BRIEF FOR THE UNITED STATES

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No. [illegible]

In the Supreme Court of the United States

October Term, 19[illegible]

The United States, Petitioner,

[illegible]

On Writ of Certiorari to [illegible]

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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 THE UNITED STATES

OPINION BELOW

The opinion of the Court of Claims (R. 13) is reported in 44 F. (2d) 885.

JURISDICTION

The judgment of the Court of Claims was entered December 1, 1930. (R. 15.) The petition for a writ of certiorari was filed February 28, 1931, and the writ was granted April 20, 1931. (R. 16.) The jurisdiction of this Court rests on Section [illegible] the Act of February 13, 1925.

QUESTION PRESENTED

Whether a corporation which sells its own bonds for par, and during the same year purchases some of the same bonds for less than par and retires them, thereby realizes a taxable gain amounting to the difference between the par value and the purchase price, under the Revenue Act of 1921.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in Appendix A, *infra* pp. 20–22.

STATEMENT

The Kirby Lumber Company, a Texas corporation, on July 16, 1923, mortgaged its property to secure the payment of certain bonds, $12,126,800 par value of which were issued by it on that date. (Finding 1, 4; R. 11, 12.) The Kirby Lumber Company received the par value of the bonds issued [1] without incurring expense incident to this issue. (Finding 7, R. 12.)

[1] The Court of Claims adopted the stipulation of counsel in its findings of fact and found (Finding 7, R. 12) that the bonds "were issued at par, the Kirby Lumber Company receiving the par value of the bonds issued." Counsel for the respondent now states (Brief in Opposition, p. 9) that the bonds were issued with cash to preferred stockholders in order to retire the preferred stock and pay the dividends due upon it. The Government maintains that this does not alter the legal effect of the transaction so far as the present question is concerned. In any case, the Lumber Company received valuable consideration equal to the par value of the bonds. Upon issuing them, its assets and liabilities were increased in equal amounts.

During the same year, 1923, the Lumber Company purchased and retired bonds of this issue aggregating $1,078,300 par value for $940,778.70, or $137,521.30 less than the amount which the Company received for the same bonds in that year. (Finding 5, R. 12.)

On March 13, 1924, the Lumber Company filed its income tax return for the calendar year 1923, disclosing a tax liability of $188,062.24. (Finding 2, R. 12.) Included in this return was $124,446.45 of the above sum of $137,521.30. (Finding 6, R. 12.) Thereafter, on February 16, 1928, the Commissioner of Internal Revenue made an additional assessment for 1923 of $8,047.05. (Finding 3, R. 12.) In making this assessment the Commissioner included, as subject to tax, the additional sum of $13,074.85, being the difference between $137,521.30 and $124,446.45. (Finding 6, R. 12.) There was thus included in the respondent's taxable income for 1923 the entire sum of $137,521.30, representing the difference between the price at which the bonds were issued and the price at which the same bonds were repurchased by the taxpayer in 1923. (Finding 6, R. 12.) A tax of $17,188.99 was imposed on this item.

A claim for refund of $17,188.99 was duly filed on the ground that the sum of $137,521.30 was not taxable gain to the Kirby Lumber Company. (Finding 8, R. 12.) This claim was rejected (Finding 9, R. 12) and thereupon the respondent brought suit in the Court of Claims. That court held that the respondent was entitled to recover the sum of $17,188.99, with interest. (R. 12, 13.)

SPECIFICATION OF ERRORS

1. The Court of Claims erred in holding that the gain resulting from the sale and retirement of the respondent's bonds was not taxable as income.
2. The Court of Claims erred in giving judgment for the respondent.

SUMMARY OF ARGUMENT

I

The retirement of the bonds at less than the issuing price produced income for the respondent. The whole transaction in 1923, so far as the retired bonds are concerned, increased the respondent's assets by $137,521.30. We submit that this was income within the meaning of the Revenue Act.

This financing strengthened the respondent's fiscal position. It had $137,521.30 where it had nothing before. The transaction caused an increase during the taxable year 1923 in the respondent's net worth. Clearly this was a transaction which resulted in a profit since within the taxable year and by virtue of the issue of its bonds at par and their repurchase at a discount the taxpayer received property worth $137,521.30 more than it paid for it.

The gain realized from this transaction is similar to that obtained by skillful or fortunate manipulation of corporate securities in "short selling." Income from this source has been uniformly taxed under the various Revenue Acts since the adoption of the Sixteenth Amendment. The taxability of such income has never been questioned. We submit that the transaction in the present case, similar in many respects, gave rise to income to the respondent.

