RESPONDENT'S BRIEF

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1931.

No. 26.

THE UNITED STATES, *Petitioner*,

v.

KIRBY LUMBER COMPANY.

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

BRIEF FOR RESPONDENT.

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BRIEF FOR RESPONDENT.

QUESTION PRESENTED.

Does a corporation realize taxable income when it discharges a debt prior to maturity by payment of a lesser sum than that called for on the face of the bonds which represent the debt?

STATEMENT.

In June, 1923, the Kirby Lumber Company issued bonds secured by a deed of trust on certain of its property. During 1923 the Kirby Lumber Company purchased $1,078,300 face value of the said bonds for $940,778.70, or $137,521.30 less than the face value of the bonds purchased, and retired them. The question is whether the said $137,521.30 is taxable income to the Kirby Lumber Company.

The Kirby Lumber Company contends that the consideration received for the bonds is immaterial. The transaction here sought to be taxed is the purchase of certain of the bonds and their retirement. If, however, the Court believes the consideration is material the motion to remand to the Court of Claims which was submitted May 25, 1931, should be granted.

In the Court of Claims the facts were stipulated, and the stipulation adopted by the Court as its findings of fact. The record does not show the consideration for which the bonds were issued.

If remanded the proof will show that in 1923 the Kirby Lumber Company had $5,000,000 par value preferred stock outstanding, callable at $105 per share, on which there were accrued dividends of $126 per share, or a total capital liability of $231 per share. $11,526,800 in bonds, plus $9,776.94 in cash, were exchanged for the preferred stock at the price of $231 per share, computed as indicated above. In July, 1925, $600,000 additional of bonds were issued, but that $600,000 of bonds are not in issue here. In other words, the issuance of the bonds in 1923 merely changed the nature of the lumber company's liability to its preferred stockholders from stockholders to

bondholders. No money came into the company, in fact, $9,776.94 was paid out, and the assets were not increased. In addition the proof will show the past history of the Kirby Lumber Company, its inability to pay interest on its preferred stock for many years prior to 1923, and other facts to indicate that the price at which the Kirby Lumber Company purchased its bonds in 1923 was not more than the value of the Company's promise to pay the said bonds fifteen years thereafter.

Counsel feels justified in calling the above-mentioned facts to the attention of the Court because the Government, in its brief, has drawn conclusions from the Court of Claims findings of fact which are not justified by the record. The Court of Claims did not find that the Kirby Lumber Company "sold" the bonds or that the Company's assets were increased by the bond issue.

SUMMARY OF ARGUMENT.

I.

It is established that "income" under the Sixteenth Amendment is the gain derived from capital, the gain derived from labor, the gain derived from capital and labor combined, the profit gained through a sale or conversion of capital assets. This case does not meet the definition as no income was derived from the transaction. The transaction was the expenditure, rather than the receipt of money. Such could not be income.

II.

The principle involved has been decided by this Court in *Bowers v. Kerbaugh-Empire Co.*, 271 U. S.

170, wherein it was held that a corporation does not realize taxable income by settling a debt for a lesser sum in dollars than it was obligated to pay.

III.

The Board of Tax Appeals in a long line of cases beginning with *Independent Brewing Co.*, 4 B. T. A. 870, decided September 18, 1926, has held that no income is realized in the circumstances here involved.

IV.

It is thoroughly established by a long line of cases that cancellation of indebtedness is a capital transaction which does not result in income. These cases involve the same principle as the case at bar.

V.

Income has been determined by this Court to mean the gain or income arising from corporate activities. It does not mean transactions not connected with the corporate activities and which only affect the capital structure of the corporate taxpayer.

VI.

Another way of looking at the transaction is that it is a purchase by the taxpayer of its promise to pay. It is settled that income can be realized only by the sale or other disposition of capital assets. If income can be realized by purchase it will mean that every "good bargain" is taxable when made. If purchase can result in income it did not in this case because bonds were purchased at their then value, as shown by the judgment of the market place.

VII.

Government's position is unsound.

VIII.

The authorities cited in the Government's brief do not support its position.

