date of its transfer; and
Let $R$ = amount by which $A$ is to be reduced; and
Let $P$ = amount deemed paid by decedent in computing the proportionate part of the proceeds includible in his gross estate.

The statutory formulae then are as follows:

1. $P = A - R$
2. $R = \frac{C}{V}$
3. Hence, $P = A - \frac{C}{V} = A \left(1 - \frac{C}{V}\right)$.

A concrete illustration will help to clarify the formulae. Assume that decedent (D) took out a policy on his life on February 1, 1941, for $5,000; that he transferred this policy to B on February 10, 1943, for $25; that on that date the value of the policy was $300; that the premiums paid by decedent prior to the transfer amounted to $600; and that he dies on March 1, 1944, the transferee in the meantime having paid $200 additional premiums.

The question is how much of the $5,000 proceeds received by B are to be includible in D's gross estate. The statutory formula (not one of those set forth above) requires computing the amount deemed paid by D. In the formulae set forth $A = $600; $C = $25; and $V = $300. Substituting those values in formula 3 (the formula aimed at), we obtain the result $P = $550. The statute provides that the part of the $5,000 to be included in D's gross estate shall equal that proportion thereof which the amounts paid by D ($550) bears to the total premiums paid for the insurance (in this instance $600 paid by D plus $200 paid by B, equal to $800). Hence $550/800$ths of $5,000, or $3,437.50.

There are two other provisions that must be followed in computing the amount paid by decedent in determining the proportion of the proceeds includible in his gross estate. The first provides a special rule therefor where the premiums or other consideration are property held as community property by the insured and the surviving spouse.\textsuperscript{17} The second is of more general interest, and reflects the changes made in Reg. 80, Articles 25, 26, and 27, by T. D. 5032. It provides that, in computing the proportion of the premiums or other consideration paid by decedent (but not in computing the total premiums paid), the amount paid by decedent on or before January 10, 1941 (the date of T. D. 5032)

\textsuperscript{17}I.R.C., sec. 811(g), as amended by R. A. 1942, sec. 404(a).
is to be excluded if decedent never possessed an incident of ownership in the policy after that date. This rule is inapplicable if decedent possessed any incidents of ownership after that date, even though he may have relinquished all of them prior to his death.

Another important change eliminates an advantage heretofore accruing to decedents dying with insurance payable to third party beneficiaries. The prior law excluded $40,000 of the proceeds of such insurance from the gross estate. This has been completely eliminated. The entire proceeds of such insurance, if meeting any of the tests of inclusion heretofore considered, are now includible in the gross estate.

The amendments are expressly made applicable only to estates of decedents dying after October 21, 1942.

Other Inclusions in Gross Estate

The provisions of the I.R.C. dealing with inter vivos transfers and joint interests have been amended with respect to property held as community property by a decedent and his surviving spouse. It is sufficient for our purposes merely to call attention to this matter.¹⁸

Deductions

The federal estate tax has from its inception been based on the net estate. This has always been defined as the gross estate less certain deductions. The deductions under the I.R.C. in computing the basic estate tax have differed from those permitted to be taken in computing the additional estate tax with respect to the deduction for the specific exemption. No change has been made in this for purposes of the basic tax. The deduction therefor in computing the additional tax has been increased from $40,000 to $60,000.¹⁹ This seeming favor to taxpayers is, however, more than cancelled for some of them by the elimination of $40,000 of insurance proceeds receivable by third party beneficiaries from exclusions from the gross estate. Another change grants the estates of non-residents who are not citizens of the United States an exemption of $2,000.²⁰ This is the first time they have been accorded this deduction. It is available in computing both the basic tax and the additional tax.

The permissible deductions have always included such amounts as were allowed by the laws of the jurisdiction under which the

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¹⁸I.R.C., sec. 811(d), as amended by R. A. 1942, sec. 402(a); I.R.C. sec. 811(e), as amended by R. A. 1942, sec. 402(b).
¹⁹I.R.C., sec. 935(c), as amended by R. A. 1942, sec. 414(a).
²⁰I.R.C., sec. 861(a), as amended by R. A. 1942, sec. 412(a).
estate was being administered for funeral expenses, administration expenses, claims against the estate, unpaid mortgages upon property included in the gross estate, and maintenance of dependents during the period of administration. It was not limited to the value of the property includible in the gross estate and which could be resorted to to pay or satisfy those items of deduction. The result was that the deduction often inured to the benefit of those receiving property includible in the gross estate but not subject to those claims. If, for example, A died leaving a gross estate of $200,000 of property subject to such claims and $400,000 worth of insurance includible in his gross estate, and if the total deductions of the character described above were $300,000, then the allowable deduction was $300,000, although but $200,000 of them would in fact be paid. This has been changed to limit the deduction to an amount equal to the value of the property includible in the gross estate which, or the avails of which, would, under the applicable law, bear the burden of the payment of such deductions in the final adjustment and settlement of the estate. The value of such property must also be first reduced by the deduction, attributable to such property, because of uncompensated losses incurred during the settlement of the estate arising from fires, storms, shipwrecks, or other casualties. The result is to limit this class of deductions to the amount that can be actually satisfied out of the assets of the estate legally applicable to their discharge.

There have been several changes made involving amounts of a decedent's estate applied to religious, educational, charitable, etc., purposes of the kind defined in I.R.C., Sections 812 (d) and 861 (a) (3). It has been held that a decedent's pledge to an educational institution which remained unpaid at the date of his death was not deductible as a claim against his estate since it was not contracted for an adequate and full consideration in money or money's worth. This has now been changed by permitting the deduction of a claim founded upon a promise or agreement of decedent to make a contribution or gift to a donee described in Section 812 (d) for the purposes therein specified, limited to the extent that it would be allowable if the promise or agreement constituted a bequest. A comparable change is made

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22I.R.C., sec. 812(b), as amended by R. A. 1942, sec. 405(a).
23Taft v. Commissioner of Internal Revenue, (1938) 304 U. S. 351, 58 S. Ct. 891, 82 L. Ed. 1393.
in the case of estates of non-residents who are not citizens of the United States.\textsuperscript{25} The provisions governing deductions for transfers for public, charitable and religious uses, in the case of both citizens and residents of the United States and of non-residents who are not such citizens, have been amended to include among such deductions property includible in the gross estate under the amended provisions as to powers of appointment where such property is received by a donee bequests to whom would be deductible.\textsuperscript{26} It is not necessary that the decedent exercise his power by appointing such donee. The same result occurs where such donee receives it on decedent's failure to appoint. Furthermore, amounts that pass to such donees as the result of an irrevocable disclaimer of a bequest, legacy, devise, transfer or power, are deductible if the disclaimer is made prior to the date prescribed for filing the estate tax return.\textsuperscript{27} This is probably no more than declaratory of existing law.\textsuperscript{28} The last change expressly conditions the right to take these charitable, etc., deductions on the factor that no substantial part of the activities of certain specified classes of donees consist of carrying on propaganda, or otherwise attempting to influence legislation.\textsuperscript{29} A similar condition had already been imposed by the Revenue Act of 1934 with respect to the other classes of donees to whom deductible transfers may be made.

The prior provisions governing the deduction for property previously taxed have been considerably amended. Some of the amendments reflect the changes made in the treatment of powers of appointment under both the estate tax and the gift tax, and of deductions under I.R.C., Sections 812(b) and 861(a)(1). There have also been changes in the conditions imposed upon the allowance of this deduction. The I.R.C. required the final determination and payment by the estate of the prior decedent of any estate tax due under the basic estate tax sub-chapter, the Revenue Act of 1926, or any prior Act of Congress. A brief résumé of the development of our present estate tax system is necessary for understanding the scope of the changes. The 1926 Act im-

\textsuperscript{25}I.R.C., sec. 861(a)(1), as amended by R. A. 1942, sec. 406(b).
\textsuperscript{26}I.R.C., sec. 812(d), as amended by R. A. 1942, sec. 403(b)(1); I.R.C., sec. 861(a)(3), as amended by R. A. 1942, sec. 403(b)(2).
\textsuperscript{27}I.R.C., sec. 812(d), as amended by R. A. 1942, sec. 408(a); I.R.C., sec. 861(a)(3), as amended by R. A. 1942, sec. 408(b).
\textsuperscript{29}I.R.C., sec. 812(d), as amended by R.A. 1942, sec. 409(a); I.R.C., sec. 861(a)(3), as amended by R. A. 1942, sec. 409(b).
posed what is now called the basic tax. The 1932 Act first imposed what is now called the additional estate tax. When the latter was enacted no change was made in those provisions of the 1926 Act providing for the deduction for property previously taxed. Hence, payment of the estate tax imposed by the 1926 Act continued to be a condition precedent to the allowance of this deduction. However, a person dying after the enactment of the 1932 Act might have to pay the additional tax imposed by the 1932 Act but no tax under the 1926 Act. Assume A to be such a person whose property was bequeathed to B. If B died while the 1932 Act was in effect, or while the I.R.C. in its unamended form was in effect, his estate would be unable to take this deduction with respect to property acquired by B from A, since it could not meet the condition that the tax due from A's estate under the 1926 Act had been paid. Furthermore, if A be assumed to have died after the enactment of the I.R.C., his estate might have had to pay a tax only under the additional estate tax subchapter of the I.R.C. If (assuming that to be the case) B died while the I.R.C. was in its unamended form, his estate would equally be denied this deduction because it could not meet the condition that A's estate have paid the tax due under the basic estate tax subchapter of the I.R.C. All this has now been changed. To meet the case in which the prior decedent died after the enactment of the 1932 Act but prior to the enactment of the I.R.C., the 1926 Act was amended. The amendment is made applicable to the estates of all decedents dying after the enactment of the 1932 Act, regardless of whether they died before or after the enactment of the I.R.C. The decedents referred to in the preceding sentence are those who acquired property from the prior decedent referred to in the second preceding sentence. To meet the case in which the prior decedent died while the I.R.C. was in its unamended form, the amendments to it are made applicable to the estates of all decedents dying after its enactment (February 10, 1939). The result is that many estates of persons dying after the enactment of the 1932 Act may have made overpayments of their tax. They are given a right to a refund or credit therefor, but claims for refund or credit must be made prior to October 21, 1943.

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30 R. A. 1926, secs. 303(a) (2) and 303(b) (2), as amended by R. A. 1942, sec. 407(b).
31 R. A. 1942, sec. 407(e) (4).
32 R. A. 1942, sec. 407(c) (1), (2), (3).
33 R. A. 1942, sec. 407(d).
Credits Against the Tax

The amendments change only the provisions involving the credits against the basic estate tax. The credit for gift taxes paid under the Revenue Act of 1924 is now to be applied against the basic estate tax after deducting therefrom the credit for state death taxes. The limit on the credits for gift taxes paid under the Revenue Act of 1932 or the gift tax chapter of the I.R.C., so far as it depended on the amount of the basic estate tax, is now made to depend upon that tax after deducting therefrom the credits for gift taxes paid under the 1924 Act and for state death taxes. Finally the 80 per cent limit on the credit for state death taxes is now to be based on the basic estate tax before deducting therefrom the credits for federal gift taxes instead of after deducting the credit for federal gift taxes paid under the 1932 Act or the gift tax chapter of the I.R.C. The net effect of these changes is to increase the value of the credit for state death taxes wherever an estate is also entitled to gift tax credits.

General Provisions

Attention is directed to the changes in I.R.C., Section 826 (dealing with the collection of unpaid taxes). The first of these reflects changes made in the treatment of insurance proceeds. The second permits an executor to recover a proportionate part of the tax from those receiving property includible in a decedent's gross estate under the amended provisions dealing with powers of appointment. Section 827 (liens for taxes) has also been amended.

The Gift Tax

The changes made in the gift tax provisions of the I.R.C. can be disposed of rather briefly.

Taxable Gifts

Two new provisions have been added in defining taxable gifts. One provides that gifts of property held as community property are to be considered as gifts of the husband unless shown to be attributable to the wife's personal earnings or separate property.

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34I.R.C., sec. 813(a) (1), as amended by R. A. 1942, sec. 410(a).
35I.R.C., sec. 813(a) (2) (A), as amended by R. A. 1942, sec. 410(b).
36I.R.C., sec. 813(b), as amended by R. A. 1942, sec. 410(c).
37I.R.C., sec. 826(c), as amended by R. A. 1942, secs. 404(b) and 414(b).
38I.R.C., sec. 826(d), added by R. A. 1942, sec. 403(c).
39I.R.C., sec. 827(b), as amended by R. A. 1942, sec. 411(a); see also I.R.C., sec. 900, as amended by R. A. 1942, sec. 411(b).
40I.R.C., sec. 1000(d), added by R. A. 1942, sec. 453.
The other is of more general importance. It provides that the exercise or release of a power of appointment is to be deemed a transfer of property by the person possessing the power. The term "power of appointment" has the same meaning as in the estate tax chapter of the I.R.C. as amended by R. A. 1942. The treatment of powers created prior to October 22, 1942, is similar to that given such powers by the amendments relating to the estate tax.

Exclusions from Gifts

The federal gift tax act of 1932 and the gift tax chapter of the I.R.C. have always excluded from gross gifts a limited portion of gifts made to any person during a given year. The amount thereof has been steadily decreased from $5000 to $3000, the amount applicable to the calendar year 1943 and subsequent calendar years. Gifts of future interests in property have never been permitted to be excluded from gross gifts, and this principle is continued with respect to 1943 and subsequent calendar years. Prior to the calendar year 1939, a gift in trust did not lose the right to be excluded merely because it was one in trust, and it was decided that in the case of such gifts the beneficiaries, and not the trustee, were the donees. This is still the rule applicable in computing gifts for years prior to 1939. The rule was, however, changed by denying such gifts the right of exclusion, and this changed rule remained in force during the period from January 1, 1939, through December 31, 1942. It applies under the amendments now made to gifts made during any calendar year within that period. However, in computing gross gifts for the calendar year 1943 and subsequent calendar years a gift in trust does not lose its right of exclusion merely because it is such. The discrimination against gifts in trust that existed during the calendar years 1939 through 1942 has thus been removed.

Deductions

The only change involves the specific exemption. This has been reduced from $40,000 to $30,000. This amount is to be used

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Footnotes:
41I.R.C., sec. 1000(c), added by R. A. 1942, sec. 452(a).
42R. A. 1942, sec. 452(b).
43I.R.C., sec. 1003(b) (3), added by R. A. 1942, sec. 454.
44I.R.C., sec. 1003(b) (1).
46I.R.C., sec. 1003(b) (2), as amended by R. A. 1942, sec. 454.
47I.R.C., sec. 1003(b) (3), added by R. A. 1942, sec. 454.
48I.R.C., sec. 1004, as amended by R. A. 1942, sec. 455.
in all computations required to be made to arrive at the tax due for the calendar year 1943 and subsequent calendar years. Hence in computing that element in arriving at the tax for 1943 which consists of the tax on the aggregate of the net gifts for all years prior to 1943, the specific exemption is taken at $30,000 even though under the law in force during those years it was in excess of $30,000. This is an advantage for the taxpayer to which he is justly entitled.

Application of Amendments

The amendments that have been herein discussed are applicable only with respect to gifts made in the calendar year 1943, and subsequent calendar years.\footnote{R. A. 1942, sec. 451.}

The income tax chapter of the I.R.C. has been amended in so many respects by R. A. 1942 as to make it imperative to confine the discussion to those changes that are likely to be of the greatest general interest. The selection of topics has been made in the light of that objective.

Alimony Payments and Alimony Trusts

No prior federal income tax act has contained any express provision on the subject of alimony. It was held in one of the early cases decided after the ratification of the Sixteenth Amendment that alimony payments were not income to their recipient.\footnote{Gould v. Gould, (1917) 245 U. S. 151, 38 S. Ct. 53, 62 L. Ed. 211.} This has remained the law ever since so far as direct payments from the former husband are concerned. The whole law on the income tax status of alimony has now been changed. The most important change was effected by a redefinition of gross income.\footnote{I.R.C., sec. 22(k), added by R. A. 1942, sec. 120(a).} This requires a wife who is divorced or legally separated from her husband under a decree of divorce or separate maintenance to treat as her income periodic payments (whether or not made at regular intervals) received subsequent to the decree so far as those payments are in discharge of a legal obligation which is based upon marital or family relationship and imposed upon the husband by the decree or incurred by him under a written instrument incident to such divorce or separation. If the periodic payments are attributable to property transferred by the husband in discharge of obligations of the character described above, they are still to be treated as income to the divorced or separated wife.

\footnote{R. A. 1942, sec. 451.}

\footnote{Gould v. Gould, (1917) 245 U. S. 151, 38 S. Ct. 53, 62 L. Ed. 211.}

\footnote{I.R.C., sec. 22(k), added by R. A. 1942, sec. 120(a).}
Payments attributable to property so transferred are expressly excluded from the husband's income. It is immaterial whether the said property is transferred in trust or otherwise. An example of a transfer of property not in trust is the purchase by the husband of an annuity payable to the wife. If the transfer is in trust to pay the income from the trust res to the wife, the matter is governed by a new section added to the I.R.C.\textsuperscript{52} It will be noted that the provision applies only to periodic payments. There is no change in the rule that a single lump-sum payment in discharge of obligations of the character herein considered are not income to the wife. A special rule is provided where the decree or instrument calls for the payment of a principal sum payable in installments. A payment of part of such principal sum is deemed a periodic payment includible in the wife's income only if the decree or instrument requires or permits the principal sum to be paid within a period ending more than ten years after the date of the decree or instrument. But even then the amount to be included in a wife's income is limited to ten per cent of the principal sum provided for in the decree or instrument. For that purpose the portion of a payment of such principal sum which is allocable to a period after the taxable year of the wife in which it is received is considered an installment payment for the year in which she receives it. Examples will clarify the meaning of these provisions. Assume a decree awarding a wife alimony in the principal sum of $100,000, payable in equal annual installments of $10,000 during a period ending ten years after the date of the decree. The $10,000 annually received by the wife and paid by the husband are not deemed "periodic payments." Hence they do not constitute income to her nor deductions for him. Assume, however, that the decree awards her $100,000, payable in equal annual installments of $5,000 for a period ending twenty years after the date of the decree. If this arrangement is carried out, the wife is chargeable with $5,000 income on account of its receipt, and the husband is entitled to an equal annual deduction. If in the latter case the husband pays the wife during 1943 $20,000, consisting of the $5,000 due for 1943, and the installments due in 1944, 1945, and 1946, or for any other years after 1943, or merely to hasten the time when the principal amount shall have been fully paid, then the whole $20,000 is deemed an installment payment for 1943 even though $15,000 is allocable to subsequent years. The amount of the

\textsuperscript{52}I.R.C., sec. 171, added by R. A. 1942, sec. 120(c).
$20,000 includible in her 1943 income, and deductible by the husband, is limited to ten per cent of the principal sum awarded by the decree. That is, $10,000 of the $20,000 is income to her and deductible by him. That would mean that he would have sacrificed a right to deduct $10,000 in subsequent years, while she would have been relieved of the necessity for reporting it as income in those subsequent years. It is to be noted that the terms of the decree or instrument determine whether installment payments constitute periodic payments. The importance of these provisions in drawing decrees of divorce or separation, and instruments incident thereto, is obvious.