II

The statute is comprehensive and the regulations expressly provide that this income is taxable. Section 213 of the Revenue Act of 1921 includes in gross income " gains or profits and income derived from any source whatever." We submit that the gain which the respondent received is taxable under the plain and comprehensive language of the statute. But the Government's position does not depend alone upon the general language of the statute. Article 45 of Regulations 62 specifically provides that the gain derived from a transaction such as the one here in question shall be included as taxable income.

This regulation has been in force without change for over twelve years. During this period Congress has four times reenacted the statute on which it is based. This reenactment in the face of consistent administrative construction amounts to a legislative recognition and approval of the statute as so construed. We submit that this fact alone is sufficient to require the decision of the present issue in favor of the United States.

III

The authorities tend to support the Government's position. The only court decision dealing directly with this question is that of the Court of Claims in the instant case. But the reasoning and dicta of other analogous decisions lend support to the Government's view that a taxable gain was realized.

The Court of Claims held that there was a gain to the taxpayer in the transaction under consideration, but that the question of the taxability of this gain was concluded against the Government by the decision of this Court in *Bowers* v. *Kerbaugh-Empire Co.,* 271 U. S. 170. But this case differs materially from the *Kerbaugh-Empire* case: Here by the repurchase of the bonds at a discount during the taxable year in which they were issued a gain resulted from the entire transaction, whereas in the *Kerbaugh-Empire* case the transaction extending over several years resulted in a loss which was merely reduced by exchange transactions within the taxable year.

The bonds of the Kirby Lumber Company were retired for cash. The cost of retiring them was $137,521.30 less than the value received by the company upon their issuance. This sum became "free assets" of the company and, we submit, was taxable income to it.

ARGUMENT

I

THE RETIREMENT OF THE BONDS AT LESS THAN THE ISSUING PRICE PRODUCED INCOME FOR THE RESPONDENT

In July, 1923, the respondent issued bonds secured by a mortgage on various of its properties of the par value of $12,126,800. This bond issue increased the respondent's assets and liabilities in equal amounts, for the Court of Claims found that the respondent received "the par value of the bonds issued." (R. 12.) Later in the same year the respondent retired some of these same bonds at less than par. Bonds of the par value of $1,078,300 were purchased by the respondent for $940,778.70 and canceled. This retirement decreased the respondent's liabilities by $1,078,300 with a corresponding decrease of its assets of only $940,778.70. The whole transaction in 1923, so far as the retired bonds are concerned, increased the respondent's assets by $137,521.30. We submit that this was income within the meaning of the Revenue Act.

This financing strengthened the respondent's fiscal position. It had $137,521.30 where it had nothing before. One of the results of the retirement was to reduce the amount of the mortgage lien that was security for the bonds. By the purchase at less than par value of the retired bonds the respondent actually received and enjoyed a net gain of the amount of the discount. The obligation of the bonds for which it received par value was liquidated by the return of less than the amount received. The transaction caused an increase during the taxable year 1923 in the respondent's net worth.

Income connotes the receipt of some tangible profit, a gain separated from the transaction which gave rise to it. The word is not used in the Revenue Acts with any intent to exclude the result of good fortune and the skill with which corporate officers in borrowing money take advantage of economic and financial conditions. Income may be realized from the gain resulting from fluctuations of corporate securities as well as from manual labor.

It is an apparent and reasonable conclusion that the respondent received a *gain* by issuing and retiring these bonds. The contract between the respondent and its bondholders was the result of negotiations involving the taxpayer's labor, business acumen, and judgment, as well as the use of its capital. The gain, that is, the increase in the company's net worth, was derived from labor or capital or both combined. The net worth of the corporation was increased as the result of the completed transaction, not because it was bound to do so by an existing obligation, but because it was advantageous to the corporation so to do. This new

and independent transaction of the retirement of the bonds was accomplished for the purpose of making a profit by the prepayment of a debt—for the purpose of realizing a gain which was the outgrowth, not of an increment in the value of property previously acquired but of changed economic conditions, which made the company's promise to pay now less valuable to the obligee although it was equally onerous on the obligor. Clearly this was a transaction which resulted in a profit since within the taxable year and by virtue of the issue of its bonds at par and their repurchase at a discount the taxpayer received property worth $137,521.30 more than it paid for it.