ARGUMENT.

I.

Only Income Can Be Taxed.

The Sixteenth Amendment grants power to Congress to "lay and collect taxes on incomes, from whatever source derived."

The question, therefore, is whether the transaction on which this taxpayer was taxed is "income" under the Amendment. Unless it is "income", then, as a direct tax on personal property, without apportionment, its imposition on this taxpayer would be beyond the powers of Congress as established by *Pollock v. Farmers Loan and Trust Co.*, 157 U. S. 429.

"Income" has been repeatedly defined by this Court as:

1. Gain derived from capital.
2. Gain derived from labor.
3. Gain derived from capital and labor combined.
4. Profit gained through a sale or conversion of capital assets.

The Court, in explaining this definition, states:

> "* * * Here we have the essential matter; *not* a gain *accruing* to capital, not a *growth* or *incre-*

ment of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being *'derived,'* that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description." (*Eisner v. Macomber*, 252 U. S. 189, 207.)

The District Court in *Kerbaugh-Empire Co. v. Bowers*, 300 Fed. 938, in applying Eisner v. Macomber to the case then being considered, uses language that aptly argues the case at bar. At page 943 the Court states:

"* * * Nothing has been severed from the plaintiff's capital as a result of this transaction which has come into the plaintiff. The improvement of the plaintiff's balance sheet is not income to the plaintiff. All that it had was a decrease in liability. In Eisner v. Macomber, *supra*, it was held that 'enrichment through increase in value of capital investment is not income in any proper meaning of the term.'"

At page 944 the Court continues:

"* * * As a matter of fact there was not even an increase of assets. There was a decrease of assets through the payment of a part of plaintiff's assets in settling the indebtedness. The fact that after the transaction the plaintiff's balance sheet had improved was not sufficient to constitute 'a gain derived from capital.' If anything, it was a gain accruing to capital, and, as such, under the Eisner and Phellis Cases, was not taxable income."

In the case at bar the real transaction was that the Kirby Lumber Company parted with $940,778.70 in cash. In return therefor it secured certain of its promises to pay as evidenced by bonds and cancelled the said promises. The balance sheet was improved, but the improvement of the balance sheet did not separate something from the property which the taxpayer got for its separate use, benefit and disposal. In other words, the net result was that the Kirby Lumber Company reduced its cash $940,778.70 and had nothing to offset it but book entries in its capital account. It realized no "income."

II.

Principle Has Been Settled by This Court.

In 1926 this Court decided that a corporation realized no income by settling a debt for a lesser sum in dollars than it was obligated to pay.

In *Bowers v. Kerbaugh-Empire Co.*, 271 U. S. 170, the Kerbaugh Company, before the war, borrowed money in Germany repayable in marks or their equivalent in gold coin of the United States. A subsidiary of the Kerbaugh-Empire Company, for whose use the money was borrowed, lost the money in business and claimed, and was allowed, a loss of such amounts in its income-tax return for the years in which the losses occurred.

In 1921 the Kerbaugh-Empire Company made payment of the balance due on its notes. Owing to the depreciated value, at that time, of the German mark there was, measured by United States gold coin, a difference between the value of the marks borrowed at the time the loans were made and the amount paid

in liquidation of the unpaid balance the sum of $684,456.18. The Commissioner of Internal Revenue treated this sum of $684,456.18 as income for the year 1921 and assessed taxes thereon. This Court held that it was not taxable income. The Court states the issue to be (page 173):

> "The question for decision is whether the difference between the value of marks measured by dollars at the time of payment to the custodian and the value when the loans were made was income."

On page 1 of the Government's brief in the Kerbaugh-Empire case (No. 173, October Term, 1925) it is stated:

> "The question in this case is whether or not the profit or gain made by a corporation as the result of borrowing foreign money and later settling its debt at a rate of exchange lower than that at which the loan was made is taxable income."

At page 16 of the Government's brief in the Kerbaugh-Empire case it is argued:

> "Another and equally logical way of viewing the transaction is to liken it to the purchase and retirement by a corporation of its own bonds at a price less than the issuing price. That such sales and retirement of corporate bonds result in income must be taken as settled."