There is another provision equally important in connection with the matters last mentioned. The new subsection 22 (k) of the I.R.C. excludes from its operation that part of any periodic payment which by the terms of the decree or instrument is for the support of the husband's minor children. If, for instance, the decree awards $5,000 a year to the wife of which $1,000 is to be used by her to support the husband's minor children, then only $4,000 is income to her and deductible by him. If it had awarded her $5,000 yearly with provision that she should use one-fourth thereof for the support of such children, then only $3,750 would have been income to her and deductible by him. It is also provided that if a periodic payment should be less than the decree or instrument awarded, the first charge against it is the amount provided for the support of the husband's minor children. Take the first example given above. If during any given year the husband had paid but $4,000 of the decreed $5,000, then but $3,000 would be income to the wife and deductible by him. If he had paid but $1,000, no part of it would have been income to her or deductible by him. If the decree, or instrument, merely imposes upon the wife the duty to provide for the husband's minor children, but allocates no part of the periodic payment thereto, then, as long as the decree or instrument remains unmodified, the whole amount paid to the wife is income to her and deductible by the husband. There is no requirement that she be the mother of such minor children.

The next important change in this field is the special provision governing alimony trusts. The doctrine that income from an alimony trust was chargeable for income tax purposes to the husband in those cases where, after the decree, he remained under a

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54 I.R.C., sec. 171, added by R. A. 1942, sec. 120(c).
continuing obligation, legal or assumed by an instrument incident to the divorce, to support his divorced wife, was established by Douglas v. Willcuts, and has remained intact ever since. It has now been abolished. The income which a wife, who has been divorced or legally separated from the settlor, is entitled to receive from an alimony trust, and which but for the new provision would be includible in the settlor's gross income, must now be included in hers. It is expressly provided that it shall be excluded from his gross income despite any other provision of the income tax chapter of the I.R.C. If any part of the income receivable by her from the trust is required by the terms of the decree or trust instrument to be used for the support of the husband's minor children, such part shall not be includible in the wife's gross income. The principles for allocating the trust income between payment to her and payments for the support of the said minor children are the same as those applicable where provision for alimony is by a method other than the alimony trust. These have already been considered. To the extent that trust income is used for the support of such minor children in accordance with the provisions of the decree or trust instrument, the trust is a maintenance trust and the income chargeable to the husband.

These changes in the legal status of alimony payments required adjustments in certain other provisions of the I.R.C. In order to prevent them from charging the same income to both the wife and the husband, a provision was added to Section 23 of the I.R.C. authorizing the husband to deduct from his gross income any alimony payments which the wife is required to include in her gross income. The deduction for any taxable year is limited to the amount paid within the husband's taxable year, regardless of whether he reports on the cash or accruals basis. The husband may not take a deduction for any amount received by the wife if such amount is expressly excludible from his gross income. For example, amounts received by the wife from the income of an alimony trust are expressly excluded from the husband's gross income.

54(1935) 296 U. S. 1, 56 S. Ct. 59, 80 L. Ed. 3.
58I.R.C., sec. 23(u), added by R. A. 1942, sec. 120(b).
income. He may not deduct the amount so received by her since it has never entered his income account for tax purposes. Its exclusion from his gross income has the same effect upon his net income as if he had been required to include it in his gross income and at the same time been permitted to deduct it therefrom. Another adjustment occurs where the alimony payments take the form of payments under a life insurance, endowment, or annuity contract. The general rule set forth in Section 22(b)(1) and (2)(A) of the I.R.C. excludes the whole or part of such payments from gross income. This has been amended to make the general rule inapplicable to so much of such payments as are required to be included in the income of a divorced or separated wife. Moreover, since these would be considered alimony payments attributable to property transferred by the husband, they would not enter his gross income and would, therefore, be non-deductible by him under I.R.C., Section 23(u), already discussed in this paragraph. Thus, if the divorced husband met his alimony obligation by purchasing for, or assigning to, his former wife an annuity contract paying her $1000 per year, the whole $1000 is income to her, is excluded from his income, and is non-deductible by him. The last adjustment prevents the divorced husband from treating the payments made to the former wife which are includible in her income as payments for the support of a dependent. That is, he cannot, by virtue of those payments, treat her as a dependent for computing his credit for dependents.

The amendments dealing with the treatment of alimony payments apply only to taxable years that begin after December 31, 1941. It will be the calendar year 1942 for all taxpayers reporting on a calendar year basis. There is, however, an exception to the general rule for the case in which the husband and his former wife have different taxable years. Two cases are possible: (1) where the husband's first taxable year beginning after December 31, 1941, begins prior to the wife's first taxable year beginning after that date; and (2) where the husband's first such taxable year begins after the beginning of the wife's first taxable year beginning after said date. In either case, the amendments first be-

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50I.R.C., sec. 22(b)(2)(A) was, prior to its amendment by R. A. 1942, I.R.C., sec. 22(b)(2).
60I.R.C., sec. 22(b)(2)(A), as amended by R. A. 1942, sec. 120(d).
61I.R.C., sec. 25(b)(2)(A), as amended by R. A. 1942, sec. 120(e)(1).
62See also for a definition of the terms "husband" and "wife," I.R.C., sec. 3797(a)(17), added by R. A. 1942, sec. 120(f).
63R. A. 1942, sec. 120(g).
come applicable to the husband on the first day of the wife’s taxable year beginning after that date. This would mean, in the second case, that they took effect during the husband’s taxable year beginning prior to December 31, 1941. An example will clarify the matter. Assume that the husband reports on the basis of a fiscal year ending on March 31, and the wife on a fiscal year basis ending February 28. In that case the amendments become applicable to the wife on March 1, 1942, and to the husband on that same date although this is within a taxable year of the husband beginning prior to December 31, 1941.

**Decedent’s Income**

The method for treating the tax problems of a taxpayer for the taxable year in which falls the date of his death has been the subject of some experimentation. A person cannot so time his death that all his claims to income will have been collected and all his obligations which, if paid, would constitute deductions, will have been paid, prior to his death. Prior to the enactment of the Revenue Act of 1934, such income items never became income to any income taxpayer if decedent reported on a cash basis, although they did constitute an asset for estate tax purposes. Similarly the deduction items would never be deductible by any income taxpayer in the case of such decedent, although they too would constitute deductions for estate tax purposes. The same considerations would apply if the decedent were reporting on an accruals basis so far as the conditions precedent to the duty to accrue income or the right to accrue deductions had not been met prior to the taxpayer’s death. Congress sought to remedy this defect by provisions placing all decedents on an accruals basis with respect to such items for the taxable year in which their death occurred. They were first enacted by the Revenue Act of 1934, were continued in all subsequent Acts, and incorporated into the I.R.C.64 The theory of accrual judicially developed for this special case was broader than the ordinary accruals theory.65 The enforcement of these provisions produced many injustices that led to a demand for their repeal. They have now been repealed so far as cash basis taxpayers are concerned. As to taxpayers reporting on the accruals basis, it is now provided that there shall not be included in their gross income for the taxable year of their death amounts

64 I.R.C., secs. 42(a) and 43.
accrued only by reason of their death. A similar rule is applied to deductions and credits. Income items and deductions are still accrued in such case, but an artificial theory of accruals in which the fact of the taxpayer's death is a dominant factor is precluded. These provisions do not apply to amounts includible in computing decedent's share in the net income of a partnership of which he is a member. The amendments are applicable to taxable years beginning after December 31, 1942. However, all Revenue Acts beginning with that of 1934, and the I.R.C., are retroactively amended to incorporate the changes, and refunds may be obtainable in the case of the estates of some decedents who died prior to the change, but subject to important conditions.

The gross income which escapes taxation to the decedent under the revised method does not, however, entirely escape taxation. There is no return to the status quo existing prior to the enactment of the 1934 Act. It is includible in the gross income of the person entitled to receive it after the death of the decedent, and must be included in the taxable year of such person during which he receives it. The persons designated are the estate of the decedent if it acquires the right to receive the item of income from the decedent. This is likely to be the most usual case. If, however, the estate does not so acquire such right, or distributes the right to a legatee, devisee, or heir, then it becomes income to the person receiving it in that capacity. The new section also provides for the case in which the right to receive the income is not acquired by either the estate, a legatee, devisee or heir, but by one who acquires the right by reason of decedent's death. The beneficiary named in certain federal bonds purchased on a discount basis would be such a person. It is to be noted that these provisions apply only to claims of decedent that would constitute items of income to him if he collected them. They have no bearing on those of his claims which would constitute capital receipts to him if collected by him. If the person entitled to receive it transfers the right to receive the item, it is includible in his income for the taxable year of its transfer. The amount includible is its fair market value at the time of the transfer or the actual consideration

\[\text{I.R.C., sec. 42(a), as amended by R. A. 1942, sec. 134(a).}\]
\[\text{I.R.C., sec. 43, as amended by R. A. 1942, sec. 134(b).}\]
\[\text{R. A. 1942, sec. 134(f).}\]
\[\text{R. A. 1942, sec. 134(g).}\]
\[\text{I.R.C., sec. 126, added by R. A. 1942, sec. 134(e).}\]
\[\text{Gains realized in such a capital transaction would, however, constitute income to the person acquiring such capital claim from the decedent.}\]
received for the transfer, whichever is the greater. If, for example, a legatee receives a claim of decedent for salary earned before his death, and sells it before collecting it, the value at the time of the sale is income to him unless the consideration received exceeds that value in which case he realizes income in the amount of the consideration received. If he had given it away, he would have realized income in an amount equal to the value of the claim at the time of the gift. An executor's or administrator's transfer of the claim to the legatee is not considered a transfer thereof involving realization of income to the transferor, since it is a transfer to one who must himself treat the amount collected on the claim as income. This is merely an illustration of the general principle embodied in the new section.

Another important principle defines the character of the income when received by the person who acquires the right to receive it in the ways described above. He is treated as if he had acquired the right in the transaction by which the decedent acquired it, and the amount includible in the former's gross income is considered to have the character it would have had if the decedent had lived and received it. Thus, if decedent's right to the item arose out of his performance of personal services, the estate, legatee, etc., is deemed to acquire it in that same manner; and, if it would have been earned income to decedent had he lived and received it, it is earned income to the estate, legatee, etc. In view of the limit on the amount that may be treated by an individual as earned income, a question might arise whether the estate, legatee, etc. could treat it as such if the amount treated as earned income in the decedent's return for the year of his death was already the maximum. It might be argued that its status should be determined by what would have been its status to decedent in the year the estate, legatee, etc., receive it had the decedent received it in such year. On the same principle, that which would be a capital gain if received by the decedent is a capital gain to the estate, legatee, etc., entitled to receive it.

The decedent may have incurred liabilities in respect of items of a character deductible in computing his net income. So far as those are not properly allowable in computing his net income for the taxable year of his death, or prior taxable years, provision is made to permit their deduction, when paid, after his death. This principle applies to deductible expenses, interest, taxes, and depletion, and also to the foreign tax credit. They are deductible
by the decedent's estate unless it is not liable to discharge the obligation to which the deduction or credit relates. In that event they are deductible by the person who, by reason of decedent's death or by bequest, devise, or inheritance, acquires, subject to such obligation, from decedent an interest in property of the decedent. An example may help to clarify this. Assume that decedent owned his home, and that the taxes thereon had accrued when he died but were payable after his death. Assume that the state law makes the property itself solely liable for the taxes thereon. The taxes are deductible under the federal income tax laws. They would not be deductible by decedent if he were reporting on the cash basis. Nor are they payable by the decedent's estate. Under the new Section 126 of the I.R.C., they could be deducted by the devisee of decedent's home. This would be true even though such devisee did not acquire from the decedent any item that he would have to include in his gross income under the principles heretofore discussed. The right to take the deduction depends not upon acquiring claims to income items from the decedent but upon acquiring from him property subject to the obligation to which the deduction relates. The right to receive an income claim of decedent is, however, property acquired from decedent. The right to deduct the credit for foreign taxes was undoubtedly granted for the benefit of one who acquires from decedent a right to receive income from foreign sources, and he is the person entitled to take it. The right to take the depletion deduction is expressly made to follow the right to receive the income to which it relates, and must be taken by the recipient of that income in the taxable year of its receipt.

It is also expressly provided that the recipient of income in respect of a decedent may deduct, for the taxable year that he receives it as income, an amount equal to a part of the decedent's estate tax. The formula for computing this deduction is extremely complicated, but its steps may be summarized as follows:

(1) Compute the value at which decedent's claims to gross income were included in his gross estate.

(2) Compute the deductions from the gross estate in respect of claims against the decedent which represent the deductions and credit that decedent could have taken for income tax purposes had he lived and which others may now take under I.R.C., Sec. 126(b).
(3) Subtract Item (2) from Item (1), which gives what the statute calls "the net value for estate tax purposes" of decedent's claims to gross income.

(4) Compute value for estate tax purposes of those of decedent's claims to gross income received by the taxpayer whose income tax is being computed (or amount for which he included it in his gross income if that is less than said value).

(5) Compute decedent's estate tax on his estate, including the items referred to in Item (1).

(6) Compute decedent's estate tax on the basis of a gross estate arrived at by deducting from the gross estate used in Item (5) an amount equal to Item (3).

(7) Subtract Item (6) from Item (5). This gives what the statute describes as the "estate tax attributable to" the "net value" described in Item (3).

(8) Multiply Item (7) by a fraction whose numerator is Item (4) and whose denominator is Item (1).

(9) The amount of decedent's estate tax that the taxpayer, whose income tax is being computed, may deduct is equal to Item (8).

Section 23 of the I.R.C. is amended to reflect the right to deductions considered in this and the preceding paragraphs.\textsuperscript{72}

The amendments made to the I.R.C. by the addition of Section 126, and by adjusting Section 23 in the manner described above, are applicable with respect to taxable years ending after December 31, 1942.\textsuperscript{73}

\textit{Taxable Years}

Section 47 of the I.R.C., which deals with returns for a period of less than 12 months, has been amended in several respects. The requirement for annualizing the return where the short period is due to a change in accounting period has been extended to corporations.\textsuperscript{74} In addition a relief provision has been added.\textsuperscript{75} Two methods are provided. The first applies where the taxpayer con-

\textsuperscript{72}Sec. 23(w), added by R. A. 1942, sec. 134(d).
\textsuperscript{73}R. A. 1942, sec. 134(f).
\textsuperscript{74}I.R.C., sec. 47(c), as amended by R. A. 1942, sec. 135(a). For the special classes of corporations to which the annualizing of income is inapplicable, see I.R.C., secs. 102, 336, 393, 505, all as amended by R. A. 1942, sec. 135(b).
\textsuperscript{75}I.R.C., sec. 47(c), as amended by R. A. 1942, sec. 135(a).
continues in existence for at least 12 months after the first day of the short period. In that case he must compute his tax and file his return without regard to this provision. Subsequently he may compute a tax on his net income for the 12 months beginning with the first day of the short period (which is treated as if it were a taxable year), under the law applicable to such year. The reduced tax is such portion of the tax so computed as the net income for the short period is of the net income for such 12-month period. The second method applies where the taxpayer is not in existence for the 12-month period referred to above, or, if it is a corporation, disposes of substantially all its assets prior to the end of such period. In that case the taxpayer computes his net income for the 12-month period ending with the last day of his short period. The rest of the procedure is the same as under the first method. The reduced tax shall in no case be less than the tax computed on the basis of the net income of the short period without placing it on an annual basis. Taxpayers wishing to take advantage of this provision must make timely application therefor. The Commissioner may prescribe regulations for applying this relief provision. A further new paragraph is added to Section 47 requiring a taxpayer who is not in existence for the whole of an annual accounting period ending on the last day of a month, or who has no such annual accounting period during the whole of a calendar year, to make his return for the fractional part of the year during which he was in existence. Under the prior law such taxpayers had to make returns for such period as the Commissioner required under administrative regulations. The amendment provides for a uniform treatment of such cases.

The frequent changes in federal income tax laws gave rise to a special problem in the case of fiscal year taxpayers. Their taxable year consisted of two parts falling in calendar years to which different laws applied. The solution that prevailed until the enactment of the Revenue Act of 1932 was to make their tax for such year the sum of (1) a tax computed under the law applicable to the first calendar year in which a part of their taxable year fell, divided by 12 and multiplied by the number of months of their taxable year falling within that calendar year, and (2) a tax computed under the law applicable to the second calendar year in which the balance of their taxable year fell, divided by 12 and multiplied by the number of months of their taxable year falling

20I.R.C., sec. 47(g), added by R. A. 1942, sec. 135(c).
within that second calendar year. The 1932 Act changed this by permitting the entire tax to be computed under the law in force during the first calendar year in which fell part of their fiscal year. That is, they did not become subject to the new Act until after their current taxable year had ended. It gave fiscal taxpayers a decided advantage during a period when each new Revenue Act increased tax rates. It is, however, still the law except as modified by Section 140 of R. A. 1942. That Section provides a special rule for taxpayers with taxable years beginning in 1941 and ending after June 30, 1942. In the case of non-corporate taxpayers the tax is determined as follows: (a) compute a tentative tax under the law in force during 1941 at the rates prevailing thereunder, divide that by the number of days in the taxable year, and multiply the quotient by the number of days in the taxable year before July 1, 1942; (b) compute a tentative tax under the law prevailing during 1941 but at the rates prescribed by the amendments made by R. A. 1942, divide by the number of days in the taxable year, and multiply the quotient by the number of days in the taxable year after June 30, 1942; (c) the tax equals the sum of (a) and (b). The computation in the case of corporate taxpayers is somewhat different. The first step (a) is the same as for non-corporate taxpayers. But in step (b) the rates prescribed by the amendments made by R. A. 1942 are applied not to net income as defined under the law in force during 1941 but to that as modified by specified amendments made by R. A. 1942. The tax payable is again the sum of (a) and (b). These provisions are applicable only to taxable years beginning in 1941 and ending after June 30, 1942. They do not apply to insurance companies subject to Supplement G, investment companies subject to Supplement Q, or Western Hemisphere Trade Corporations covered by Section 109, added to the I.R.C. by R. A. 1942, Section 141.