The gain realized by the respondent from this transaction is similar to that realized by skillful or fortunate manipulation of corporate securities in "short selling." Income from this source has been uniformly taxed under the various Revenue Acts since the adoption of the Sixteenth Amendment. The "borrower" in short selling, like the respondent in the instant case, increases his liabilities and by skillful or fortunate handling of the sums so obtained makes a clear profit when later he pays off his obligations and liquidates these newly acquired liabilities.

In the instant case the respondent's contractual obligation was to meet the newly issued bonds. By retiring them it liquidated that liability for less than it had received on assuming it and so realized a clear gain. That taxable income is received in the case of a short sale upon the close of the transaction has been settled for years (see 1 Cumulative Bulletin (April–December, 1919) p. 60), and has never been seriously questioned. We submit that the transaction in the instant case, similar in many respects, gave rise to income to the respondent.

II

THE STATUTE IS COMPREHENSIVE, AND THE REGULATIONS EXPRESSLY PROVIDE THAT THIS INCOME IS TAXABLE

The Revenue Act of 1921 imposed an income tax upon the "net income of every corporation" and defined "net income" as being gross income less certain deductions not material in this case. Section 213 of that Act defined gross income as follows:

> That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—
>
> (a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

The statute thus plainly makes taxable "gains or profits and income derived from any source whatever." It is clear that the respondent did derive a gain from the transaction now under consideration, and we submit that this gain is taxable under the plain and comprehensive language of the statute. But the Government's position does not depend alone upon the general language of the statute. By Section 1303 of the Revenue Act of 1921, authority was expressly granted to the Commissioner of Internal Revenue to issue regulations with the approval of the Secretary of the Treasury. In accordance with this authority, Regulations 62 were duly promulgated on February 15, 1922. Section 1 of Article 545 of these regulations reads as follows:

> ART. 545. *Sale and retirement of corporate bonds.* (1) (*a*) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (*b*) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. See section 234 of the statute and article 563. (*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face

value over the purchase price is gain or income for the taxable year.[2]

This regulation under the 1921 Act is in identically the same language as that of Article 544 of Regulations 45, promulgated April 17, 1919, under the provisions of the Revenue Act of 1918. This article incorporated the previous practice, although the earlier regulations did not deal fully with the question.[3] And the same regulation has continued without change under each of the revenue acts enacted since 1921. Article 545 of Regulations 65, promulgated October 6, 1924, under the Revenue Act of 1924; Article 545 of Regulations 69, promulgated August 28, 1926, under the Revenue Act of 1926; Article 68 of Regulations 74, promulgated February 15, 1929, under the Revenue Act of 1928.

It consequently appears that for at least twelve years there has been a formal regulation specifically requiring that the gain from such a transaction as that now in question shall be included in gross income. This regulation deals with the matter specifically and reasonably. It is of long standing and has been consistently applied. The regulation is in accord with common understanding and business practice.[4] Such a regulation should not be overturned unless it is clearly contrary to law.

[2] Sections 2 and 3 of Article 545 (set out in full in Appendix A, *infra*, pp. 20–22) deal comprehensively with the issuance of bonds at a premium or at a discount and their later repurchase at either a gain or loss.

[3] See Article 135 of Regulations 33, promulgated January 5, 1914, under the Revenue Act of 1913, and Article 150, par. 464, of Regulations 33 (revised), promulgated January 2, 1918, under the Revenue Act of 1916.

Since this regulation was first promulgated in its present form Congress has four times reenacted the statute on which it is based. The reenactment of this statute in 1921, 1924, 1926, and 1928, in the face of the consistent administrative construction amounts to a legislative recognition and approval of the statute as so construed. *National Lead Co.* v. *United States*, 252 U. S. 140; *Brewster* v. *Gage*, 280 U. S. 327, 336; *Universal Battery Co.* v. *United States*, 281 U. S. 580; *Fawcus Machine Co.* v. *United States*, 282 U. S. 375, 378; *McCaughn* v. *Hershey Chocolate Co.*, 283 U. S. 488.

We submit that this fact alone is sufficient to require the decision of the present issue in favor of the United States.

III

THE AUTHORITIES TEND TO SUPPORT THE GOVERNMENT'S POSITION

The only court decision dealing directly with this question is that of the Court of Claims in the instant case. The reasoning and dicta in certain analogous cases lend support to the Government's view that a taxable gain was realized.