The brief then cites Article 545 of Regulations 65 to sustain the contention that the purchase and retirement of corporate bonds results in income. No decisions are cited.

At pages 17 and 18 of the Government's brief in the Kerbaugh-Empire case it is stated:

> "So in the instant case, the reality of the transaction is that defendant in error sold its promise to pay a certain number of marks for $764,867.30 and later bought this promise back for $80,411.12. The fact that this promise was in the shape of a promissory note instead of a corporate bond did not affect the essential character of the transaction. Nor does the fact that the note itself was never actually returned to defendant in error make any material difference. So far as the practical result is concerned the receipt which the defendant in error received from the Alien Property Custodian is as effective as though the note itself had been returned and cancelled. In the present case, if the corporation had borrowed $764,867.30 through the sale of bonds which it later retired for $80,411.12, no one would doubt for a moment that under the Treasury Regulations above referred to the difference between these sums would have been taxable as a part of its income. What was actually done was that the corporation borrowed $764,867.30 through the sale of its note and retired that obligation for $80,411.12. Is there any conceivable difference in principle between the case supposed and that now under consideration? The analogy is perfect."

It seems, therefore, that while the Government now contends that the Kerbaugh-Empire case is not controlling on the case at bar it argued directly to the contrary when the Kerbaugh-Empire case was before the Court.

In other words, the question in the Kerbaugh-Em-

pire case was precisely the same as the question here presented. Does a corporation realize taxable income by settling a debt for a lesser sum in dollars than it was obligated to pay? Unless this Court specifically over-rules the Kerbaugh-Empire case decision must be for the Kirby Lumber Company in the case at bar.

In the Kerbaugh-Empire case the Government had a strong equity not here present, because the taxpayer's subsidiary had been permitted to deduct losses totalling $1,983,000 from prior years' income, and yet the taxpayer was out of pocket in the principal amount of only $80,411.12 when the obligation was paid in 1921.

That the Court correctly decided the Kerbaugh-Empire case is quite apparent. In disposing of the case the Court states (page 174):

> "* * * 'Income' has been taken to mean the same thing as used in the Corporation Excise Tax Act of 1909, in the Sixteenth Amendment and in the various revenue acts subsequently passed. *Southern Pacific Co. v. Lowe,* 247 U. S. 330, 335; *Merchants L. & T. Co. v. Smietanka,* 255 U. S. 509, 519. After full consideration, this Court declared that income may be defined as gain derived from capital, from labor, or from both combined, including profit gained through sale or conversion of capital. *Stratton's Independence v. Howbert,* 231 U. S. 399, 415; *Doyle v. Mitchell Brothers Co.,* 247 U. S. 179, 185; *Eisner v. Macomber,* 252 U. S. 189, 207. And that definition has been adhered to and applied repeatedly. See e. g. *Merchants L. & T. Co. v. Smietanka, supra,* 518; *Goodrich v. Edwards,* 255 U. S. 527, 535; *United States v. Phellis,* 257 U. S. 156, 169; *Miles v. Safe Deposit Co.,* 259 U. S. 247, 252-253; *United States v. Supplee-Biddle Co.,* 265 U. S. 189, 194; *Irwin v. Gavit,* 268 U. S. 161, 167; *Edwards v. Cuba Railroad,* 268 U. S. 628, 633. In determining what constitutes income substance rather than form is to be given controlling weight. *Eisner v. Macomber, supra,* 206.
>
> "The transaction here in question did not result in gain from capital and labor, or from either of them, or in profit gained through the sale or conversion of capital. * * *"

In its brief in the case at bar the Government makes much of the mention in the Kerbaugh-Empire decision that "The result of the whole transaction was a loss" (page 18 Government's brief). It is quite apparent from the statement of "the question for decision" that the decision was not dependent upon the disposition of the money borrowed. That disposition was a separate transaction upon which the gain or loss was computed. In the Kerbaugh-Empire case the taxpayer was permitted to deduct losses in prior years far in excess of its actual loss in dollars. That fact, however, did not influence the Court because the question involved was the taxation of the transaction which settled the debt.