**Gross Income—Commodity Credit Loans**

The income tax is based on net income minus certain credits

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77This added a Section 108 to the I.R.C.
78The amendments referred to are as follows: I.R.C., sec. 13(a)(2) and 13(b)(2), as amended by R. A. 1942, sec. 105(a); I.R.C., sec. 15, as amended by R. A. 1942, sec. 105(b); I.R.C., sec. 23(c)(1)(B) and 23(c)(2), as amended or repealed by R. A. 1942, sec. 105(e); I.R.C., sec. 26(e), as amended by R. A. 1942, sec. 105(d); I.R.C., sec. 26(b), as amended by R. A. 1942, sec. 105(e)(1). In connection with the amendment of I.R.C., sec. 15, see for exception to its application, I.R.C., sec. 108(a)(1)(B), added by R. A. 1942, sec. 140(a).  
79R. A. 1942, sec. 140(b).  
80I.R.C., sec. 108(b), added by R. A. 1942, sec. 140(a).
against it. Net income is defined to mean gross income computed under Section 22 less the deductions allowed by Section 23. The statutory concept of gross income is thus one of the most important factors determining a taxpayer’s liability. Its principal elements are stated in Section 22 of the I.R.C. The changes made therein, and in other sections dealing with gross income problems, must now be considered.

The proceeds of loans are capital receipts, not income. They have been generally so treated under federal income tax laws. A permissive departure from this principle was introduced by the Revenue Act of 1939 with respect to the proceeds of loans made by the Commodity Credit Corporation, and this was carried into the I.R.C. as Section 123 thereof. It was intended as a relief measure for farmers borrowing from that Corporation on the security of farm products. It gave such borrowers an election to treat such proceeds as income includible in their gross income for the taxable year of their receipt. The election could be made for any taxable year beginning after December 31, 1938, and the provision was made retroactive for any year subject to tax under the Revenue Acts of 1934, 1936, or 1938, if election were made within one year from date of enactment of the 1939 Act. A new provision has been added to Section 123 of the I.R.C., whose effect is to permit such borrower to elect this method for any taxable year beginning after December 31, 1938, and before January 1, 1942, but the election must be made at, or prior to, the time for filing the return for his taxable year beginning during 1942. He may, however, do so only if his records are sufficient to permit an accurate computation of his income for such years, and if he consents to the assessment of deficiencies for any such years though the statute of limitations may have run against their assessment. Furthermore, Section 223(d) of the 1939 Act has been amended so as to permit such borrower to make an election with respect to any taxable year subject to the Revenue Acts of 1934, 1936, and 1938. He must make such election within the same period mentioned above. There is no change in the requirement that the borrower must follow the method in subsequent taxable years unless the Commissioner authorizes a change.

1 I.R.C., sec. 21.
2 Rev. Act of 1939, sec. 223(d).
3 I.R.C., sec. 123(c), added by R. A. 1942, sec. 154(a).
4 Rev. Act of 1939, sec. 223(d), as amended by R. A. 1942, sec. 154(b).
Gross Income—Annuities

Section 22(b)(1) of the I.R.C. excludes from gross income amounts received under a life insurance contract paid by reason of the insured's death. Section 22(b)(2) thereof provides for excluding therefrom a limited amount received under life insurance or endowment contracts (other than amounts paid by reason of the insured's death and the amounts received as annuities) or as an annuity under an annuity or endowment contract. It also provides that the amount recoverable tax-free, where an insurance, endowment, or annuity contract is transferred for a valuable consideration, shall not exceed the actual value of the consideration plus the premiums or other sums subsequently paid by the transferee. The amendment made by R. A. 1942 merely excepts from the principle stated in the preceding sentence the case where the transferee of such a contract (or an interest therein) takes the loss or gain basis of the transferor with respect to such contract (or interest therein). The cases in which the transferee takes the transferor's basis are described in Section 113(a) of the I.R.C. An example would be the acquisition by one corporation, in the course of a reorganization as defined in Section 112(g) of the I.R.C., of an insurance policy taken out by the transferor corporation on the life of its president in which it was the beneficiary. The effect of the exception is that the proceeds paid on the insured's death have the same status when received by the transferee that they would have had in the hands of the transferor had it received them. The amendment is made applicable to taxable years beginning after December 31, 1940. There may be some taxpayers entitled to refunds as a result thereof.

R. A. 1942 also adds a new subparagraph to Section 22(b)(2) of the I.R.C. It deals with the treatment by an employee of the amounts received by him under an annuity purchased by his employer under a plan with respect to which the employer's contribution is deductible under I.R.C., Section 23(p)(1)(B) (deduction of amounts paid to pension trusts), or under an annuity contract purchased by an employer exempt from tax under I.R.C., Section 101(6). Space limitations prevent a detailed analysis of

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For the treatment of such a case under prior law, see King Plow Co. v. Comm'r of Internal Revenue, (1940) 110 Fed. (2d) 649.

I.R.C., sec. 22(b)(2)(B), added by R. A. 1942, sec. 162(c).
the method under which the employee must compute his income from this source.\textsuperscript{87}

\textit{Gross Income—Gifts, Bequests, Etc.}

All federal income tax laws since 1913 have excluded from gross income the value of property acquired by gift, bequest, devise, or inheritance, but included therein the income from such property.\textsuperscript{88} The amendments leave these principles intact, but have clarified the meaning of the latter requirement. It is now expressly provided that a gift, etc., of income from property is includible in the recipient's gross income.\textsuperscript{89} This merely gives statutory form to an accepted construction of prior law.\textsuperscript{90} However, the amendment also provides that, if under the terms of the gift, etc., an amount is to be paid, credited, or distributed at intervals, it is to be deemed a gift, etc., of income to the extent that it is paid, credited, or to be distributed out of income from property. An example based on an actual case may clarify the meaning hereof.

A bequeaths an annuity to B which is made a charge on the capital of the estate. During 1943 this annuity is in fact paid out of the estate's income. Under prior law the amount received by B during 1943 would not have been income to B.\textsuperscript{91} It would be includible in B's 1943 income under the new provision.

It is obvious that the purpose of this amendment will be promoted by establishing a definite rule for determining when, and to what extent, such amounts are to be treated as paid, credited, or to be distributed from income. The applicable rule provides that, if such amounts can be paid, credited, or distributed out of something other than income (i.e., out of corpus), the amount paid, credited, or to be distributed during the taxable year of an estate or trust is treated as coming from income if the total thus paid, credited, or to be distributed is not in excess of the "distributable income" of the estate or trust for that taxable year. If, however, the aggregate amount paid, credited, or to be distributed during a given taxable year exceeds such "distributable income," the amount deemed received by any legatee, heir, or beneficiary out of income is computed as follows: (1) Compute the "distribu-

\textsuperscript{87}For another amendment to I.R.C., sec. 22(b)(2), see discussion of alimony payments, p. 237, supra.

\textsuperscript{88}Sec. I.R.C., sec. 22(b)(3).

\textsuperscript{89}I.R.C., sec. 22(b)(3), as amended by R. A. 1942, sec. 111(a).


\textsuperscript{91}See Burnet v. Whitehouse, (1931) 283 U. S. 148, 51 S. Ct. 374, 75 L. Ed. 916.
table income" of the estate or trust for the taxable year in question; (2) determine the amount paid, credited, or to be distributed to any given legatee, heir, or beneficiary during that taxable year; (3) determine the aggregate amount paid, credited, or to be distributed, to all legatees, heirs, or beneficiaries during that taxable year; (4) divide Item (1) by Item (3), and multiply the quotient thereof by Item (2). The amount deemed paid, etc., out of income to the given legatee, etc., is the answer obtained by performing the operations described in Item (4). This insures that the whole "distributable income" for the estate's or trust's taxable year will become income to those to whom the estate or trust pays or credits amounts included within the principle. It should be noted in this connection that the principle applies only to such amounts as are to be paid or credited at intervals. It does not apply to amounts payable in a lump sum. These may be made, even from income, without becoming part of the recipient's gross income. The following examples illustrate the above discussion. A makes bequests of annuities to B for $5,000 and to C for $10,000, and creates a testamentary trust to insure their payment out of either the trust's annual income or its corpus. Assume that the trust, B, and C all report on a calendar year basis. If during 1943 the trust's "distributable income" equals or exceeds $15,000, the whole amounts paid during 1943 to B and C are deemed to be paid out of income and includible in B's and C's 1943 gross income. If, however, the trust's "distributable income" had been but $10,000 only two-thirds of the amounts paid to B and C would enter their respective gross incomes. If A had merely bequeathed B and C $5,000 and $10,000, respectively, payable in a lump sum, and the trustee had in fact paid each his bequest during 1943 from the trust's "distributable income," neither would have had to include such sum in his 1943 gross income since the bequests were not of amounts "to be paid at intervals."

The amount deemed paid from income under the principle discussed in the preceding paragraph is seen to depend upon the trust's "distributable income" for the taxable year of the trust. This is a new concept. It means either (1) the net income of the estate or trust computed by taking as deductions the income which

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92 I.R.C., 162(d)(1), added by R.A. 1942, sec. 111(c). The amounts deemed paid out of income under this provision would be deductible in computing the net income of the estate or trust under I.R.C., sec. 162(b), (c), and would make inapplicable thereto the principles applied in Helvering v. Pardee, (1933) 290 U. S. 365, 54 S. Ct. 221, 78 L. Ed. 365.
is to be currently distributed (where the instrument creating it provides therefor) and the income actually distributed (where the trustee has discretion to distribute or accumulate the income), or (2) the income of the estate or trust minus the items referred to as deductible under (1), whichever is the greater. The net income referred to in (1) means net income as defined by the income tax law. The income referred to in (2) means the income as defined by the law that determines what is available for distribution to those entitled to income from the property. The deductions mentioned do not include payments that can be made from corpus, nor amounts distributable during the estate's or trust's taxable year from income of prior years.

There is one other amendment to Section 162 of the I.R.C. that must be considered. It concerns cases in which an amount that can be paid at intervals out of something other than income becomes payable during the first 65 days of any taxable year of an estate or trust. In such case a part thereof is treated as paid, credited, or to be distributed on the last day of the preceding taxable year of the estate or trust. The part to be so treated is that which bears to the total amount that becomes payable within said 65 day period the same ratio that the part of the interval at which payments are to be made which falls outside the taxable year of the payment bears to the total interval. For example, assume that A makes a bequest to B of $1800 payable on February 1 of each year, that such amount can be paid out of capital, and that he is paid it on February 1, 1943. The part deemed paid him on December 31, 1942 (assuming the estate or trust is on a calendar year basis) equals 334/365ths of $1800. A variation occurs where the part of the interval falling outside the taxable year of the estate or trust in which payment is made exceeds 12 months. In that case the interval is deemed to commence on the date which is 12 months before the end of the taxable year in which the part is deemed paid. If, for example, the $1800 above were assumed to be payable every other year on February 1, the total interval would be 2 years, and that part falling outside of 1943 would be

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101 I.R.C., sec. 162(d)(1), added by R. A. 1942, sec. 111(c).
23 months. The interval would then be deemed to commence on January 1, 1942, and thus become 396 days. This reduces the time falling outside the taxable year 1943 to 365 days, and thus the total deemed paid on December 31, 1942, would equal 365/396ths of $1800. The part of the amount deemed paid on December 31, 1942, out of income (as distinct from corpus) would be computed in the manner already considered on the basis of the facts of 1942.

**Gross Income—Tax-Free Interest**

Section 22(b)(4) of the I.R.C. excludes from gross income the interest on certain public obligations. It provides that in the case of obligations of the United States issued after September 1, 1917, and of obligations of a corporation organized under an Act of Congress, the interest shall be exempt only if and to the extent provided in the Acts authorizing their issue, or amendments thereof, and shall be excluded from gross income only if and to the extent that it is wholly exempt from federal income taxes; that is, only if and to the extent that it is exempt from both normal and surtax. An exception to this principle was made for postal savings certificates of deposit. The interest on them was excludable from gross income. That exception has now been limited to the interest on such certificates of deposit to the extent that they represent deposits made before March 1, 1941. The amendment is made effective as of March 1, 1941.

**Gross Income—Military Pensions**

Sec. 22(b)(5) of the I.R.C. excludes from gross income amounts received as compensation for injuries or sickness. This has been amended in two respects. There has been added to the exclusion “amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country.” The language is broad enough to include such amounts received from the countries

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96A similar rule is applied where distributions from income are made within the first 65 days of the estate's or trust's taxable year; see I.R.C., sec. 162(d)(3)(A), added by R. A. 1942, sec. 111(c). As to reasons for such a provision, see Com'r of Int. Revenue v. Dean, (1939) 102 Fed. (2d) 699.

97As to effective date of the several amendments discussed in this section, see R. A. 1942, sec. 111(e).

98I.R.C., sec. 22(b)(4), as amended by R. A. 1942, sec. 112(a).

99R. A. 1942, sec. 112(c).

100I.R.C., sec. 22(b)(5), as amended by R. A. 1942, sec. 113.
with which we are at present at war for active service in their armed forces during that very war.\textsuperscript{101}

\textbf{Gross Income—Income from Discharge of Indebtedness}

It has been decided by the Supreme Court that a taxpayer may realize income from the advantageous discharge of a debt owed by him. Thus a corporation issuing its bonds at par would, if solvent after the purchase of any of those bonds, realize income if it repurchased or redeemed them for less than par.\textsuperscript{102} The Revenue Act of 1939 permitted corporate taxpayers to exclude such income (a) if the debt were evidenced by a bond, debenture, note, certificate, or other evidence of indebtedness, in existence on June 1, 1939; (b) if the corporation was shown to be in an unsound financial condition; and (c) if it consented in writing to apply the amount thus excluded from gross income to reduce the loss or gain basis of any property held by it at any time during the taxable year in which such indebtedness was so discharged.\textsuperscript{103} It was originally applicable only if such discharge occurred between June 29, 1939 and the close of a taxable year beginning prior to December 31, 1942. This period has been extended to the close of a taxable year beginning prior to December 31, 1945. It has also been amended to make the provision applicable to any security (defined as in (a), \textit{supra}) issued by any corporation regardless of the date of its issue, and to remove the condition that the debtor be in an unsound financial condition.\textsuperscript{104} The changes afford corporate debtors a favorable opportunity for repurchasing their bonds, etc., if market conditions should be favorable at any time during the extended period of this provision’s application.\textsuperscript{105}

\textbf{Gross Income—Improvements by Lessee}

The effect upon a lessor’s income of improvements made on the leased premises by a lessee, which enhanced the value of the

\textsuperscript{101}For another amendment of I.R.C., sec. 22(b) (5), see “Deductions—Medical Expenses,” infra, pp. 272, 273.

\textsuperscript{102}United States v. Kirby Lumber Co., (1931) 284 U. S. 1, 52 S. Ct. 4, 76 L. Ed. 131.

\textsuperscript{103}I.R.C., sec. 22 (b) (9), added by Rev. Act of 1939, sec. 215(a). It also provided for excluding any unamortized premium with respect to such indebtedness from gross income, and any unamortized discount with respect thereto from deductions. As to the adjustment of the basis of the debtor’s property, see I.R.C., sec. 113(b) (3).

\textsuperscript{104}I.R.C., sec. 22(b) (9), as amended by R. A. 1942, sec. 114(a).

\textsuperscript{105}A new provision, sec 22(b) (10) is added to the I.R.C. by R. A. 1942, sec. 114(b); dealing with discharges of indebtedness of railroad corporations in receivership or bankruptcy proceedings. This is made retroactive to taxable years beginning after December 31, 1939 (R.A., 1942, sec. 114(c)). Other railroads are included among the corporations to which I.R.C., Sec. 22(b) (9) applies.
property when returned to the possession of the lessor, was a matter long in dispute between the Treasury and the taxpayers. An early case held that no part of the value of improvements made prior to the ratification of the Sixteenth Amendment could be treated as income to the lessor for any year subsequent thereto.\textsuperscript{106} It was later decided that no part of their value could be treated as income to the lessor for any year while the lessee remained in possession.\textsuperscript{107} A later decision of the Supreme Court held that the increase in value of the premises resulting from the improvements could validly be included in the lessor's income during the year of the forfeiture or other termination of the lease.\textsuperscript{108} The matter will for the future be governed by a new provision of the I.R.C. which excludes from the lessor's gross income any "income, other than rent, derived by a lessor of real property upon the termination of a lease, representing the value of such property attributable to buildings or other improvements by the lessee."\textsuperscript{109} While the amendment excludes such value only for the year of the termination of the lease, the change, coupled with prior decisions, excludes any part of the value of such improvements (or of the value of the property attributable to them) from the lessor's gross income for any other year as well. A question may arise whether lessors may hereafter validly be extended an optional method of treatment with respect to this matter. The probable answer is negative. In any event, it would be a futile thing, especially in the light of R. A. 1942, Section 115(b).