In *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 351–352, it was said, although not necessary to the decision, that if certain reserves set aside in 1912 were excessive and were released to

[4] Excerpts from authorities on accounting are quoted in Appendix B, *infra*, pp. 23–24.

the general use of the company and increased its free assets in 1913 then the amount of such excess released to the general uses of the company should be treated as income in the year 1913, and taxed accordingly. This Court said:

> Reserves, as we have seen, are funds set apart as a liability in the accounts of a company to provide for the payment or reinsurance of specific contingent liabilities. * * * The amount "reserved" in any given year may be greater than is necessary for the required purposes, * * *. If, in this case, it were due to an overestimate of reserves for 1912 with a resulting excessive deduction for that year from gross income and if such excess was released to the general uses of the company and increased its free assets in 1913, to that extent it should very properly be treated as income in the year in which it became so available, for the reason that in that year, for the first time, it became free income, under the system for determining net income provided by the statute, and the fact that it came into the possession of the company in an earlier year in which it could be used only in a special manner, which permitted it to become nontaxable would not prevent its being considered as received in 1913 for the purposes of taxation, within the meaning of the act.

In *Commissioner* v. *Simmons Gin Co.*, 43 F. (2d) 327 (C. C. A. 10th), it was held that cancellation by creditors of indebtedness of an *insolvent*

corporation was not taxable income to the debtor corporation. The court intimated that had the corporation been solvent so that the release of the liability would have set free assets, the transaction might have resulted in a taxable gain.

In *Charleston & W. C. Ry. Co.* v. *Burnet*, 50 F. (2d) 342 (App. D. C.), it was held that unpaid wages, carried in a suspense account awaiting demand of the employee, are to be treated as income in the year in which they are charged to profit and loss on the assumption that they will never be claimed. The same point was similarly decided in *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. (2d) 990 (C. C. A. 7th). It was also held in this latter case that where outstanding bonds are retired by an issuance of stock, in the absence of a showing that the stock was worth more than the bonds there is no deductible loss. The court in discussing the problem recognized that if the bonds, which had been issued below par, had been retired at par a loss would have been realized, and conversely that had the bonds been bought in at less than the issuing price a taxable gain would have resulted.

The Court of Claims, in its decision in the present case, held that there was a gain to the taxpayer in the transaction under consideration, but that the question of the taxability of that gain was concluded against the Government by the decision of this Court in *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170.[6] It said (R. 15):

> We think the decision in the Kerbaugh-Empire case fully sustains the contentions of plaintiff in the instant case that the excess of the issuing price of its bonds over the purchasing price of such of its bonds as it purchased subsequent to issue, is not taxable as income, and that the taxes herein were erroneously assessed and collected.

Since that view of the *Kerbaugh-Empire* case was expressed there has been an authoritative definition of its holding. In the case of *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, this Court said (p. 364):

> In that case [*Bowers* v. *Kerbaugh-Empire Co.*] the taxpayer, which had lost, in business, borrowed money, which was to be repaid in German marks, and which was later repaid in depreciated currency, had neither made a profit on the transaction, nor received any money or property which could have been made subject to the tax.

[6] The Board of Tax Appeals in a number of cases has reached the same conclusion by the same process of reasoning. See *Appeal of Independent Brewing Company*, 4 B. T. A. 870; *Appeal of New Orleans, Texas and Mexico Ry Co.*, 6 B. T. A. 436; *Houston Belt & Terminal Railway Company* v. *Commissioner*, 6 B. T. A. 1364; *Indianapolis Street Railway Company* v. *Commissioner*, 7 B. T. A. 397; *National Sugar Manufacturing Co.* v. *Commissioner*, 7 B. T. A. 577, note dissenting opinion; *Petaluma & Santa Rosa Railroad Co.* v. *Commissioner*, 11 B. T. A. 541; *General Manifold & Printing Co.* v. *Commissioner*, 12 B. T. A. 436; *Douglas County Light & Water Co.* v. *Commissioner*, 14 B. T. A. 1052, reversed on another issue, 43 F. (2d) 904 (C. C. A., 9th); *John F. Campbell Co.* v. *Commissioner*, 15 B. T. A. 458, affirmed on another issue (App. D. C.), May 4, 1931.

That the Court of Claims in its decision in the instant case did not so understand the *Kerbaugh-Empire* case seems indicated by its statement that (R. 15)—

> In our opinion the question whether the person engaging in such transaction is solvent or insolvent, or whether he made a profit or suffered a loss through the use of the money for which the obligations were issued is wholly immaterial.