> "The question for decision is whether the difference between the value of marks measured by dollars at the time of payment to the Custodian and the value when the loans were made was income." (*Bowers v. Kerbaugh-Empire Co.,* 271 U. S. 170, 173.)

In substance the Government's argument is that, assuming there was a gain in 1921, the losses of the

Kerbaugh-Empire Company's subsidiary for 1913, 1914, 1916, 1917 and 1919 should be offset against the assumed gain in 1921. In *Burnet v. Sanford & Brooks Co.*, 282 U. S. 259, it was definitely settled that income for tax purposes must be computed on an annual basis. Obviously the Government cannot distinguish the Kerbaugh-Empire case on the argument used. In the Sanford & Brooks case, *supra*, the company lost money from 1913 to 1916 in carrying out a Government dredging contract. In 1920 by suit it recovered from the Government the amount of its losses on the contract. The Court followed the Kerbaugh-Empire case and held the amount recovered was taxable income in 1920 even though the result of the whole transaction was not a gain. These decisions make it apparent that the only question to be decided in the case at bar is whether the Kirby Lumber Company realized taxable income by the purchase and retirement of its bonds. Any question with reference to the issuance of the bonds or the consideration received therefor is a separate and distinct transaction upon which gain or loss is computed and which should not be considered by this Court.

That the purchase and retirement of the bonds must be considered as separate and distinct from their issuance is further shown by the complications which will follow if such a course is not adopted. The taxpayer at bar purchased certain of the bonds of the issue here involved at less than the face value and retired them during 1924, 1925 and 1926. (See *Kirby Lumber Co.*, 19 B. T. A. 1046, now pending before the Circuit Court of Appeals for the Fifth Circuit.) Although the bonds were issued in 1923 it seems obvious that the case for subsequent years should be

disposed of on the same basis as 1923, which is before this Court in the case at bar.

III.

The Board of Tax Appeals Has Held that no Taxable Income Results in the Situation Here Involved.

The Board of Tax Appeals, which is composed of sixteen experts in tax law, has many times decided the question here involved in favor of the taxpayer. Among the cases are:

Independent Brewing Co., 4 B. T. A. 870;
New Orleans, Texas & Mexico Ry. Co., 6 B. T. A 436;
Houston Belt & Terminal Ry. Co., 6 B. T. A. 1364;
National Sugar Mfg. Co., 7 B. T. A. 577;
Petaluma & Santa Rosa R. R. Co., 11 B. T. A. 541;
General Manifold & Printing Co., 12 B. T. A. 436;
Douglas County Light & Water Co., 14 B. T. A. 1052;
Eastern Steamship Lines, Inc., 17 B. T. A. 787;
North American Mortgage Co., 18 B. T. A. 418;
Kirby Lumber Co., 19 B. T. A. 1046;
American Tobacco Co., 20 B. T. A. 586;
Houghton & Dutton Building Trust, 20 B. T. A. 591;
Boulevard Building Co., 21 B. T. A. 864;
Norfolk Southern R. R. Co., 22 B. T. A. 302;
Coastwise Transportation Co., 22 B. T. A. 373;
Rail Joint Co., 22 B. T. A. 1277;
New York, Chicago & St. Louis R. R. Co., 23 B. T. A. 177;
Terre Haute, Indianapolis and Eastern Traction Co., 24 B. T. A.—; decided September 29, 1931.

The Revenue Act of 1926 providing for appeals to Circuit Courts of Appeal from the Board of Tax Appeals became law February 26, 1926. Despite this the first appeal on this point was not taken until December 19, 1930, when Kirby Lumber Co., 19 B. T. A. 1046, was taken to the Fifth Circuit. That case involves the identical question here presented except that it is for the years 1924, 1925 and 1926, while the case at bar involves 1923.

IV.

Similar to Cancellation of Indebtedness Cases.