The exclusion discussed in the preceding paragraph does not mean the permanent exclusion from the lessors' gross income of any gain he may ultimately realize from such improvements. His loss or gain basis with respect to such real property would have increased to the extent that he had included any part of such increased value in his income. He is now expressly denied the privilege of adjusting his loss or gain basis with respect to such property for any increased value excludible from his gross income under the amendment discussed in the preceding paragraph.\textsuperscript{110} There are, however, taxpayers who included some of such increase

\textsuperscript{106}Miller v. Gearin, (1919) 258 Fed. 225.
\textsuperscript{108}Helvering v. Bruun, (1940) 309 U. S. 461, 60 S. Ct. 631, 84 L. Ed. 257.
\textsuperscript{109}I.R.C., sec. 22(b) (11), added by R.A. 1942, sec. 115(a).
\textsuperscript{110}I.R.C., sec. 113(c), added by R.A. 1942, sec. 115(b).
in value in their gross income under prior Regulations\textsuperscript{111} or decisions. If this occurred during any taxable year beginning prior to January 1, 1942, they may increase their loss or gain basis with respect to such property by the amount included in their gross income on that account.\textsuperscript{112}

\textbf{Gross Income—Recovery of Bad Debts, Etc.}

The concept of income developed in the construction of federal income tax laws included in gross income for a given year recoveries on account of items deducted in computing the tax for a prior taxable year. The two types of recoveries that produced the greatest amount of litigation were (1) the recovery of a claim charged off and deducted as a bad debt in a prior year, and (2) the recovery of taxes with respect to which a partial or total refund or credit was obtained in a year subsequent to that in which the tax had been taken as a deduction. The disputes were of three types: (a) whether the adjustment should be made by reopening the year of the deduction (a procedure impossible where the statute of limitations had run against the assessment or collection of taxes for such year); (b) whether the adjustment should be made by including the amount recovered in gross income for the year of recovery (a method always required where the statute of limitations had run against the assessment or collection of a tax for the year of deduction); and (c) the amount to be included in gross income for the year of recovery in cases where that method of adjustment was required. Taxpayers contended, with respect to (c), that the amount of any recovery to be included in gross income should be limited by the so-called "tax benefit" rule. The amendments now made to the I.R.C. exclude from gross income that "attributable to the recovery during the taxable year of a bad debt . . . to the extent of the amount of the recovery exclusion with respect to such debt . . ."\textsuperscript{113}

The phrase "recovery exclusion" is defined as "the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions . . . allowed, on account of such bad debt . . . which did not result in a reduction of the taxpayer's tax" under the income tax chapter of the I.R.C. or corresponding provisions of prior revenue laws.

\textsuperscript{111}See Reg. 103, sec. 19, 22(a)-13.
\textsuperscript{112}I.R.C., sec. 113(c), added by R.A. 1942, sec. 115(b).
\textsuperscript{113}I.R.C., sec. 22(b) (12), added by R.A. 1942, sec. 116(a). The amendments do not resolve the conflicts with respect to issues (a) and (b) mentioned in the text.
"reduced by the amount excludible in previous taxable years with respect to such debt."\textsuperscript{114} This enacts the "tax benefit" rule at least in part. The Commissioner's power to determine its amount could conceivably be exercised by treating the deduction for the bad debt as the first deduction made in computing the taxpayer's deficit in statutory net income for the year of the deduction. This would generally mean that the whole of the bad debt deduction had been used to offset an equal amount of gross income. That, in turn, would mean that the whole of it had resulted in a reduction of the taxpayer's tax for that year, and that, therefore, no part of that recovered was excludible from gross income in the year of recovery. Such a regulation would defeat the purpose of the amendment. The deduction whose effect under the "tax benefit" rule is to be determined will have to be taken as the last made in arriving at the deficit in statutory net income for the year in which the deduction was taken. The term "bad debt" is defined as a "debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year." There is no express requirement that the prior deduction must have been taken as and for a "debt ascertained to be worthless and charged off." It may well be held to include debts evidenced by a security although for some years the losses thereon have been treated as capital losses. The amendments do not apply to recoveries with respect to bad debts previously charged or chargeable against a reserve for bad debts where the taxpayer uses the reserve method for treating his bad debt deduction. Such a recovery never enters his income under that method.\textsuperscript{115}

The amendments discussed up to this point in this section are applicable with respect to taxable years beginning after December 31, 1938,\textsuperscript{116} and are also made effective as if they had been a part of the Revenue Act of 1939 or any prior revenue Act.\textsuperscript{117} A great

\textsuperscript{114}The quoted portion is limited to that applicable to bad debts. The same language applies to the other two types of recoveries to which this amendment relates, viz. (a) prior taxes, and (b) delinquency amounts (penalties and interest for failure to file a tax return or pay a tax within the time required by law, or for failure to file a return or pay a tax. The language is not expressly restricted to penalties and interest in the case of income taxes). The principles discussed in the text in their application to bad debts apply also to the two types of recoveries mentioned in this footnote.

\textsuperscript{115}For the special rules in the cases of the Section 102 Tax and the Personal Holding Company Tax, see I.R.C., sec. 22(b)(12)(E), added by R. A. 1942, sec. 116(a).

\textsuperscript{116}R. A. 1942, sec. 116(b).

\textsuperscript{117}R. A. 1942, sec. 116(c).
many taxpayers will be entitled to refunds so far as the right thereto has not been barred by the statute of limitations.

The case in which the recovery is with respect to a federal tax deducted in a prior year receives special treatment where the tax has been held unconstitutional. The taxpayer may exclude this from his gross income to the full amount of the recovery. He must, however, consent in writing to treat it as not having been an allowable deduction for the year in which he deducted it, and to the assessment of any tax deficiency resulting from such treatment even though the statute of limitations has already run against its assessment prior to the filing of such consent. This provision will undoubtedly be held to apply only to recoveries to the extent that they are attributable to the unconstitutionality of the tax. It is expressly made inapplicable to the interest element in the recovery. This provision does not operate to prevent a taxpayer from treating such recoveries by the method first discussed in this section. It is an alternative method enabling him, for a price, to exclude the whole amount of this particular type of recovery from his gross income for the year of the recovery. This provision is applicable with respect to taxable years beginning after December 31, 1940.

Gross Income—Military and Naval Allowance

A new provision excludes from gross income a limited amount received before the termination of the present war as salary or compensation from the United States for active service in the military or naval forces of the United States during that war. It applies only to personnel below the grade of commissioned officer. It is limited to $250 in the case of a single person and to $300 in the case of a married person or the head of a family. The status for purposes of applying these limits is determined as of the end of the taxable year.

Gross Income—Non-Resident Citizens

The I.R.C., Section 116(a), excludes from the gross income of a citizen of the United States, who was a bona fide non-resident thereof for more than 6 months during a taxable year, amounts received from sources without the United States (unless paid by the United States or any agency thereof), if such amount would

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119 R. A. 1942, sec. 157(b).
120 See footnote 10 for definition of "military and naval forces of the United States."
121 I.R.C., sec. 22(b) (13), added by R. A. 1942, sec. 117.
constitute earned income if received from sources within the United States. This has been changed to permit such exclusion only if the taxpayer establishes to the satisfaction of the Commissioner that he was a bona fide resident of a foreign country or countries during the entire taxable year. This part of the amendment applies only to taxable years beginning after December 31, 1942. The amendment has also added a special provision for the taxable year during which such taxpayer changes his residence to the United States. If he has been a bona fide resident of a foreign country or countries for at least 2 years before the date on which he changes his residence to the United States, he may exclude from his gross income amounts received from sources without the United States (unless paid by the United States or any agency thereof) attributable to the period of his foreign residence before the date of his change of residence to the United States. This applies only if the income would have constituted earned income if it had been received from sources within the United States. It applies, however, even though received after such change of residence, and even though received in a taxable year during a part of which he was a resident of the United States. The right to exclude it depends upon whether it is attributable to the period of the taxpayer's foreign residence.

Assume that A, a citizen of the United States, was a bona fide resident of Canada from January 1, 1940, until March 31, 1942, at which date he changed his residence to the United States; that he was employed there during that period as sales manager for B Co.; that he changed his residence to the United States on April 1, 1942; that on June 30, 1942, he recovered from B Co. a bonus for services rendered during the calendar year 1941; and that he reports on the cash basis. The amount of the bonus would be excludible from his 1942 gross income (assuming A reports on a calendar year basis), or for his taxable year in which June 30, 1942, falls (if he reports on a basis other than the calendar year). This part of the amendment of I.R.C., Section 116(a), applies to taxable years beginning in 1942 as well as to those beginning after December 31, 1942.

122 For cases construing this provision, see Muhleman v. Hoey, (1942) 124 Fed. (2d) 414; Comm'r of Int. Revenue v. Fiske's Estate, (1942) 128 Fed. (2d) 487.
123 I. R. C., sec. 116(a) (1), as amended by R. A. 1942, sec. 148(a).
124 R. A. 1942, sec. 148(b).
125 I.R.C., sec. 116(a) (2), added by R. A. 1942, sec. 148(a).
126 R. A. 1942, sec. 148(b).
Deductions—Expenses

All federal income tax acts have permitted the deduction of ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.\(^{127}\) There have been numerous cases in which the deductibility of an expense item turned on whether the activity in connection with which it had been incurred constituted "carrying on a trade or business." The courts tended to give this phrase a rather narrow construction. Thus the owner of extensive investments in securities in connection with whose management and conservation he incurred expenses was held not entitled to deduct those expenses since those activities did not constitute carrying on a trade or business.\(^{128}\) The effect of this, and other similar, decisions has now been eliminated, but only in the case of individual taxpayers.\(^{129}\) These may now deduct "all ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income." The scope of the change will depend upon who is deemed an "individual." The estate of a decedent will probably be held such.\(^{130}\) If so, it will be permitted to take such deductions, if they are of the type deductible under Section 812(b) of the I.R.C. (deduction for expenses, etc., in computing the decedent's net estate), only if the estate files a statement that they have not been claimed or allowed as deductions in computing the net estate, and a waiver of the right to have them allowed at any time in computing the net estate.\(^{131}\) It will probably also be held to include a trust established by an individual, even though the trustee be a corporation.\(^{132}\) It is only by such a construction that the evil aimed at can be wholly remedied. The deduction for depreciation, heretofore limited to property used in trade or business, is also broadened to include "property held for the production of income."\(^{133}\) If any such deductions are allocable against interest wholly exempt from federal income taxes, they may not be deducted even though no such interest was received

\(^{127}\)I. R. C., sec. 23(a).
\(^{128}\)Higgins v. Com'r of Internal Revenue, (1941) 312 U. S. 212, 61 S. Ct. 475, 85 L. Ed. 783.
\(^{129}\)I. R. C., sec. 23(a)-(2), added by R. A. 1942, sec. 121(a).
\(^{130}\)For prior law, see U. S. v. Pyne, (1941) 313 U. S. 127, 61 S. Ct. 893, 85 L. Ed. 1231.
\(^{131}\)I. R. C., sec. 162(e), added by R. A. 1942, sec. 161.
\(^{132}\)For prior law, see City Bk. Farmers Trust Co. v. Helvering, (1941) 313 U. S. 121, 61 S. Ct. 896, 85 L. Ed. 1227.
\(^{133}\)I.R.C., sec. 23(1), as amended by R. A. 1942, sec. 121(c).
or accrued during the taxable year.\textsuperscript{134} The foregoing amendments are applicable to taxable years beginning after December 31, 1938,\textsuperscript{135} and are made part of the Revenue Act of 1938 and all prior revenue Acts.\textsuperscript{136} This affords some taxpayers an opportunity to obtain tax refunds or credits for prior years that are still open.

\textit{Deductions—Taxes}

R. A. 1942 has made several important changes in the law governing the deduction of taxes paid or accrued. In the past the right to deduct taxes has been limited to the person upon whom they are imposed or, in the case of property taxes payable only out of the property, to the owner thereof. The mere fact that a vendor added the tax to his price did not permit the vendee to deduct the tax if it was one imposed upon the vendor. Exceptions have now been made to this principle.\textsuperscript{137} The tax must be one imposed by a state, territory, the District of Columbia, or a possession of the United States, or any political subdivision thereof. It must be one imposed upon persons (a) engaged in selling tangible personal property at retail, or (b) engaged in furnishing services at retail. In case (a) it must be one measured by the gross sale price of the article or the gross receipts from the sale, or be a stated sum per unit of the property sold (e.g., 2 cents per pound of sugar). In case (b), \textit{supra}, the tax must be measured by the gross receipts for furnishing the service. A condition to the purchaser’s right to take the deduction is that the amount of the tax be separately stated. He may deduct it to the extent that he pays the amount so stated in the same manner as if it had been a tax imposed upon and paid by him. It is apparently not essential that the purchaser pay the whole amount separately stated by the vendor as such tax, and it is not clear whether the vendor must separately state the whole of such tax. A purchaser buying such articles or services in connection with his trade or business may not take this deduction. The whole price paid by him, including the tax, is deductible by him as a business expense. This prohibition does not apply where the purchaser acquires the article or services in connection with an economic activity the expenses connected with which are deductible under the amendment discussed in the preceding section.

An equally important departure from the principle that only

\begin{footnotes}
\item[134] R.C., sec. 24(a) (5), as amended by R. A. 1942, sec. 121(b).
\item[135] R. A. 1942, sec. 121(d).
\item[136] R. A. 1942, sec. 121(e).
\item[137] R.C., sec. 22(c) (3), added by R. A. 1942, sec. 122.
\end{footnotes}
he may deduct a tax upon whom it is imposed was enacted as a measure of justice to tenant-stockholders of co-operative apartment corporations. Such corporation must meet certain definitely prescribed qualifications. It may have but one class of outstanding stock. All its stockholders must be entitled, solely by reason of their ownership of its stock, to occupy for dwelling purposes apartments in a building owned or leased by it. They must not be entitled, either conditionally or unconditionally, to receive any capital distribution except upon a complete or partial liquidation of the corporation. Finally 80 per cent or more of the corporate gross income for its taxable year in which the taxes (and interest) are paid or incurred must be derived from tenant-stockholders. The amendment also contains a definition of the term "tenant-stockholder" so formulated as to restrict the right to this deduction to bona fide tenants. It is defined to mean an individual who is a stockholder in such corporation, and whose stock is fully paid up in an amount not less than that which bears a reasonable relationship to that part of the value of the corporation's equity in the building and the land on which it is situated attributable to the apartment which he is entitled to occupy. If, for example, such corporation's equity in its building and land is $100,000, and a fair amount thereof attributable to the apartment that A is entitled to occupy is $5,000, then he would clearly meet this condition if his stock were fully paid up in an amount approximating $5,000. It may be that the requirements for meeting this condition will be stated in terms of a comparison of the ratio that the value of his apartment bears to the corporation's equity and the ratio that the amount of his paid-up shares bear to the total of such paid-up shares outstanding. The Commissioner is given a wide discretion with respect to this matter. The only tax entering into the computation of this deduction by a tenant-stockholder is the real estate tax paid or accrued by the corporation for the tenant-stockholder's taxable year on its building and the land on which it is situated. He may deduct such part thereof as the stock owned by him is of the corporation's total outstanding stock, including that held by the corporation. The right to the deduction exists only where such amount is not otherwise deductible by him.\footnote{I.R.C., sec. 23(z), added by R. A. 1942, sec. 128.\footnote{The principles herein discussed with respect to taxes of co-operative apartment corporations also apply to "interest paid or incurred by the corporation on its indebtedness contracted in the acquisition, construction, alteration, rehabilitation, or maintenance of such apartment building, or in}}
Three other changes made in the provisions of the I.R.C. relating to the deduction for taxes require brief mention. The excess profits tax is no longer deductible in computing corporate net income for normal and surtax purposes.140 The repeal of the former provision allowing its deduction reflects the fact that the latter taxes are now based on amounts of corporate net income reduced by the income used in computing the excess profits tax.141 Another change relates to the deduction of income and profits taxes paid to any foreign country or to a possession of the United States. These were formerly deductible unless the taxpayer signified in his return that he elected to use them to any extent as a credit against his tax. They are now non-deductible if he chooses to credit them to any extent against his tax.142 The change is purely formal. Lastly, formerly taxpayers were given an option to deduct or capitalize taxes and other carrying charges on unimproved and unproductive real property, but there was no express statutory provision excluding amounts thus capitalized from deductions. This omission has now been cured.143 That change merely gives statutory expression to what was already the law. However, the amendment uses the term "property" instead of "unimproved and unproductive real property," and this change has undoubtedly modified the law somewhat. The provisions relating to the loss or gain basis are also amended to reflect this change.144

Deductions—Bad Debts

Under prior laws a bad debt was deductible in the taxable year in which it was ascertained to be worthless and charged off. Partial write-offs were allowable if the Commissioner was satisfied that a debt was recoverable only in part. He might also permit taxpayers to use the reserve method under which the amount of deduction for any taxable year was limited to a reasonable addition to the bad debt reserve for that year.145 No change has been made with respect to the employment of the reserve method. Amendments have been made with respect to the other two. The reason

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140 I.R.C., sec. 23(z), added by R. A. 1942, sec. 128.
141 I.R.C., sec. 23(c) (1) (B), as amended by R. A. 1942, sec. 105(c), and I.R.C., sec. 23(c) (2), repealed thereby.
142 I.R.C., sec. 13(a) (2), as amended by R. A. 1942, sec. 105(a) ; I.R.C., sec. 15, as amended by R. A. 1942, sec. 105(b).
143 I.R.C., sec. 23(c) (1) (C), as amended by R. A. 1942, sec. 158(b).
144 I.R.C., sec. 24(7), added by R. A. 1942, sec. 130(a).
145 I.R.C., sec. 113(b) (1) (A), as amended by R. A. 1942, sec. 130(b).
146 See I.R.C., sec. 23(k).
for these changes is to be found in the risks to which taxpayers were exposed in taking this deduction as a result of judicial decisions and administrative practices. The ascertainment of worthlessness and the charge-off had to occur in the same taxable year. The cases were in conflict as to whether the provision imposed a subjective or objective test of worthlessness. As a result taxpayers frequently were wholly debarred from taking a deduction for particular debts that in fact had become bad during some taxable year. The recent amendment no longer requires either that the debt be ascertained to be worthless or be charged off. A bad debt is now deductible if it becomes worthless during the taxable year, or, in the case of a debt not bad in its entirety, the Commissioner may allow a deduction in an amount not in excess of the part which becomes worthless during the taxable year. The exception from this principle of debts evidenced by a security is retained without change. “Security” is defined as before, but the loss with respect to such debts is a capital loss in the taxable year when they become worthless instead of in that in which they are ascertained to become worthless and are charged off.