The Government urges that the fact that the Kirby Lumber Company made a gain where the Kerbaugh-Empire Company suffered a loss, is highly material.

In addition to the presence here of an express Treasury regulation fully covering the situation, which was not present in the *Kerbaugh-Empire* case, the case at bar differs from that case in this outstanding feature:

Here by the repurchase of the bonds at a discount during the taxable year in which they were issued a gain resulted from the entire transaction, whereas in the *Kerbaugh-Empire* case the transaction, extending over several years, resulted in a loss which was merely reduced by exchange transactions within the taxable year.

The importance of these differences appears when it is considered that in the *Kerbaugh-Empire* case this Court pointed out (p. 175):

> 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. * * * The result of the whole transaction was a loss.

There was but one transaction involved in that case: the borrowing of money prior to July 2, 1913, its loss before 1921, and its repayment according to the tenor of the original contract. This Court described that transaction as follows (p. 175):

> When the loans were made and notes given, the assets and liabilities of defendant in error were increased alike. The loss of the money borrowed wiped out the increase of assets, but the liability remained. The assets were further diminished by payment of the debt. The loss was less than it would have been if marks had not declined in value; but the mere diminution of loss is not gain, profit, or income.

In the instant case the transaction resulting in the gain taxed can not be so described. It is, of course, true that under the original undertaking, *i. e.,* the issuance of the bonds, the assets and liabilities were increased alike, so that no gain or loss then resulted. It is also true that this original undertaking contemplated that the closing of the transaction, *i. e.,* the payment of the bonds at maturity, would eliminate the increase of the assets at the time the liability was extinguished. But that contemplated result did not occur. Nor did any intervening cause diminish the assets leaving the liability. Upon the repurchase of the bonds the liability was wiped out without an equivalent elimination of the earlier increase in the assets.

The bonds of the Kirby Lumber Company were retired for cash. No further capital liability of uncertain value such as a stock issue was incurred in order to cancel the bonds. The cost of retiring them was $137,521.30 less than the value received by the company upon their issuance. This sum became "free assets" of the company and, we submit, was taxable income to it.

CONCLUSION

The decision of the court below is erroneous and should be reversed.

Respectfully submitted.

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OCTOBER, 1931.

APPENDIX A

STATUTES AND REGULATIONS INVOLVED

The Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 254, provides in part:

> SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—
>
> (a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
>
> SEC. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in sections 213 * * *.

Article 545 of Regulations 62, promulgated February 15, 1922, under the Revenue Act of 1921, provides:

> ART. 545. *Sale and retirement of corporate bonds.*—(1) (*a*) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (*b*) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. See section 234 of the statute and article 563. (*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.
>
> (2) (*a*) If bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. (*b*) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price minus any amount of premium already returned as income, the excess of the purchase price over the issuing price minus any amount of premium already returned as income (or over the face value plus any amount of premium not yet returned as income) is a deductible expense for the taxable year. (*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price minus any amount of premium already returned as income, the excess of the issuing price minus any amount of premium already returned as income (or of the face value plus any amount of premium not yet returned as income) over the purchase price is gain or income for the taxable year.
>
> (3) (*a*) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds.

(*b*) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. (*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted) over the purchase price is gain or income for the taxable year.

APPENDIX B

EXTRACTS FROM AUTHORS ON ACCOUNTING

I

Gilman, Principles of Accounting, 1916, at pages 209 and 210.

Thus a twenty-year $1,000 bond may contain the provision that it is redeemable or callable in ten years at 105. This means that the holder of the bond must surrender it for $1,050.00 at any time after ten years if he is called upon to do so. If, however, the corporation can buy its own bonds in the open market **for less than $1,050.00**, it will do so. **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**.

II

Dickinson, Accounting Practice & Procedure, 1918, at page 137:

The first and most correct method * * * the effective interest method, * * *. For instance, if the conditions of the issue provided that $100,000 of bonds be retired during the year at 105, and as a matter of fact they are purchased at 95, the true interest on the bonds bearing interest during the year would be reduced by $10,000, representing the saving on bonds retired during the year as compared with the price therefor assumed in determining the effective rate.

The second and more common method, which may be called the equal installment method, is to ignore altogether the effective interest rate; to charge to income account each year the interest actually paid, together with a proportionate part, according to the whole term of issue, of the discount on issue or premium on redemption; Income account being also credited with any savings made by purchase of bonds in the market.

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