Many cases have been decided where taxpayers have had indebtedness cancelled. The earliest of these decisions is *U. S. v. Oregon-Washington R. & Nav. Co.*, 251 Fed. 211 (decided April 24, 1918), wherein the Oregon Short Line Railroad, the sole stockholder of the taxpayer, released $6,190,769.57 of the indebtedness of the taxpayer to the Short Line. The Commissioner of Internal Revenue held that the debt released was income. In denying the Commissioner's contention the Circuit Court of Appeals for the Second Circuit said (page 212):

> "However, the tax, though it includes income 'from all sources,' nevertheless includes 'income' only, and the meaning of that word is not to be found in its bare etymological derivation. Its meaning is rather to be gathered from the implicit assumptions of its use in common speech. The implied distinction, if seems to us, is between permanent sources of wealth and more or less periodic earnings. Of course, the term is not limited to earnings from economic capital; *i. e.*, wealth industrially employed in permanent

> form. It includes the earnings from a calling, as well as interest, royalties, or dividends, though in the case of corporations this may be of slight importance. Yet the word unquestionably imports, at least so it seems to us, the current distinction between what is commonly treated as the increase or increment from the exercise of some economically productive power of one sort or another, and the power itself, and it should not include such wealth as is honestly appropriated to what would customarily be regarded as the capital of the corporation taxed.
>
> "Now, it seems to us hardly arguable that the cancellation of the debt in question was not in the category of capital. * * *"

The Board of Tax Appeals has many times decided that a cancellation of indebtedness does not result in taxable income. Cases are:

Meyer Jewelry Co., 3 B. T. A. 1319;
John F. Campbell Co., 15 B. T. A. 458; 50 Fed. (2d) 467.
Eastside Mfg. Co., 18 B. T. A. 461;
Progress Paper Co., 20 B. T. A. 234;
Herman Sonnor, 22 B. T. A. 655.

Many of the cancellation of debt cases cite the Kerbaugh-Empire case, so if the rule of that case is not followed in the case at bar great confusion and much hardship will result in cases where cancellation of indebtedness is necessary. It will mean, in fact, that the United States will be a preferred creditor, thereby reducing payments to other creditors. Such a situation would, in many instances, eliminate the possibility of composition with creditors with the

resulting destruction of enterprises which otherwise might continue to operate. Such a rule would be, to say the least, economically unsound.

At pages 15 and 17 of the Government's brief in the case at bar it is intimated that the rule should be different in cases of solvent taxpayers as compared with insolvent taxpayers. The Court of Claims rejected this contention (R. 15). Had it held otherwise a poor taxpayer would have been given a preference over a richer taxpayer who was identically situated. In determining if income is realized the nature of the transaction involved and not the solvency of the taxpayer controls.

V.

Taxable Corporate Income is the Gain or Increase Arising from Corporate Activities.

The decisions show that the income sought to be taxed was that gain or increase arising from corporate activities. The principle is expressed in *Doyle v. Mitchell Bros. Co.*, 247 U. S. 179, 185:

> "* * * Whatever difficulty there may be about a precise and scientific definition of 'income,' it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities * * *."

In the case at bar the corporate activities of the Kirby Lumber Company were the manufacture and sale of lumber. The income to be taxed, as defined by this Court, was the income from those activities,

and not transactions which affected only the capital structure of the taxpayer.

VI.

Transaction in Realty is Purchase by Taxpayer of Its Promise to Pay.

One way of looking at this case is that this taxpayer has, for a valid consideration, given its promise to pay certain money in 1938.

This promise was represented by negotiable bonds of various denominations. The taxpayer saw fit to purchase a portion of its promise to pay. The query is, therefore: Did the lumber company realize taxable gain by purchasing its promises to pay? There is no instance when gain or loss is realized by the purchase of anything. It is established that gain or loss is realized only by "the sale or other disposition" of property, and not by its purchase. If this Court holds otherwise it will mean that every "good bargain" will be taxable when the purchase is made. Aside from the administrative difficulties that would follow such a ruling it is obvious that it cannot be the law because there would be no "income derived from the property" as described in Eisner v. Macomber, *supra*.