The former law made no distinction between business debts and non-business debts. This has been changed with respect to all taxpayers other than corporations. A taxpayer, other than a corporation, may no longer deduct a non-business bad debt as a bad debt. If such a debt becomes worthless during a taxable year, such taxpayer must treat it as a short-term capital loss. A “non-business debt” is defined as a debt other than one evidenced by a security (as defined in I.R.C., Sec. 23(k)(3)) and other than one the loss from the worthlessness of which is incurred in a taxpayer’s trade or business. Thus a debt loss by a taxpayer incurred in connection with his activities in managing his own investments would be a loss with respect to a non-business debt unless it were one evidenced by a security. If the latter were the case, its loss would be governed by the general provisions of Section 23(k) of the I.R.C. applicable to debts evidenced by a security.


147I.R.C., sec. 23(k), as amended by R. A. 1942, sec. 124(a).

148For a special provision relating to bad debt deductions of insurance companies, other than life or mutual, see I. R. Co., sec. 204(c)(6), as amended by R. A. 1942, sec. 124(b). For a special provision relating to the treatment of losses incurred in connection with debts evidenced by securities issued by any corporation affiliated with the taxpayer, see I.R.C., sec. 23(k)(5), added by R. A. 1942, sec. 124(a); this is effective only with respect to taxable years beginning after December 31, 1941.

This amendment relating to non-business debts is effective only with respect to taxable years beginning after December 31, 1942, while the other amendments discussed above are effective with respect to all taxable years beginning after December 31, 1938. A special seven year period is provided for filing claims for credit or refund based on the treatment of bad debt deductions or capital losses covered by the above discussion. No interest is, however, allowed on such claims.

**Deductions—Depletion**

The only changes made in the provisions of the I.R.C. relating to depletion are as follows: (1) the addition of several types of wasting assets with respect to which depletion may not be computed on the basis of discovery value; (2) the inclusion of those types of wasting assets among those with respect to which depletion may be taken on the percentage of gross basis; and (3) the elimination of the provisions requiring taxpayers to make an election as a condition to employing the method referred to in (2). The net effect of (3) is to permit taxpayers entitled to use method (2) to deduct depletion on the basis of the percentage of gross method or on the basis of cost, whichever is the greater, and to do so for each taxable year beginning after December 31, 1941.

**Deductions—Amortizable Bond Premiums**

A purchaser who buys a bond at a premium will receive only its par value if he holds it till maturity, or, if he holds it until called or redeemed, its call or redemption value. He will, in the former situation, and may, in the latter, receive less than he paid for it. Under prior tax laws, as construed by Regulations and decisions, he would be entitled to treat the excess of what he paid for the bond over what he received on its maturity, or when called or redeemed, as a loss incurred in the year it matured, or was called or redeemed. A new provision has been added to the I.R.C. that makes important changes in the treatment of bond premiums. The new method is intended to apply to all bonds.

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150 R. A. 1942, sec. 124(d).
151 I.R.C., sec. 322(b) (2), as amended by R. A. 1942, sec. 169(a). This applies also to capital losses under I.R.C., sec. 23(g) (2).
152 I.R.C., sec. 3771(d), added by R.A. 1942, sec. 124(c).
153 I.R.C., sec. 114(b) (2), as amended by R. A. 1942, sec. 145(b).
154 I.R.C., sec. 114(b) (4), as amended by R. A. 1942, sec. 145(a).
155 I.R.C., sec. 23(v), added by R. A. 1942, sec. 126(a); and I.R.C., sec. 125, added by R. A. 1942, sec. 126(b).
The term "bond" in effect includes any debt, evidenced by a security, if the obligor is a corporation, a government, or a political subdivision of the latter.\textsuperscript{156} It does not include any such obligation if it constitutes stock in trade for the taxpayer, if held by him primarily for sale to customers in the ordinary course of his trade or business, or if of a kind properly includible in his inventory if it were owned by him at the close of his taxable year. The latter provisions probably apply only to dealers in securities. The application of the new method demands some basis for computing (a) the total bond premium, and (b) the amortizable bond premium attributable to any given taxable year. The total bond premium equals the excess of the loss basis of the bond in the hands of the taxpayer over the amount payable on its maturity or earlier call date, minus an amount that reflects the amount that would have been amortizable prior to the date on which this new section takes effect (i.e., prior to the first date of the taxpayer's taxable year beginning after December 31, 1941).\textsuperscript{157} For example, if A (assumed to report on a calendar year basis) had purchased a $1,000 bond on January 1, 1937, for $1,100, having 20 more years to run after the date of purchase, then the total bond premium that he may amortize for taxable years beginning after December 31, 1941, would be $(1,100 - 1,000) - (\frac{20}{20} \text{ths of } $100) = $75. The amortizable bond premium for a given taxable year is the amount of that $75 attributable to that year.\textsuperscript{158} If A be assumed to amortize the premium equally over the years between his acquisition of the bond and its maturity (the assumption made in computing the $75), then his annual amortizable bond premium will equal $5. The amendment provides that both the total bond premium and the annual amortizable amount thereof shall be computed in accordance with the method regularly employed by the bondholder if that is reasonable, or in accordance with regulations prescribed by the Commissioner.\textsuperscript{159}

The bonds to which the new method applies are divided into three classes as follows:

1. Those the interest on which is wholly excludible from gross income (e.g., those issued by a state).
2. Those the interest on which is wholly includible in gross income.
3. Those the interest on which is includible in gross income but

\textsuperscript{156}I.R.C., sec. 125(d), added by R. A. 1942, sec. 126(b).
\textsuperscript{157}I.R.C., sec. 125(b) (1), added by R. A. 1942, sec. 126(b).
\textsuperscript{158}I.R.C., sec. 125(b) (2), added by R. A. 1942, sec. 126(b).
\textsuperscript{159}I.R.C., sec. 125(b) (3), added by R. A. 1942, sec. 126(b).
which constitutes a credit against net income in computing an individual's normal tax net income, or a corporation's adjusted income (e.g., interest on a United States bond exempt from normal tax). The treatment accorded bond premium depends on to which of said classes the bond belongs.

The treatment in the case of a bond whose interest is wholly excludible from gross income is as follows. The amortizable bond premium is not deductible. It is, however, treated as an adjustment of the bond's gain or loss basis. The adjustment operates by way of a reduction of that basis. An example may make this clearer. Assume that A buys a 20 year bond issued by State B, bearing 4 per cent interest; that he bought it on its issue on January 1, 1937; that he paid $1,100 for a $1,000 bond; and that he reports on a calendar year basis. His total bond premium (computed as above outlined) is $75. The amortizable bond premium, which he is, however, not allowed to deduct, is $5 for the taxable year 1942 and each taxable year thereafter during the whole of which he owns the bond (a fraction thereof if he holds it for part only of such taxable year). If he holds it until maturity, the disallowed deduction will total $75. His unadjusted loss basis with respect to the bond is $1,100. This must be reduced by $75, the amount of unallowed bond premium amortization. His loss, therefore, becomes $1,025—$1,000, or $25. The effect upon his position for the whole period of his ownership of the bond is as follows. During the 20 years of his ownership he has collected $800 of wholly exempt interest. He paid the $100 premium because the nominal interest rate on the bond was greater than the rate of return demanded by him. Amortization is a method for adjusting the amount received annually to the effective rate of return demanded by A. The statutory method in this case quite rightly denies A the privilege of deducting the $5 for each taxable year since no part of the amount received by him as interest on the bond is income for tax purposes. However, the reduction of his gain or loss basis by the amount of the non-allowable deduction decreases the amount of his loss, or increases the amount of his gain, in the same amount as was disallowed, in the year that the bond matured (or was sold by A). If the taxable period were the whole period of A's ownership of the bond, his net income would be greater by the amount of the non-deductible

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160 I.R.C., sec. 125(a) (2), added by R. A. 1942, sec. 126(b).
161 I.R.C., sec. 113(b) (1) (H), added by R. A. 1942, sec. 126(c).
amortizable bond premium. This would be exactly the result had
the law required the wholly exempt interest for that 20 year period
to be computed on the basis of the effective rate earned by A on
his investment in that bond rather than on the basis of the nominal interest rate borne by the bond. The constitutionality of
this provision might once have been assailed as an indirect method
taxing the exempt interest. It is, however, a reasonable method
for adjusting the amount of the exempted interest to the amount
of the true interest which such a bond holder receives on his in-
vestment in the bonds. It does reduce the value of the exemption.

The treatment of bond premium in the case of a bond the
interest on which is wholly includible in gross income differs from
the case just discussed. The amount of the amortizable bond pre-
mium for the taxable year is deductible. The aggregate of the
amounts so deducted during the taxable year beginning after De-
cember 31, 1941, and subsequent taxable years, is deducted from
the bond's gain or loss basis. If the bond in the example given in
the preceding paragraph had been that of a private corporation
but all other facts were assumed to be the same as therein, then
the amortizable bond premium for A's taxable year 1942 and sub-
sequent years would be $5. The annual nominal interest that A
would receive would be $40. The deduction of the $5 amortizable
bond premium would mean that the net accretion to A's income
for each such taxable year was $35. It is in effect treating the
$5 as a recovery of that much of A's investment in that bond.
Consequently his basis for computing loss (or, in case of a sale be-
fore maturity, his gain or loss basis) should be reduced by the
aggregate amount of such capital recoveries. This is exactly what
the new method requires.102 The same method of treatment ap-
plies also to those bonds heretofore described as belonging to class
(3), supra. There is, however, one further feature applicable
only to that class of bonds. The interest on them is a credit against
net income in arriving at an individual's normal tax net income,
and in arriving at a corporate taxpayer's adjusted net income. The
theory on which amortizable bond premium is deductible is that
its deduction corrects an overstatement of the bondholder's in-
terest income by the amount of such deduction. The credits
against net income mentioned above should be limited to the
amount of interest effectively included in the taxpayer's gross in-

102I.R.C., sec. 125(a)(1), added by R. A. 1942, sec. 126(b), and
I.R.C., sec. 113(b)(1)(H), added by R. A. 1942, sec. 126(c).
come, not to the nominal amount of such interest. Hence these
credits should also be reduced by the amount of the amortizable
bond premium for the taxable year in question. This is what the
new law requires. 163

There remains one further consideration. The method de-
scribed above for treating the premium on a bond whose interest
is wholly excludible from gross income is compulsory for every
class of taxpayer. A taxpayer other than a corporation need
employ it with respect to all other types of bond only if he elects
to do so. If he elects to do so, he must employ it for all such
bonds held by him at the beginning of the first taxable year to
which the election applies and to all such bonds subsequently ac-
quired by him. An election is binding for all subsequent years
unless the Commissioner permits a change. The partnership alone
may make this election for a member of a partnership with respect
to such bonds owned by the partnership. A corporation is given
an election only with respect to bonds other than those the in-
terest on which can be used as a credit against net income in
computing its adjusted net income. The manner and effect of an
election by it are the same as those applying to non-corporate
taxpayers. 164 There appears to be no requirement in the new pro-
vision that the right to take a deduction for amortizable bond
premium exists only in those taxable years when the taxpayer
receives interest on such bond.

Deduction—Amortization of Emergency Facilities

The provision for the amortization of emergency facilities was
introduced into the I.R.C. by the Second Revenue Act of 1940.
The election to take this deduction was originally restricted to
corporations. It is now made available to every person. 165 The
election may now be made with respect to emergency facilities
completed or acquired after December 31, 1939, instead of with
respect to those completed or acquired after June 10, 1940 (as

rules for the treatment of this credit adjustment are provided for the
following classes of taxpayers: (1) Estates, trusts, and the beneficiaries
thereof; I.R.C., sec. 163(c), added by R. A. 1942, sec. 126(d); (2) Par-
ticipants in common trust funds; I.R.C., sec. 169 (c) (2), as amended
by R. A. 1942, sec. 126(e); (3) Partners; I.R.C., sec. 184, as amended
by R. A. 1942, sec. 126(f); (4) United States shareholders in foreign per-
sonal holding companies; I.R.C., sec. 337(c), as amended by R. A. 1942,
sec. 126(g); (5) Shareholders in personal service corporation; I.R.C., sec.
394(c), as amended by R. A. 1942, sec. 126(h).
164 I.R.C., sec. 125(c), added by R. A. 1942, sec. 126(b).
165 I.R.C., sec. 124(a), as amended by R. A. 1942, sec. 155(a).
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originally provided).6 A life tenant is entitled to take this deduction as if he were the absolute owner of the facility.6 It is also made available to estates and trusts, and to partnerships. The amendments made by R.A. 1942 are made effective as of October 8, 1940, the date of enactment of the Second Revenue Act of 1940. Refunds and credits resulting from giving the amendments this retroactive effect shall be made without interest.

**Deductions—War Losses**

Space and time limitations prevent the discussion of this new deduction allowed taxpayers. It deserves, however, to be called to the attention of the bar. This amendment of the I.R.C. is applicable to taxable years beginning after December 31, 1940.

**Deductions—Pension Trusts**

The provisions of Section 23(p) of the I.R.C., relating to the deduction by an employer of contributions to a pension trust maintained for the benefit of his employees, have been completely overhauled. The amendments reflect an equally important series of amendments to the I.R.C. section relating to pension trusts. These changes are also responsible for an addition of a new sub-paragraph to Section 22(b)(2) of the I.R.C. which deals explicity with the treatment by an employee of amounts received by him under certain annuities purchased by his employer. The changes referred to in this paragraph are too extensive to permit of more than this mere reference to them.

**Net Operating Loss Deduction**

The Revenue Act of 1939 reintroduced into the federal income tax system the provision according taxpayers the right to carry over into subsequent years the net operating losses of a given taxable year. The new law amends this section to provide for carrying back the net operating loss of a given taxable year to the

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163I.R.C., sec. 124(e), as amended by R. A. 1942, sec. 155(d).
164I.R.C., sec. 124(f), added by R. A. 1942, sec. 155(f).
165I.R.C., sec. 172, added by R. A. 1942, sec. 155(g).
166I.R.C., sec. 190, added by R. A. 1942, sec. 155(h).
167R. A. 1942, sec. 155(i).
169I.R.C., sec. 23(p), as amendd by R. A. 1942, sec. 162(b).
170I.R.C., sec. 165, as amended by R. A. 1942, sec. 162(a).
171I.R.C., sec. 22(b) (2) (B), added by R. A. 1942, sec. 162(c).
172As to the taxable years to which these amendments are applicable, see R. A. 1942, sec. 162(d).
173I. R. C., sec. 122, added by Revenue Act of 1939, sec. 211(b).
two preceding taxable years and permitting amounts thereof not offset by the net income of those years to be carried forward to the two succeeding taxable years. A net operating loss may not be carried back to any taxable year beginning prior to January 1, 1941. If, therefore, a taxpayer on a calendar year basis has a net operating loss for 1942, he may carry it back only into his taxable year 1941.

The necessary effect of the new provision is to affect the taxable net income of the years to which the net operating loss deduction of a given taxable year may be carried back, just as the effect of the prior law was to affect the taxable net income of the subsequent years to which the net operating loss of a given year could be carried forward. However, the first thing to be computed is the net operating loss for a given taxable year which is to be carried back to prior years, or forward to subsequent taxable years. There has been no substantial change in its definition. It means the excess of the deductions allowed by the income tax chapter of the I.R.C. over the gross income, with certain adjustments. Four of the five existing adjustments have not been changed. That relating to capital gains and capital losses has been amended to reflect changes in the treatment of such gains and losses. These are still required to be taken into account without regard to the percentage limitations prescribed in Section 117(b) of the I.R.C., but a change has been made in defining the extent of the deductibility of such losses. The amount deductible on account of such losses may not exceed the amount includible on account of such gains.

\[ \text{I.R.C., sec. 122(b), as amended by R. A. 1942, sec. 153(a).} \]
\[ \text{I.R.C., sec. 122(e), as amended by R. A. 1942, sec. 153(c).} \]
\[ \text{I.R.C., sec. 122(a), as amended by R. A. 1942, sec. 105(e).} \]
\[ \text{I.R.C., sec. 122(d) (4), as amended by R. A. 1942, sec. 150(e).} \]
\[ \text{I.R.C., sec. 122(d) (6), added by R. A. 1942, sec. 105(e) (3) (C).} \]
\[ \text{R. A. 1942, sec. 105(c) (2).} \]
The most important changes in Section 122 of the I.R.C. have been made in subsection (b) thereof. The first of them concerns the "net operating loss carry back." It prescribes the rules in accordance with which the net operating loss of a given taxable year is to be carried back to the preceding two taxable years. The statute mentions a "first preceding taxable year" and a "second preceding taxable year," but does not expressly define to which of the years in the two-year period each of these terms refers. However, it does state that the carry-back for the first preceding taxable year shall be the excess of the net operating loss over the net income for the second preceding taxable year. If the aim of the statute is to afford the maximum possible relief, then the first preceding taxable year will mean the taxable year immediately preceding the taxable year in which the net operating loss occurred. An example will clarify this matter. Assume that A (who reports on a calendar year basis) has a $5,000 net operating loss for 1943, a net income of $4,000 for 1942, and a net income of $2,000 for 1941. If the first preceding taxable year is 1942, then the carry back to it is $5,000—$2,000, or $3,000. The net operating loss of 1943 is then carried back as follows: to 1941, $2,000, and to 1942, $3,000, leaving $1,000 of 1942 net income available for offsetting any net operating loss for 1944. If, however, 1941 be taken as the first preceding taxable year, then the carry back to it is $5,000—$4,000 or $1,000. The net operating loss of 1943 is then carried back as follows: to 1941, $1,000, and to 1942, $4,000, thus leaving $1,000 of 1941 net income never useable as an offset to the net operating loss for any taxable year. It may, therefore, be safely asserted that the first preceding taxable year is that immediately preceding that whose net operating loss is being carried back.