In the event the Court holds that income can be realized by the taxpayer's purchase of its promise to pay there is serious doubt whether the taxpayer realized a gain by the said purchase. Hoskold and other mathematicians have devised tables which give the theoretical present value of money due at some time in the future. In the last analysis the only real value of a promise to pay is the price at which, in the judg-

ment of the market place, the promise brings. The purchasers of such promises take into consideration the hazards of the business and other factors which make the selling price the real value. This Court will go beyond the sphere of its proper function if it attempts to say that the value of a promise to pay is something different than the price which the said promise will bring on the market. In other words, despite any theories or any face value printed on the bonds here involved the fact is that they were worth only what the taxpayer paid for them, so no taxable gain could result from their purchase.

VII.

Government's Position is Unsound.

If the Government prevails in this case it will upset established practice and cause great confusion to business and in tax administration. To illustrate:

Suppose a corporation bought a factory for $150,000, paying $50,000 in cash and assuming a mortgage for $100,000. Before maturity the holders of the mortgage became in need of funds and accepted $90,000 in full settlement of the mortgage. Under the Government's theory the corporation realized a taxable gain of $10,000, although the true fact is that the factory cost but $140,000 and not $150,000. The next step in this theory probably would be that if the corporation sold the factory for $140,000 it would lose $10,000. The foregoing is just one example of the absurd results which will follow if the Government theory is adopted.

VIII.

Comment on Authorities Cited in Brief for the United States.

POINT 1.

As previously argued in this brief the transaction here sought to be faxed is the purchase and retirement of certain bonds. The issuance of the bonds is not involved, as that is a separate transaction on which gain or loss is separately computed.

In this case it is not the fact that the Respondent "had $137,521.30 where it had nothing before." The fact is that the Respondent had parted with $940,778.70 in cash and got in return nothing more than a book entry. No one knows if the bonds left outstanding will be paid at their face value. They are not due until 1938. By that time the Kirby Lumber Company may not have sufficient assets to pay the bonds at par. If it has not, the book entry showing this $137,521.30 certainly will be of no value to the Respondent or to any holder of bonds. As the record is silent on the fact as to whether the Respondent's promise to pay fifteen years hence was worth par in 1923 it cannot truthfully be said that the Respondent realized income from the transaction.

The best test of value is sales price so it must be assumed that the Respondent in this case paid only the actual value for the bonds purchased. That being true no income was realized.

The statement "Income may be realized from the gain resulting from fluctuations of corporate securities as well as from manual labor" is not true and no authorities can be supported to sustain it. The only time that income can be realized due to the fluc-

tuation in price of corporate securities is by their sale or conversion. Income cannot be realized by the purchase of corporate securities, which is the situation in the case at bar.

The "short selling" argument was vigorously advanced in the Kerbaugh-Empire case, *supra*, and definitely rejected. The Court states at page 175:

> "Plaintiff in error insists that in substance and effect the transaction was a 'short sale' of marks resulting in gain to defendant in error. But there is no similarity between what was done and such a venture. A short seller borrows what he sells, and the purchase price goes to the lender and is retained as security for repayment. The seller receives nothing until he repays the loan. Such a transaction would not meet the requirements of defendant in error. * * *"

POINT 2.

Admittedly the statute is comprehensive and covers income derived from "any source whatever." The statute, however, cannot tax something which is not income. As has been previously shown no income arose from the transaction here involved.

The argument with reference to the enactment of the revenue acts and the Commissioner's regulations is likewise without merit. The first of the cases decided on the point was filed with the Board of Tax Appeals April 9, 1925, argued June 18, 1925, and decided September 18, 1926. It is apparent, therefore, that Congress when enacting at least one of the statutes referred to was on notice that the tribunal established to review the acts of the Commissioner of Internal Revenue had decided against him on the

point here involved. By the time the Revenue Act of 1928 was passed at least six cases on the point had been decided. Failure of Congress to change the law might just as well be construed as approving the Board of Tax Appeals as the Commissioner. Weight is given to this suggestion by the fact that the Commissioner for years apparently acquiesced in the Board's decisions on the point as no appeal was taken to Circuit Courts until December 19, 1930. In any event, if no income was realized the mere reenactment of a revenue statute will not make income.

Likewise if the transaction did not result in income the reenactment of regulations will not make it income.

The citations from authors on accounting to support the Government's argument that the regulation is in accord with common understanding and business practice actually tend to support the Respondent's position. Appendix B (page 23 Government's brief) quotes Gilman as stating:

> "Assuming that a reserve has been built up for the purpose of buying back bonds at 105 you will find that each purchase in the market at a less price will result in a profit which may very properly be credited to the interest account."

It is obvious that the reserve referred to had been built up by a charge to expense. It developed that too much expense had been so deducted from income in order to accomplish the purpose of the reserve. As too large an expense item had been deducted it is quite proper that the overdeduction be charged to profit. Apparently Dickinson had the same thought in mind.

It is thoroughly settled by accounting authorities that the purchase, at more or less than par, and retirement of bonds by the corporation issuing them is a capital transaction. The difference between the purchase price and par must be charged to surplus, and not profit and loss. H. A. Finney, Professor of Accounting, Northwestern University, Editor of the Students' Department of the Journal of Accountancy, and manager of Haskins & Sells, Chicago, in his revised edition (1929) of "Principles of Accounting," Volume II, Chapter 46, page 13, states:

> "If they (bonds) are purchased at more or less than par and cancelled, the difference should be absorbed in Surplus. * * *"

POINT 3.

The authorities cited in the Government's brief do not "tend to support the Government's position."

In *Maryland Casualty Co. v. United States*, 251 U. S. 342, the casualty company in 1912 apparently overestimated the reserves to be set aside "with a resulting excessive deduction for that year from gross income * * *." (Page 352.) The money had actually been received by the taxpayer as premiums, so, in 1913, when the excess deduction for 1912 was discovered the Government quite properly held it was income in 1913. Even in this case of plain income, the Court showed that it sought to tax only real income and not mere bookkeeping entries, stating (page 353):

> "* * * Such deductions can be restored to income again only where it is clearly shown that

> subsequent business conditions have released the amount of them to the free beneficial use of the company in a real, and not in a mere bookkeeping sense. * * *"

In other words, as in the case at bar, if the only profit was a bookkeeping entry there was no income.

Commissioner v. Simmons Gin Co., 43 Fed. (2d) 327, is one of the many cancellation of indebtedness cases. The Court held that the cancellation of the taxpayer's indebtedness did not result in income. The dicta wherein the Court "intimated" that the solvency of the taxpayer might affect the result is of no importance. It is interesting to note that in the Simmons Gin Company case the Government relied, unsuccessfully, upon Maryland Casualty Co. v. United States, which is the first case cited under Point 3 in the case at bar.

Charleston & W. C. Ry. Co. v. Burnet, 50 Fed. (2d) 342, is very similar to the Maryland Casualty Company case. In the Charleston Ry. Co. case the taxpayer believed it would have to pay certain wages which it believed employees had earned so set aside the said wages in a reserve account and deducted them from income. When it became apparent the wages would not be called for the amount thereof was credited to profit and loss. The real transaction is that the railway paid the then due wages to itself as trustee, found that they were not claimed so used them for its own purposes. In other words, the railway had erroneously charged itself with an expense which it was not obligated to pay. Clearly this is vastly different from the situation at bar where there could be no liability to pay until 1938, and, of course, no prior deduction from income.

Chicago R. I. & P. Ry. Co. v. Commissioner, 47 Fed. (2d) 990, presents the same situation as the case just discussed. The taxpayer deducted from income certain expense which it was not obligated to pay. The deduction should not have been taken, so its taxation was proper.

The argument on the Kerbaugh-Empire case is without merit as it does not discuss the vital point, *i. e.,* the question for decision which this Court stated to be (page 173):

> "The question for decision is whether the difference between the value of marks measured by dollars at the time of payment to the Custodian and the value when the loans were made was income."

CONCLUSION.

For the reasons stated the decision of the Court of Claims should be affirmed.

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