The change in treating net operating losses has required an amendment of the provisions relating to the "net operating loss carry-over." The carry-over period remains as before, being the two taxable years succeeding that in which the net operating loss occurred. The carry-over to the second succeeding taxable year is defined as the excess of such net operating loss over the net

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186 This net income must be computed by making all of the adjustments required in computing a net operating loss except that relating to non-business deductions, but the net operating loss deduction for such second preceding taxable year must be computed without regard to the net operating loss that is being carried back to it (i.e., the net operating loss of the taxable year 1943 in the illustration given in the text).
The net income of the first succeeding taxable year.\(^{186}\) The net operating loss must, however, also be reduced by the sum of the net incomes for each of the two taxable years preceding that whose net operating loss is being carried over.\(^{187}\) These will be the two taxable years to which part of that same net operating loss will already have been carried back, since the carry-over provision operates only in cases in which the loss has not been wholly offset against the two preceding taxable years. The effect of this is to prevent any part of such loss from being twice offset against the net income of other years.\(^{188}\) An example may aid in clarifying this whole matter. Assume that A (a taxpayer reporting on the calendar year basis) had a $2,000 net income in 1941, $3,000 net income in 1942, a $7,000 net operating loss in 1943, $1,000 net income in 1944, and $3,000 net income in 1945. His carry-back and carry-over amounts for the years involved will be as follows: (1) a $2,000 carry-back to 1941; (2) a $3,000 carry-back to 1942;\(^{189}\) (3) this leaves $2,000 to be carried forward into 1944 and 1945; (4) the amount that may be carried over to 1945 is (a) $7,000 (total net operating loss for 1943)—$1,000 (net income for 1944, the first taxable year succeeding 1943)—$5,000 (the sum of the net incomes of 1941 and 1942, which have already been used to offset an equal amount of the $7,000 net loss); (5) the result of the computations in (4) gives $1,000, the amount that may be carried over to 1945; (6) which leaves $1,000 (equal to the 1944 net income) as the carry-over to 1944. The result is that the whole of the $7,000 net operating loss for 1943 has either been carried back or carried over to other years.

The result of the operations considered in the two preceding paragraphs is to determine the net operating loss carry-back for

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\(^{186}\) The net income for such first succeeding taxable year is defined as in footnote 185, except that in computing its net operating loss deduction any net operating loss carry-back to it is disregarded. This modification is to take care of the case in which there is a net operating loss for a taxable year subsequent to it which loss can be to any extent carried back to it.

\(^{187}\) The net income for each of the preceding two taxable years is, for this purpose, computed in the manner described in footnote 185, except that the net operating loss deduction for each of them is computed without regard to the net operating loss being carried over and the net operating loss for the taxable year succeeding that in which was incurred the net operating loss which is being carried over. The net operating loss for such succeeding taxable year might be carried back to the first taxable year preceding that whose loss is being carried over under the net operating loss carry-back provisions.

\(^{188}\) This works an injustice with respect to a net operating loss for 1942 unless it is wholly offset against 1941 net income.

\(^{189}\) As to (1) and (2) see preceding paragraph.
each of the two years preceding that in which a net operating loss was incurred, and the net operating carry-over for each of the two taxable years succeeding the year of the loss. A taxable year may be one to which a part of the net operating loss of a subsequent year has been carried back, and at the same time one to which a part of the net operating loss of a prior taxable year may have been carried over. The aggregate amount of the net operating loss carry-backs and carry-overs are the starting point for computing the net operating loss deduction for that year. This is reduced, in the case of a non-corporate taxpayer, by the excess of the net income, computed with the adjustments provided for in subsection 122(d)(1), (2), (3) and 4, over the net income, computed without the net operating loss deduction which is being determined. The reduction, in the case of a corporation, is the excess of its net income, similarly adjusted, over its normal-tax net income, computed without the net operating loss deduction and without the credit for income subject to excess profits tax. This gives the amount of the net operating loss deduction for any taxable year.\(^1\) The following example (taking the case of a non-corporate taxpayer) will illustrate these principles. Assume that during the calendar year 1944 A (who reports on a calendar year basis) has a net income (before taking the net operating loss deduction) equal to $100,000; that the net loss carry-back to it with respect to a net operating loss for 1945 is $10,000, and for 1946 $5,000; and that the net operating loss carry-over to it with respect to a net operating loss for 1942 is $2,000, and for 1943 is $3,000. The aggregate of these net operating loss carry-backs and carry-overs for 1944 is thus $20,000. The next thing necessary is to determine its net income as affected by the required adjustments. For the sake of simplicity we will assume that the only adjustment that has to be made is for $4,000 of wholly exempt interest received by A during 1944. He is required to add this to his net income, thus making his income, as adjusted, $104,000. This is $4,000 in excess of his 1944 net income, computed without the net operating loss deduction. The $20,000 mentioned above has to be reduced by this $4,000. The net operating loss deduction for 1944 is thus $16,000. The effect of the reduction in this case is to require A to offset a part of his net loss against his exempt income, which, while not taxable, is a part of his total 1944 income.

\(^1\)I.R.C., sec. 122(c), as amended by R. A. 1942, secs. 105(e) and 153(b).

One effect of these amendments is to leave each taxable year subject to a recomputation of its tax on the basis of events occurring during the two succeeding taxable years. Claims for refund or credit for overpayments attributable to carry-backs to such year of net operating losses of subsequent years do not bear interest. All the amendments discussed in this section apply only to taxable years beginning after December 31, 1940.

_Deductions—Charitable, Etc., Contributions_

The changes in the provisions governing this matter have been slight. The prior 15 per cent limit on this deduction, in the case of individuals, was based on net income computed without this deduction. It is now based on net income computed without this deduction and the deduction for medical expenses. The charitable deduction provision applicable to corporations has been amended in two respects. It now includes gifts to the United States, any State, Territory, or any political subdivision thereof, the District of Columbia, or any possession of the United States, for exclusively public purposes. The second change provides that the requirement that gifts to trusts, chests, funds or foundations be for use within the United States or any of its possessions, shall apply only if the payment of the gift is made within a taxable year beginning after the date of the cessation of hostilities in the present war, as proclaimed by the President.

_Deductions—Medical Expenses_

The new law introduces a deduction for medical expenses into the federal income tax system for the first time. An expense of this character is deductible only if paid during the taxable year when taken, regardless of the taxpayer's method of reporting. It includes all expenses paid for the medical care of the taxpayer, his spouse, or a dependent with respect to whom he is entitled to the dependent's credit against net income. He may not include any amount for which he is compensated by insurance or otherwise. The term "medical care" is liberally defined. It includes amounts paid for diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body, and also amounts paid for accident or health insur-

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191I.R.C., sec. 3771(c), added by R. A. 1942, sec. 153(d).
192R. A. 1942, sec. 153(e).
193I.R.C., sec. 23(o).
194I.R.C., sec. 23(o), as amended by R. A. 1942, sec. 127(c).
195I.R.C., sec. 23(q), as amended by R. A. 1942, sec. 125.
196I.R.C., sec. 23(x), added by R. A. 1942, sec. 127(a).
The amount of the deduction is, however, limited. An individual filing a separate return may deduct only such part of these expenses as exceed 5 per cent of his net income (computed without this deduction), but in no case may the deduction exceed $2,500 in the case of the head of a family, or $1,250 in the case of all other individuals. If a husband and wife file a joint return, the deduction is only of such amount as exceeds 5 per cent of their aggregate net income (computed without this deduction), but may in no case exceed $2,500 for any taxable year. The amounts deductible hereunder are expressly excluded from non-deductible living expenses.\footnote{I.R.C., sec. 24(a), as amended by R. A. 1942, sec. 127(b).} The allowance of this deduction has also necessitated an amendment of the provision excluding from gross income compensation received for injuries or sickness. There has now to be eliminated therefrom amounts attributable to (but not in excess of) this deduction in any prior taxable year.\footnote{I.R.C., sec. 22(b) (5), as amended by R. A. 1942, sec. 127(d).} Assume that A should recover $500 during the taxable year 1943 under a health insurance policy with respect to an illness during 1942, had paid the expenses thereof in 1942, and had had a $200 medical expense deduction for 1942. Under prior law this $500 would have been wholly excludible from his gross income for 1943. The amount excludible from his gross income for 1943 would now be reduced to $300. Had A recovered the $500 during 1942, the medical expenses for that year would have been computed without including the expenses attributable to the illness with respect to which he received said compensation since the new Section 23(x) expressly permits inclusion of medical expenses only if they are not compensated for by insurance or otherwise.

Non-Deductible Items

The only change involving non-deductible items in addition to those already noted is that relating to amounts paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract.\footnote{I.R.C., sec. 24(a) (6). added by R. A. 1942, sec. 129.} These amounts are included among the items that are expressly non-deductible. The phrase “single premium life insurance or endowment contract” is given a broad meaning to reduce avoidance of this restriction. It includes such contracts if substantially all the premiums thereon are paid within a period of four years from the date on which such contract is purchased. The language of this provision does not require that the contract be on the life of the taxpayer. It
applies if taken out by him on the life of another if the taxpayer is directly or indirectly the beneficiary thereof. The test of includible contracts is the period during which the premiums are paid, not that in which they are payable by the terms of the contract. If A should take out a policy on his life on which the premiums were payable in ten annual installments, and thereafter anticipate the payment thereof and pay them within the four year period mentioned above, the contract would be treated as a single premium contract. Had he borrowed to finance the premium payments, interest on those loans would appear to be non-deductible for even those years during which the facts did not yet bring such contract within the statutory definition of single premium policies. That is, at least, a reasonably possible construction of this provision. The indebtedness must have been incurred or continued to purchase such contract. It may be difficult in some cases to prove the requisite connection between the incurring or carrying of a particular indebtedness and the purchase of a contract of this character. However, this is an issue that also arises in interpreting and applying a similar requirement in the provision relating to the deduction of interest.200

Capital Gains and Losses

The Supreme Court long ago decided that capital gains constituted income within the meaning of the 16th Amendment.201 The taxation of such gains has been an important factor contributing to the complexity of the federal income tax system. Congress has from time to time experimented with their taxation in order to reduce some of the injustice of taxing in one year a gain that might have accrued over a long period of years. Section 117 of the I.R.C. was its latest effort in this direction prior to the recent amendments thereof. The starting point for the computations required by this provision is the definition of the term "capital asset." The new Act makes but one change therein. The prior law excluded depreciable property used in a taxpayer's trade or business. Since land is not depreciable property, it was treated as a capital asset, although the buildings thereon were not such if used in a trade or business. This has now been changed by ex-

200 See I.R.C., sec. 23(b).
cluding from capital assets "real property used in a taxpayer's trade or business."  

Every capital asset is, as under prior law, either a short-term or a long-term capital asset. The definition of those terms has been changed. A short-term capital asset is one held for not more than 6 months (formerly not more than 18 months), while a long-term capital asset now means one held for more than 6 months (formerly more than 18 months). The percentages of the recognized gain or loss required to be taken into account according as the capital asset belongs to the one or the other of these classes have been changed somewhat. That percentage remains 100 for corporate taxpayers, and for short-term capital gains or losses of other taxpayers. There is no longer a sub-classification of the long-term capital gains or losses of non-corporate taxpayers with respect to this matter. The percentage of gain or loss to be accounted for is 50 per cent. The foregoing percentages apply in computing net capital gain, net capital loss, and net income. If, for example, A had sold a capital asset at a gain (or loss) of $1,000, the whole amount would have entered into the computation of not only his net capital gain or loss but also of his net income, had the asset been a short-term capital asset. Had it been a long-term capital asset, the amount would have been $500. Had A been a corporation, the amount would have been $1,000, whether the asset had been a long-term or short-term capital asset.

Since the percentage of the gain or loss to be accounted for depends upon the length of time that the taxpayer is treated as having held the capital asset, the statute has provided certain rules for computing the holding period. It includes not only the period during which he held the particular asset sold, but also that during which he held the asset whose gain or loss basis determines the gain or loss basis of the asset sold. Thus, if he sells shares of stock in one corporation received in exchange for shares of stock in another corporation, a party to a reorganization, in the course of a reorganization, the period for which he is deemed to have held the shares sold includes that for which he held the shares given in exchange for those sold by him. Also, if he had

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203 I.R.C., sec. 117(a), as amended by R. A. 1942, sec. 150(a).

204 I.R.C., sec. 117(h), as amended by R. A. 1942, sec. 150(c).

205 I.R.C., sec. 117(h).
acquired the shares by gift, he would tack on to the period he himself had held them the period for which they were held by the donor, or other person, whose gain or loss basis would constitute his gain or loss basis with respect to those shares. The specific instances in which such tacking is required under the prior law are all retained, and new ones added. The first of these expressly extends it to property acquired as an incident to the involuntary conversion of other property under Section 112(b) of the I.R.C. The second of them relates to stock or securities acquired by the taxpayer from a corporation by the exercise of rights to acquire them. The amendment provides that the holding period shall begin with the date upon which the right to acquire them was exercised. Attention should be directed in connection with this discussion of the holding period to the provisions of I.R.C., Section 23(g) and 23(k). The former of these provides that a loss incurred through securities (defined as corporate shares or rights thereto) becoming worthless shall, if the securities are capital assets, be treated as a capital loss occurring on the last day of the taxable year in which they became worthless. The latter subsection applies the same rule to bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by a corporation, or a government or political subdivision thereof. The last day of such taxable year thus marks the end of the holding period with respect to such securities or bonds, etc., regardless of the actual day within that taxable year on which they became worthless.

The capital gain and loss provisions apply only where the capital gain or loss results from the sale or exchange of a capital asset. There have been many decisions on the question whether the gain or loss did result from a sale or exchange or from a method of disposing of the asset not includible in the category of "sale or exchange." The I.R.C. contained several provisions expressly determining the status of certain methods of disposing of capital assets. The new Act makes no general changes in this matter. It does, however, add a special provision relating to

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206 I.R.C., sec. 117(h)(1), as amended by R. A. 1942, sec. 151(c). This amendment is made applicable to taxable years beginning after December 31, 1938.
207 I.R.C., sec. 117(h)(6), added by R. A. 1942, sec. 152.
209 See I.R.C., secs. 23(g) (shares of stock becoming worthless); 23(k) (bonds, etc., becoming worthless); 117(f) (gains or losses on retirement of bonds, etc.); 117(g) (gains or losses from short sales).
gains or losses from involuntary conversion and from the sale or exchange of certain other property used in trade or business.\textsuperscript{210} It applies to the conversion, sale or exchange of assets that are ordinarily excluded from the class of capital assets. It secures this result by defining "property used in trade or business" to include depreciable property and real estate used in a trade or business if it has been held for more than 6 months (excluding that held primarily for sale to customers in the ordinary course of the taxpayer's trade or business). The method to be followed by a taxpayer proceeding hereunder is as follows: (1) Compute the amount of the recognized gain upon the sale or exchange of "property used in the taxpayer's trade or business;" (2) compute the amount of recognized gain from the compulsory or involuntary conversion of such property; (3) compute the amount of the recognized gain\textsuperscript{211} from the compulsory or involuntary conversion of capital assets; and (4) compute the amount of recognized losses in transactions of the kind described in (1), (2), and (3).\textsuperscript{212} If the sum of items (1) and (2) and (3) is greater than item (4), the gains and losses are treated as gains or losses from the sale or exchange of capital assets. If the sum of items (1), (2), and (3) equals or is less than item (4), the gains and losses are not considered as gains or losses from the sale or exchange of capital assets. In the latter event they become ordinary gains or losses, with the result that 100 per cent of such gains are includible in gross income and the losses are fully deductible therefrom. A special provision has also been added to the I.R.C. for the relief of banks as defined in Section 104 of the I.R.C. This provides that if its losses from the sale or exchange of bonds, etc., during any taxable year exceed the gains from the sale or exchange of bonds, etc., then no such sale or exchange shall be considered a sale or exchange of a capital asset.\textsuperscript{213} Such losses would then be deductible without limit, even though the bonds, etc., would be within the definition of long-term capital assets.

\textsuperscript{210}I.R.C., sec. 117(j), added by R. A. 1942, sec. 151(b).

\textsuperscript{211}As to extent of recognition of gains and losses on involuntary conversions of property, see I.R.C., sec. 112(f), as amended by R. A. 1942, sec. 151(d), (e).

\textsuperscript{212}In computing the gains and losses mentioned in items (1), (2), (3) and (4) in the text, compute them as if the purpose were to determine the extent to which they would enter into the computation of net income, except that the whole 100 per cent (instead of 50 per cent) of the gain or loss is to be taken, and except that limitations upon the deductibility of capital losses are to be ignored.

\textsuperscript{213}I.R.C., sec. 117(i), added by R. A. 1942, sec. 150(d).
We have seen that the I.R.C., as amended, retains the distinction between short-term and long-term capital assets. It is also still necessary to make separate computations of the amount of the short-term capital gain and the short-term capital loss in order to determine the amount of the net short-term capital gain or net short-term capital loss. A change is made only in the definition of "net short-term capital gain." This is now the excess of the short-term capital gains over the short-term capital losses. Separate computations must also still be made of the amount of long-term capital gain and long-term capital loss in order to determine the net long-term capital gain and net long-term capital loss. There have been, however, no changes in the definitions of these terms. Two new concepts have been developed in connection with the new treatment of capital gains and losses. The first of these is that of "net capital gain." In the case of corporations it means the excess of the gains from the sale or exchange of capital assets over the losses therefrom during the same taxable year. In the case of taxpayers other than corporations it means (1) the sum of (a) gains from sale or exchange of capital assets and (b) the taxpayer's net income or $1,000, whichever is the smaller, (2) minus the losses from the sale or exchange of such assets during the same taxable year. The second new concept is that of "net capital loss." This is defined to mean the excess of the losses from the sale or exchange of capital assets over the amount fixed as the limit to the deduction of capital losses. That limit will be discussed later. This concept derives its importance from the fact that the right to the capital loss carry-over depends upon it. The importance of the "net capital gain" concept will be considered later.

The prior law permitted long-term capital losses to be deducted in full in computing net income, requiring long-term capital gains to be included in full in gross income. Short-term

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214I.R.C., sec. 117(a) (6), as amended by R. A. 1942, sec. 150(a). The prior law also required the net short-term capital loss of the prior year to be deducted from the taxable year's short-term capital gains. The amendment reflects the change in the capital loss carry-over provision (I.R.C., sec. 117(d), as amended by R. A. 1942, sec. 150(c)).

215I.R.C., sec. 117(a) (10), added by R. A. 1942, sec. 150(b).

216Such net income is to be computed without regard to gains or losses from sales or exchanges of capital assets.

217I.R.C., sec. 117(a) (11), added by R. A. 1942, sec. 150(b). The capital losses do not include short-term capital losses being carried over to the taxable year from prior taxable years.

218I.R.C., sec. 117(e) (1), as amended by R. A. 1942, sec. 150(c).
capital losses were, however, deductible only to the extent of short-
term capital gains, the excess constituting the basis for the net short-term loss carry-over.\textsuperscript{210} The limits on the deductibility of capital losses now apply to the total of such losses, whether they be short-term or long-term losses.\textsuperscript{220} In the case of corporations, they are allowed only to the extent of the capital gains, both short-term and long-term. In the case of other taxpayers it is the same as for corporations except that it is increased by the amount of the taxpayer's net income\textsuperscript{221} or $1,000, whichever is the lesser. The effect of this is to permit non-corporate taxpayers to offset their capital losses against their ordinary net income to the extent indicated. This limitation is an important factor in the definition of the "net capital loss." The limitation provision, the definition of "net capital loss," and that of "net capital gain" are closely inte-
grated. All contribute to determining the capital gains includible in income, and the amount of the capital loss carry-over.

The following is an illustration of the last statement. Assume that A (who reports on the calendar year basis) had during 1942 a net income of $1,200; capital gains (short-term and long-term) of $1,100,\textsuperscript{222} and capital losses (short-term and long-term) of $1,500. A's net capital gain equals $1,100 (his capital gains), plus $1,000 (taken because his net income\textsuperscript{223} is in excess of $1,000), minus $1,500 (his capital losses), which equals $600. This amount is includible in his gross income. The amount of his capital losses which he can deduct equals $1,100 (his capital gains), plus $1,000 (taken because his net income is greater), which equals $2,100. Hence his entire capital losses are deductible. This is as if $1,000 had been set off against his net income (leaving $200 net income not so offset) and the remaining $500 of the losses had been set off against the $1,100 capital gains (leaving $600 not needed as an amount against which to apply his capital losses). That $600 is precisely the amount of his net capital gain under the statutory definition. A's net capital loss equals $1,500 (his capital losses) minus $1,500 (the amount of his deductible capital losses). Hence he has no net capital loss, and will not come within the capital loss

\textsuperscript{210}See I.R.C., sec. 117(d), (e).
\textsuperscript{220}I.R.C., sec. 117(d), as amended by R.A. 1942, sec. 150(c).
\textsuperscript{221}That net income is to be computed without regard to capital gains or capital losses.
\textsuperscript{222}The capital gain and loss figures represent amounts after applying the percentages that define the extent of their recognition under I.R.C., sec. 117(b), as amended.
\textsuperscript{223}Computed as set forth in footnote 221.
carry-over provision. Had A's capital losses been $2,100, his net capital gain would have been zero; the entire amount of such losses would have exhausted the limits on their deductibility, and he would still have no capital loss and so no carry-over. Had they been $2,200, his net capital gain would have been—$100. the amount of his capital loss deduction would have been $2,100, and he would have had a net capital loss of $100, and thus a capital loss carry-over of $100. These examples suffice to show the inter-relations between, and the functions of, the concepts mentioned in the last part of the preceding paragraph.

One method long used for benefiting taxpayers with capital losses has been to permit those not offset against income (or a particular type of income) to be carried forward as a deduction in a subsequent taxable year or years. The prior law employed this device for net short-term capital losses only.\footnote{224I.R.C., sec. 117(e).} It was unnecessary to use it for net long-term capital losses since that law imposed no limit on their deductibility. Since the amended law imposes the limit on total capital losses (long-term as well as short-term), the carry-over provision is now extended to the net capital loss, regardless of whether it is wholly, in part, or not at all, a short-term capital loss.\footnote{225I.R.C., sec. 117(e), as amended by R. A. 1942, sec. 150(c).} Every net capital loss, regardless of the character of the losses that have contributed to its existence, is a short-term capital loss in any year to which any part thereof may be carried over. The maximum number of subsequent taxable years to which any part of it may be carried over is five. These years must be successive, and the first of them is that immediately following that in which the net capital loss occurred. The amount that can be carried over to any one of such five years equals the total net capital loss minus the sum of the net capital gains during the years intervening between that in which the loss occurred and that to which any part of such loss is to be carried over. The following illustration will help to clarify the meaning of this formula. Assume that A (who reports on a calendar year basis) had a net capital loss during 1942 of $5,000; that his net capital gains were $1,000 for 1943, $2,000 for 1944, $1,500 for 1945, and $1,000 for 1947; and that he had a net capital loss and no net capital gain for 1946. The amount of capital loss carry-over into 1943 equals $5,000. However but $1,000 thereof can be absorbed during that year since the net capital gain for 1943 was only $1,000. The
amount carried over to 1944 equals $5,000 (the net capital loss for 1942) minus $1,000 (the net capital gain for 1943), or $4,000, of which but $2,000 can be carried over to 1944. In the same manner the carry-over to 1945 is $5,000―($1,000+$2,000) or $2,000, of which but $1,500 can be used. There is no amount that can be carried over into 1946 since there is no net capital gain for that year. The amount of the carry-over into 1947 is $5,000―($1,000+$2,000+$1,500) or $500. Thus the whole 1942 net capital loss has been in effect set off against the net capital gains for the succeeding five taxable years. It should be noted that in computing the net capital gain for any taxable year after 1942 the net capital loss being carried forward is disregarded as are the net capital losses arising in any of the intervening years. That is, in computing the net capital gain for 1944 the $2,000 of the 1942 net capital loss allocable to it, and any net capital loss arising during 1943 (had there been such) would be disregarded. A prior method for granting relief to taxpayers having capital gains was to provide alternative methods of taxation in such cases. The prior law provided such methods for non-corporate taxpayers only, and then only if they had either a net long-term capital gain or a net long-term capital loss. This has been greatly changed. The new relief measure applies to both corporate and non-corporate taxpayers. It is available only if for the taxable year the taxpayer’s net long-term capital gain exceeds his net short-term capital loss. The alternative tax is determined as follows. A partial tax is computed on the taxpayer’s net income reduced by the aforementioned excess. This is computed at the rates and in the manner that the tax would have been computed but for this relief provision. The tax payable equals such partial tax plus 25 per cent of said excess in the case of corporations, or plus 50 per cent thereof in the case of all other taxpayers. For a special rule for the treatment of a net short-term capital loss of the last taxable year beginning in 1941, see I.R.C., sec. 117(e) (2), added by R. A. 150(c). It treats such loss as a short-term capital loss for the succeeding taxable year, subject to certain specified limitations. This is to preserve for the taxpayer some benefit to compensate for the loss of his right to treat it as a net short-term capital loss carry-over resulting from the amendment of I.R.C., sec. 117(e). Amendments were made to various other sections of the I.R.C. to reflect these changes in section 117. See I.R.C., sec. 169, as amended by R. A. 1942, sec. 150(f) ; I.R.C., sec. 182, as amended by R. A. 1942, sec. 150(g) (1) ; I.R.C., sec. 183, as amended by R. A. 1942, sec. 150(g) (2) ;
Gain and Loss Basis

There have been few changes of general interest in this part of the law. There has been added one new provision defining a transfer of property on which no loss is recognized to the transferor. It is limited to transfers in connection with railroad reorganizations.\(^2\) This has required an addition to the I.R.C. to provide that the transferee corporation shall take the transferor's basis with respect to the property transferred in this type of tax-free reorganization.\(^3\) A change has also been made in the provision dealing with involuntary conversions of property. Whereas formerly neither gain nor loss was recognized in these cases (except that gain was recognized in an amount not in excess of the money not expended in certain specified ways), now no gain is recognized but a loss is, and the principle defining the extent to which gain is recognized is made applicable regardless of whether the money received (and not spent in specified ways) is received in one or more taxable years or whether it constitutes gain.\(^4\)

The remaining amendments involve changes in the gain or loss basis, or in adjustments thereto. The provision relating to the loss basis for property acquired by gift after December 31, 1920, has been slightly amended. Under prior law it was the basis of the donor or last preceding owner who did not acquire it by gift, or the fair market value of the property at the time of the gift, whichever was the lower. Now said fair market value becomes the loss basis only if it is less than the basis of the donor or last preceding owner not acquiring it by gift, adjusted for the period prior to the date of the gift in accordance with the provisions of Section 113(b) of the I.R.C.\(^5\) Another amendment changes the provision defining the basis for property acquired after December 31, 1920, by a transfer in trust. It had been held that the former provision applied even to donative transfers in trust.\(^6\) The result of that decision was to make the alternative loss basis for gifts in-

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\(^2\)I.R.C., sec. 336, as amended by R. A. 1942, sec. 150(h); and I.R.C. sec. 505, as amended by R. A. 1942, sec. 150(i). All deal with adjustments of the treatment of capital gains and losses for special classes of taxpayers.

\(^3\)I.R.C., sec. 112(b)(9), added by R. A. 1942, sec. 142(a).

\(^4\)I.R.C., sec. 113(a)(20), added by R. A. 1942, sec. 142(b). See also I.R.C., sec. 113(a)(21), added by R. A. 1942, sec. 142(c).

\(^5\)I.R.C., sec. 112(f), as amended by R. A. 1942, sec. 151(d), (e). In connection with the latter amendment, see Wilmore S. S. Co., Inc. v. Com'r of Int. Revenue, (1935) 78 Fed. (2d) 667.

\(^6\)I.R.C., sec. 113(a)(2), as amended by R. A. 1942, sec. 143(a).

\(^7\)Com'r of Int. Revenue, (1941) 122 Fe-l. (2d) 915.
applicable to property acquired after December 31, 1920, by a donative transfer in trust. This has now been changed by excepting such donative transfers in trust from this provision of the I.R.C. They are, therefore, now subject to the rule applicable to property acquired by gift after December 31, 1920. The last change of general importance, that has not already been considered, relates to the basis for property transmitted to the taxpayer as a result of the death of another person. The basis under the prior law was the fair market value at the time of acquisition, which meant the date of the death of the person from whom it had been acquired. However, under the Federal Estate Tax Act, the decedent's estate may value his gross estate either on that basis or, at the executor's election, as of a date one year thereafter. The amended provision relating to the basis of property transmitted at death requires that, if the executor elects to have the gross estate of a decedent valued as of such later date, the gain and loss basis of property, transmitted from the decedent by reason of his death, shall be its value on said optional valuation date. This amendment applies only with respect to property includible in the gross estate of a decedent dying after October 21, 1942.

**Dividends**

The prior law treated the gain realized by a shareholder from distributions in partial liquidation of a corporation as a short-term capital gain, while treating the gain realized from a distribution in complete liquidation as a long-term capital gain. The provision embodying those rules has been eliminated by the new definition of "distributions in liquidation." The effect of this change is that the short-term or long-term character of such gains now depend upon the holding period of the shares with respect to which the distributions were made.

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215 I.R.C., sec. 113(a) (3), as amended by R. A. 1942, sec. 143(b).
216 For adjustments to the basis with respect to taxes and carrying charges capitalized, see pp. 262-266, supra; with respect to the amount of amortizable bond premium, see p. 260, supra; and with respect to improvements by lessee, see p. 252.
218 I.R.C., sec. 811(j).
219 I.R.C., sec. 113(a) (5), as amended by R. A. 1942, sec. 144(a).
220 R. A. 1942, sec. 144(b).
221 I.R.C., sec. 115(c).
222 I.R.C., sec. 115(c), as amended by R. A. 1942, sec. 147.
223 An amendment has also been made to I.R.C., sec. 115(1) (relating to the computation for corporate earnings and profits available for dividends)
Credits Against Net Income

The credits which an individual may take against his net income are divisible into (1) those available in computing his normal-tax net income only, and (2) those available in computing both his normal-tax net income and his surtax net income. The only change made in the former is that it is now expressly provided that the credit for interest on obligations of the United States includes the interest on such obligations only if, under the Act authorizing the issue of such obligations, as amended and supplemented, such interest is exempt from normal tax. This appears to be merely declaratory of the prior law. The principal changes in the credits available for both normal and surtax computations were made in the personal exemption and the credit for dependents. The personal exemptions are now as follows: (a) in the case of a single person or a married person not living with husband or wife, $500; and (b) in the case of the head of a family or a married person living with husband or wife, $1,200. If a husband and wife living together make separate returns, their combined exemption is still $1,200, which may be taken by either or divided between them. The only change in this respect is the elimination of the former provision limiting the one spouse to a personal exemption of $750 (the total for both was $1,500) if the other filed a return under the optional tax provisions. This was eliminated because those provisions have been amended to deny one spouse the right to compute his tax on that basis if the other spouse makes his return and computes his tax on the regular basis. The only change in the credit for dependents is its reduction from $400 to $350. It is also provided that payments made to a divorced wife which are now includible in her income shall not be deemed payments for the support of a dependent.

disallowing losses on wash sales in computing such earnings or profits (R.A. 1942, sec. 146(a)). The amendment is applicable to taxable years beginning after December 31, 1938 (R.A. 1942, sec. 146(b)).

214I.R.C., sec. 25.
215I.R.C., sec. 25(a)(1), as amended by R. A. 1942, sec. 112(b). The amendment is effective as of March 1, 1941 (R.A. 1942, sec. 112(c)).
216I.R.C., sec. 25(b)(1), as amended by R. A. 1942, sec. 131(a).
217See I.R.C., sec. 25(b)(1).
218I.R.C., sec. 404, as amended by R. A. 1942, sec. 104(c).
220I.R.C., sec. 25(b)(2)(A), as amended by R. A. 1942 sec. 120(e). The changes in credits required the amendment of certain other sections of the I.R.C., such as those relating to the credits of nonresident aliens and citizens of possessions of the United States, and sections governing the duty to make returns (See for these, R. A. 1942, sec. 131).
The two principal changes in the credits of corporations against net income are as follows: (1) the addition of a credit for the amount of net income subject to the excess profits tax;251 and (2) changing the limit on the dividends received credit from 85 per cent of the adjusted net income to 85 per cent thereof after its reduction by the amount of the credit referred to in (1).252 The other changes are with respect to credits that relate to special classes of taxable corporations.253

**The Optional Tax**

The optional tax is a tax imposed on individuals in lieu of the regular normal and surtax. It is in substance an adjusted gross income tax. It was introduced into the federal income tax system by the Revenue Act of 1941. It is optional with the taxpayer entitled to use it. The group so entitled includes individuals only. There are several factors that condition inclusion therein. The method may be used only by taxpayers whose gross income (which means the same thing as in the case of any other individual) is not in excess of $3000, and then only if such income consists wholly of income from salary, wages, compensation for personal services, dividends, interest or annuities.264 The amendment made by R. A. 1942 eliminated rent and royalties from the income which those entitled to select this method of taxation might receive. The taxpayer's taxable year and his method of reporting also affect his right to use it. It is available only to one whose taxable year is the calendar year and who makes his return on the cash basis.265 There have been several additions to those who are expressly made ineligible to use it. The prior law excluded non-resident aliens, and estates and trusts. There have been added to that group an individual filing a return for less than 12 months, one filing a return on a fiscal year basis, and a married individual, living with husband or wife at any time during the taxable year, whose spouse files a return and computes a tax without regard to this method.266 Under prior law such married per-

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251 I.R.C., sec. 26(e), added by R. A. 1942, sec. 105(d).
252 I.R.C., sec. 26(b), as amended by R. A. 1942, sec. 105(e).
253 See as to net operating loss credit, I.R.C., sec. 26(c), as amended by R. A. 1942, sec. 132(a); the dividends paid credit, I.R.C., sec. 27, as amended by R. A. 1942, sec. 132(b), (c); the consent dividend credit, I.R.C., sec. 28, as amended by R. A. 1942, sec. 186(e); and as to credit for dividends paid on public utility preferred stock, I.R.C., sec. 26(h), added by R. A. 1942, sec. 133.
254 I.R.C., sec. 400, as amended by R. A. 1942, sec. 104(a).
255 I.R.C., secs. 400 and 404, as amended by R. A. 1942, sec. 104(a), (c).
260 I.R.C., sec. 401, as amended by R. A. 1942, sec. 104(b).
son was permitted to use it even though the other spouse did not. The only result of the fact that both did not use it was that the personal exemption of the one not using it was reduced to half of the exemption accorded a married person living with husband or wife.

The schedule of taxes payable appears as part of Section 400 of the I.R.C. This also provides a $385 credit for each dependent instead of $400 as formerly. A person entitled to this credit must subtract from his gross income $385 for each dependent in order to determine the line in the tax schedule in which the amount of his tax will be found. If, for example, A is a married person whose spouse has no gross income (or a married person making a joint return, or the head of a family) with two dependents, and having a gross income from proper sources of $2,850, he would subtract 2 x $385 or $770 from $2,850. This would give him a gross income of $2,080 for purposes of applying the tax schedule. The line in which his tax will be found is that reading "If the gross income is over $2,075 but not over $2,100." That shows his tax to be $133 (the third column specifying the amount that the tax shall be).

The application of the tax schedule depends upon whether the taxpayer is a single person who is not the head of a family, a married person living with husband or wife, a married person not living with husband or wife, or the head of a family, and also upon whether he has any dependents. The definition of these terms under the prior law was the same as applied in the computation of the regular income tax. This has now been changed. The status of a taxpayer is no longer determined as of the last day of his taxable year but as of July 1 of the taxable year. Thus a person is a "married person" if living with husband or wife on July 1 of the taxable year, and a single person, even though married, if not living with husband or wife on such July 1. The fact of dependency is also determined as of that date. The definition of a "dependent" is in all other respects the same as with respect to the regular income tax.

A taxpayer is entitled to make an election to be taxed by this method for each taxable year. But an election once made for a given taxable year is irrevocable. Furthermore, if he has filed a return on the regular basis for any taxable year, he has made an election for that year and may not thereafter elect to be taxed by

256a I.R.C., sec. 401, as amended by R. A. 1942, sec. 104(b).
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the optional tax method.257 There has been no change with respect to these matters. The provision that no credits are allowable against the optional tax for foreign income and profits taxes and taxes withheld at the source has also been left as before.258

The Victory Tax

This is a wholly new tax all of whose provisions are added to the I.R.C. by section 172(a) of R. A. 1942.259 The tax is equal to 5 per cent of the "victory tax net income" of every individual, other than a non-resident alien taxable under section 211(a) of the I.R.C.260 It is also imposed upon estates and trusts, but not upon corporations. A limit is put on the amount of the tax. That will be subsequently discussed.

The starting point for computing the victory tax net income is the same gross income that the taxpayer would report for regular income tax purposes.261 This must be reduced by excluding three items that are includible in the regular gross income.262 These are (1) capital gains as defined in Section 117 of the I.R.C.; (2) the interest on obligations of the United States or its instrumentalities which constitutes a credit against net income for normal tax purposes; and (3) the amount received as compensation for injury or sickness which has been included in gross income because attributable to medical expense deductions during prior years.263 The victory tax net income is the excess of this adjusted gross income over the sum of certain specified deductions.264 The business and non-business expenses are deductible under the same circumstances and to the same extent as in computing the regular income tax. Interest is deductible only on indebtedness incurred in carrying on a business, for producing or collecting income, or for managing, conserving or maintaining property held for the production of income. The same restriction applies to the deduc-

257I.R.C., sec. 402.
258I.R.C., sec. 403.
259Other subsections of R. A. 1942, sec. 172, make various amendments to other provisions of the I.R.C. which are not of sufficient importance for present purposes to warrant their treatment in this article.
260I.R.C., sec. 450, added by R. A. 1942, sec. 172(a). Section 211(a) deals with the taxation of non-resident aliens not engaged in business within the United States.
261The phrase "regular income tax" is used in this discussion of the victory tax to designate the tax imposed by sections 11 and 12 of the I.R.C. upon individuals. The term "regular gross income" is used to designate the gross income used in computing the "regular income tax."
262I.R.C., sec. 451(a), added by R. A. 1942, sec. 172(a).
263Sec as to this third item p. 273, supra.
264I.R.C., sec. 451(a), added by R. A. 1942, sec. 172(a).
tion of taxes. Losses and bad debts are deductible only if incurred in connection with the taxpayer's trade or business. The deductions for depreciation, depletion, contributions to pension trusts, the amortization of emergency facilities, and for net operating losses may be taken in the same manner and to the same extent as in computing the regular income tax. The principle underlying these deductions is to limit them to items of the stated descriptions that are related to business and other income producing activities. The only two permissible deductions that fall outside of that principle are deductible alimony payments, and charitable contributions in the case of estates or trusts and in the case of an individual permitted to take that deduction not subject to the usual 15 per cent limitation thereon. All deductions are subject to the limitations contained in Section 24 of the I.R.C., and in Supplements J and H thereof. The foregoing discussion has no application to a taxpayer computing his tax under the optional tax method. His victory tax net income for any taxable year when he uses that method is his gross income for that year. In the case of a member of a partnership, he is required to include in computing his victory tax net income, so far as that depends upon the partnership income, his distributive share of the partnership's ordinary net income or ordinary net loss.

The victory tax is computed upon the amount of the victory tax net income reduced by the amount of a specific exemption of $624 for each taxpayer. A special rule applies where a husband and wife file a joint return and the victory tax net income of one of them is less than $624. In that case the aggregate exemption of both the spouses is limited to $624 plus the victory tax net income of the spouse whose victory tax net income is less than $624. For example, if the victory tax net income of the husband is $4,000 and that of his wife is $100, and if they file a joint return, the credit which they may take against their combined

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265 See I.R.C., sec. 120.
266I.R.C., sec. 121).
267I.R.C., sec. 24 relates to non-deductible items; Supplement J, to citizens of possessions of the United States; and Supplement H to non-resident aliens.
269I.R.C., sec. 452, added by R. A. 1942, sec. 172(a).
victory tax net income of $4,100 is $724. The tax would thus be based on $3,376. That is exactly the amount that would have been subjected to the victory tax had separate returns been filed. This provision is intended to prevent crediting against the victory tax net income of one spouse that part of the credit available to the other spouse which he or she cannot use because of a deficiency in victory tax net income. It will prevent resort to joint returns solely to reduce the tax of the spouse whose victory tax net income exceeds $624.

The victory tax will constitute a compulsory loan with respect to such part thereof as is to be refunded or credited to the taxpayer after the cessation of hostilities in the present war. This is the effect of the system of post-war refunds and credits provided for by the Act.\footnote{\textit{271}T.C., sec. 454(a), added by R. A. 1942, sec. 172(a).} The amount of such refund or credit depends upon the status of the taxpayer during the taxable year. The amounts are as follows: (1) if the taxpayer is a single person or married person not living with husband or wife, 25 per cent of the victory tax or $500, whichever is the lesser; (2) if he is the head of a family, 40 per cent of the victory tax or $1,000, whichever is the lesser; (3) if he (or she) is a married person living with wife (or husband) and separate returns are filed, 40 per cent of the victory tax or $500, whichever is the lesser; (4) in the case of such a married person as is described in (3), if a separate return is filed by one spouse and no return is filed by the other, or if a joint return is filed, 40 per cent of the victory tax or $1,000, whichever is the lesser; and (5) an additional 2 per cent of the victory tax or $100, whichever is the lesser, for each dependent, defined in the same manner as for purposes of computing the regular tax or optional tax. In the case of a change of marital status, or of status with respect to dependents, during the taxable year, the amount of the refund is apportioned on a time basis, disregarding fractions of a month unless in excess of a half a month in which case they count as a month.\footnote{\textit{272}T.C., sec. 454(b), added by R. A. 1942, sec. 172(a).} The following examples illustrates the meaning of the preceding sentence. (1) Assume that A is a single person from January 1 until July 5 of his taxable year (taken to be the calendar year), and a married person living with his wife for the remainder thereof; that his victory tax is $200; and that his wife has no victory tax net income. His refund or credit will be $50 (the amount he had been a single person during the whole of the taxable year) plus $80 (the amount
had he been a married person living with his wife during the whole of said year). That is, his refund or credit for that year will be $65. (2) Assume that A is married and living with his wife during the whole of a taxable year, and the birth of a child to them on Sept. 3 of that year; that he files a return for that year and that his wife files no return; and that his victory tax is $200. His credit or refund will be $80 (due to his marital status) plus \( \frac{3}{2} \)ths of $4 (the amount he would have been entitled to had the dependent been such during the whole of the taxable year). That is, his refund or credit will be $81.25. The foregoing discussion does not apply to a taxpayer computing his regular tax by the optional tax method. His marital status, and his status with respect to dependents, is determined by conditions as of July 1 of the taxable year, and no apportionment formula is required to compute the amount of his refund or credit.\(^{273}\) It should be noted that taxpayers will have to apply for their refunds or credits after the war. They are not made automatically.\(^{274}\)

There are certain conditions under which a taxpayer may apply the amount to which he would be entitled as a post-war refund or credit against his current victory tax.\(^{275}\) The amount of this current credit is the sum of three different items. The first consists of amounts paid during the taxable year as life insurance premiums on policies in force on September 1, 1942. The insurance must be upon either his own life, that of his spouse, or that of a dependent with respect to whom he is entitled to a credit in computing his regular income tax. There may also be included premiums on life insurance which is a renewal or conversion of insurance in force on September 1, 1942, to the extent that such premiums do not exceed the premiums payable on such insurance in force on said date. In other words, the premiums on policies not in force on that date constitute no part of this credit.

The second item in the computation of the current credit against the tax is defined as "The amount by which the smallest amount of indebtedness of the taxpayer outstanding at any time during the period beginning September 1, 1942, and ending with the close of the preceding taxable year, exceeds the amount of indebtedness, of the taxpayer outstanding at the close of the taxable year." The basis for it is not the mere payment of indebtedness, but the net reduction of the taxpayer's indebtedness, during the

\(^{273}\)I.R.C., sec. 454(c), added by R. A. 1942, sec. 172(a).

\(^{274}\)I.R.C., sec. 454(d), added by R. A. 1942, sec. 172(a).

\(^{275}\)I.R.C., sec. 453, added by R. A. 1942, sec. 172(a).
taxable year against whose victory tax he wishes to take this credit, the September 1, 1942, indebtedness being the starting point. The following example may clarify this provision. Assume that A reports on a calendar year basis; and that the record of his debt position from September 1, 1942, until December 31, 1944, was as follows:

1. Amount of his indebtedness at 9/1/42 ......................... $5,000
2. Amount thereof paid on 12/1/42 ............................... 1,000
3. Amount of new indebtedness incurred on June 1, 1943... 2,000
4. Amount of indebtedness paid off on October 1, 1943 ... 1,500
5. Amount of indebtedness paid off during 1944 ............. 1,700

The amount of this credit for 1943 would be computed as follows:
(1) the smallest amount of A's indebtedness outstanding during the period beginning with September 1, 1942, and the close of his 1942 taxable year equals $4,000; (2) the amount of his indebtedness at the close of his taxable year 1943 equals $4,500; (3) the excess of (1) over (2) equals $500; (4) hence, he is entitled to no such credit for 1943. The amount of this credit for 1944 would be computed as follows: (5) the smallest amount of A's indebtedness during the period beginning September 1, 1942, and ending at the close of his taxable year 1943 equals $4,000; (6) the amount of his indebtedness outstanding at the end of his taxable year 1944 equals $2,800; (7) the excess of (5) over (6) equals $1,200, which is the amount of his credit for 1944. Although he has paid off $3,200 on his indebtedness since the victory tax went into effect, $2,000 of it was applied against debts incurred after December 31, 1942, leaving but $1,200 to apply against debts incurred prior to January 1, 1943. A variation of the second case is interesting. Assume that A had paid $1,500 on his indebtedness on June 1, 1943, and borrowed the $2,000 on October 1, 1943. Then the computation would be as follows: (8) the smallest amount of his debt between September 1, 1942, and December 31, 1943, would equal $2,500; (9) the amount of his indebtedness on December 31, 1944, would still be $2,800; but (10) the excess of (8) over (9) would now be $200, that is, non-existent. Hence A would be entitled to no credit for 1944. The $1,500 paid by him during 1943 is in effect applied against his September 1, 1942, indebtedness, and he is penalized for incurring indebtedness after such repayment. The relative order of debt reductions and increases after December 31, 1942, is thus an important factor in determining the extent of this credit. The method of its computation
operates as a deterrent to increasing one's indebtedness after once having reduced it.

The last item in computing the current credit against the tax is based on the purchase of obligations of the United States. The credit for any taxable year is defined as "The amount by which the amount of the obligations of the United States owned by the taxpayer on the last day of the taxable year exceeds the greater of (A) the amount of such obligations owned by the taxpayer on December 31, 1942, or (B) the highest amount of such obligations owned by the taxpayer on the last day of any preceding taxable year ending after December 31, 1942." It will be seen from this that the basis of the credit is not the amount of such obligations purchased during the taxable year, but the net increase in the taxpayer's holdings measured from the higher of two alternative figures reflecting holdings at the end of 1942 or the end of any taxable year ending thereafter. The following example illustrates the meaning of this provision. Assume that A reports on the calendar year basis, and that his holdings of the proper types of obligations of the United States are represented by the following schedule:

<table>
<thead>
<tr>
<th>Year</th>
<th>Holdings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1942</td>
<td>$5,000</td>
</tr>
<tr>
<td>1943</td>
<td>$7,000</td>
</tr>
<tr>
<td>1944</td>
<td>$8,000</td>
</tr>
<tr>
<td>1945</td>
<td>$7,500</td>
</tr>
<tr>
<td>1946</td>
<td>$9,000</td>
</tr>
</tbody>
</table>

On the basis of these figures his credit for 1943 will be $2,000; for 1944, $1,000 (the excess over his holdings on December 31, 1944, over his holdings on December 31, 1943, since the latter is greater than his holdings on December 31, 1942); for 1945, no credit since his holdings at the end of that year are not in excess of $8,000 (the highest amount at the end of any taxable year ending after December 31, 1942, which is taken as the basis of computation because it is greater than his holdings on the date last mentioned); and for 1946, $1,000 (the excess of his holdings at the end of 1946 over his holdings at the end of 1944, when his holdings were greater than at December 31, 1942, and the highest amount of his year end holdings for any taxable year ending after the last mentioned date).\[^{276}\] The device employed for measuring the amount of this credit penalizes any transfers of such obligations.

\[^{276}\] The illustration assumes that the victory tax will still be in effect during 1946.
that are not offset by the purchase of other such obligations in an equal amount. This was one of its purposes.

For the purpose of applying the formula discussed in the preceding paragraph a taxpayer is deemed to own the amount owned solely by him, and one-half of the amount owned jointly by him and one other person. He may not include in his holdings the amount of any such obligations acquired by any other method than purchase. The amount of his holdings equals the amount paid by him therefor, not their par or redemption value. The statute does not specify which obligations of the United States may enter into the computation of this credit. It defines them as such obligations of the United States as the Secretary of the Treasury "may by regulations prescribe, and as are purchased in such manner and under such terms and conditions as he may specify." This discretionary power might be exercised to exclude obligations available for the payment of federal income taxes, or those purchased on the installment plan, or those whose purchase was financed by borrowing or from the proceeds of the sale of obligations of the United States issued prior to some given date. Taxpayers will have to familiarize themselves with these regulations if, as, and when they are issued.

The current credit available is the sum of the three items just discussed. Its amount is, however, subject to a limitation.\footnote{R.C., sec. 453(b), added by R. A. 1942, sec. 172(a).} It may not exceed the amount of the taxpayer's post-war refund or credit with respect to the same taxable year,\footnote{See pp. 289, 290.} but this refers to such refund or credit computed without regard to the limitation imposed on it. The reason for this qualification is that the post-war refund or credit is to be reduced by the amount of the current credit.\footnote{R.C., sec. 254(e), added by R. A. 1942, sec. 172(a).} The sum of the current credit and the post-war refund or credit with respect to any taxable year may not exceed the percentages of the victory tax for that year which have already been discussed.\footnote{See pp. 289, 290.}

There is also a limit imposed upon the amount of the victory tax for any taxable year.\footnote{R.C., sec. 456, added by R. A. 1942, sec. 172(a).} The total tax (computed without regard to the current credit, the post-war refund or credit, and the credit for victory tax collected at the source) shall not exceed the excess of 90 per cent of the taxpayer's net income for the tax-
able year over the normal and surtax imposed thereon (computed without regard to the credits against said income taxes for foreign income and profits taxes, for ordinary income taxes collected at the source, and for the excess of the victory tax collected at the source over the victory tax, less the current credit, due from the taxpayer). Assume that A's net income for 1943 is $1,000,000; that he is a single person without dependents; that he has no interest income that can be used as a credit for normal tax purposes; that his earned net income is in excess of $14,000; that his victory tax net income in excess of $624 is $1,100,000. On the basis of these figures his normal tax and surtax would be $854,616. His victory tax would be $55,000. The sum of these taxes would be $909,616. 90 per cent of his net income is $900,000. His victory tax would be subject to the limitation now being considered. It would be computed as follows: (1) 90 per cent of his net income equals $900,000; (2) his normal tax and surtax equal $854,616; (3) the excess of (1) over (2) equals $45,384, which is the amount of his victory tax. This is in effect limiting the aggregate amount of his normal tax, his surtax, and his victory tax to 90 per cent of his net income as calculated for purposes of computing his normal tax and his surtax. It is apparent that the limit will operate in relatively few cases.

The fact that the victory tax is collected at the source so far as the taxpayer's income is derived from wages gives rise to another credit problem. There are likely to be many cases in which the amount of the victory tax collected at the source exceeds the total victory tax due from the taxpayer entitled to take, and who does take, what has been called the current credit against that tax. Assume that A derives all but $1,000 of his 1943 income from wages, and that his wages (which includes salary) for that year were $5,624. His total victory tax for 1943 would then be $300, of which his employer will have withheld and paid $250. Assume that A, married man living with his wife for the whole of 1943, purchased $500 worth of the proper kind of obligations of the United States. This is in excess of 40 per cent of his victory tax which would be $120. Hence he is entitled to a current credit against his victory tax of $120, leaving the tax due and payable $180. But his employer has already deducted from his salary, and paid over to the United States, $250 on account of victory tax for 1943. Hence A has overpaid his victory tax by $70. He may apply this against the income taxes due from him with
respect to his 1943 income, whether he has computed that by the regular method or by the optional tax method. If such income taxes are less than $70, he is entitled to a refund.\textsuperscript{282}

The provisions for the collection of the victory tax at the source are extremely long. They will not be discussed. The footnote gives the references to the most important provisions relating thereto.\textsuperscript{283}

The victory tax is intended to be a temporary tax. It is not to apply to any taxable year commencing after the date of the cessation of hostilities in the present war as fixed by Presidential proclamation.\textsuperscript{284}

\textbf{Returns}

Attention is directed to the fact that an individual taxpayer is no longer required to swear to his return. The return must, however, contain or be verified by a written statement that it is made under the penalties of perjury.\textsuperscript{285}

\textbf{Conclusion}

The foregoing discussion has selected those particular provisions of the Revenue Act of 1942 that were deemed likely to be of general interest to the greatest number of those required to handle federal tax problems. No attempt has been made to consider procedural changes, though some of these are of considerable importance.\textsuperscript{286} It would take a volume to explain all of the amendments to the I.R.C. with that degree of detail necessary to make the discussion valuable. It is hoped that the general practitioner will find the writer's selection of points for discussion conforming to his needs.

\begin{itemize}
\item \textsuperscript{282}I.R.C., sec. 466(e), (f), added by R. A. 1942, sec. 172(a). The statements in the text may be made obsolete if some form of the Rumr plan is adopted and applied to 1943.
\item \textsuperscript{283}I.R.C., secs. 465-470, added by R. A. 1942, sec. 172(a).
\item \textsuperscript{284}I.R.C., secs. 475, 476, added by R. A. 1942, sec. 172(a).
\item \textsuperscript{285}I.R.C., sec. 51, as amended by R. A. 1942, sec. 136(a).
\item \textsuperscript{286}See particularly I.R.C., sec. 3772(d), added by R. A. 1942, sec. 503 (this deals with the effect of a suit against a collector as a bar to other suits); and I.R.C., sec. 3804, added by R. A. 1942, sec. 507 (this relates to the postponement, by reason of the war, of certain acts required to be done under the I.R.C.).
\end{itemize}