BRIEF FOR RESPONDENT, GLENSHAW GLASS COMPANY.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1954.

No. 199

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

GLENSHAW GLASS COMPANY,
Respondent.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

WILLIAM GOLDMAN THEATRES, INC.,
Respondent.

**BRIEF FOR RESPONDENT,
GLENSHAW GLASS COMPANY.**

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Statement of the Case.

The taxpayer, Glenshaw Glass Company (Glenshaw), is a small manufacturer of glass bottles, with a plant located near Pittsburgh, Pennsylvania. For twenty years it experienced a struggle, in business and litigation, to free itself from a monopolistic and fraudulent patent yoke that Hartford-Empire Company (Hartford) and the dominant glass bottle manufacturers had fastened upon the industry.

On December 15, 1947 Hartford made a settlement payment to Glenshaw of some $813,000. This brought to a close the prolonged litigation in the course of which Glenshaw had been victimized by gross fraud practiced upon both the Patent Office and the Federal courts. By an injunction obtained through fraud in 1934, Hartford had effectively barred Glenshaw from using the royalty-free Glenshaw glass feeding machines. Under the whip of that injunction, Glenshaw was compelled to return to Hartford licenses, to submit to exorbitant royalties and to accept onerous restrictions upon the type and quantity of glass containers it could produce. Relief was ultimately obtained through action by this Court.[1]

The nature of the fraud, which gave rise to the punitive damage payment under scrutiny in this case, was described by this Court as follows:

> "Every element of the fraud here disclosed demands the exercise of the historic power of equity to set aside fraudulently begotten judgments. This is not simply a case of a judgment obtained with the aid of a witness who, on the basis of after-discovered evidence, is believed possibly to have been guilty of perjury. Here, even if we consider nothing but Hartford's sworn admissions, we find a deliberately planned and carefully executed scheme to defraud not only the Patent Office but the Circuit Court of Appeals." (322 U.S. at 245-6)

In requiring that, apart from compensatory damages, Glenshaw be awarded substantial punitive damages by reason of this fraud, the Court of Appeals for the Third Circuit said:

> "The seriousness, the long duration and the aggravated character of the fraud which has necessitated this litigation is set forth in the cited opinions of the Supreme Court. In those circumstances, the trial court has power to inflict such damages, 'having in view the enormity of * * * [the] offense rather than the measure of compensation. * * *' *Denver & Rio Grande Ry.* v. *Harris*, 122 U.S. 597, 609."[2]

[1] *Shawkee Manufacturing Co.* v. *Hartford Empire Co.*, 322 U.S. 271 (1944) and *Hazel-Atlas Glass Co.* v. *Hartford-Empire Company*, 322 U.S. 238 (1944).

The Court of Appeals then directed the District Court to assess punitive damages "taking into consideration the whole wretched scheme." By reason of that opinion, Hartford made its settlement, and the Tax Court determined that, of the amount paid, $324,529.95 was attributable to punitive damages and represented neither replacement of property nor compensation for lost profits or expense. The allocation was accepted by the petitioner in the court below and is not in issue here.

The Tax Court held that so much of the settlement as was equated with compensatory damages was subject to tax as ordinary income and that the payment in lieu of punitive damages did not constitute taxable income under the income tax provisions of the Internal Revenue Code.[3]

The Court of Appeals for the Third Circuit heard this case and the companion *Goldman* case, *en banc*. In a unanimous opinion written by Chief Judge Biggs, the decision of the Tax Court was affirmed.[4]

[2] *Hartford-Empire Co.* v. *Shawkee Mfg. Co.*, 163 F. 2d 474, 480 (3rd Cir., 1947).

[3] *Glenshaw Glass Co.* v. *Commissioner*, 18 T.C. 860 (1952), (R. 7-20).

[4] *Commissioner* v. *Glenshaw Glass Co.*, 211 F. 2d 928 (1954), (R. 31-7).

Summary of Argument.

The constitutional power of the Congress to tax penalties and punitive damages is not challenged. The issue is whether such awards constitute income as contemplated by the taxing statute.

We read the income tax statute as providing for a levy upon receipts which, in ordinary usage, are regarded as income. That is what this Court said in *Eisner* v. *Macomber* and in every decision touching the subject since then. The primary characteristic of income, as ordinarily understood, is that it is a profit or compensation derived from investment or labor. This generic concept has broad implications, and we do not by its statement suggest any rigidity of application. But this Court has never departed from that generic concept, and the Congress has repeatedly enacted new and revised income tax statutes in the light of such judicial construction. The new Code adopted in 1954 is particularly instructive on the legislative acceptance of that concept of income.

Punitive damages represent a penalty imposed upon a wrongdoer as a matter of law but paid to the victim rather than to the public treasury. They stand apart from compensatory awards which are designed to make good actual losses of profit or property. They are in the nature of a windfall rather than a yield upon labor or capital and accordingly fall outside the commonly accepted concept of income.

Petitioner sees the statute not as a tax on income but as an excise tax on "gains". The latter term is lifted out of context in the statutory definition, to which the Congress has adhered for a quarter of a century fully aware of the ordinary notion of income adopted by the courts. The contention—never made in either of the

courts below—that the statute imposes not a tax on income but an excise tax on "gains" has neither statutory nor judicial support. Nor do any of the cases sustain the argument that the basic concept of income of *Eisner v. Macomber* has been discarded.

The rule that punitive damages do not constitute taxable income has prevailed since 1935. The principles upon which the rule was predicated have continued vitality. Any change in a rule of such long duration should be left to the Congress, which has shown a constant alertness to the amendment of the Code whenever it found itself differing with judicial construction. The emotional argument that the recipient of a windfall is best able to pay an income tax should be addressed to the Congress and not to the courts.

Argument.

I. Punitive Damages Do Not Constitute Taxable Income Under Section 22(a) of the Internal Revenue Code of 1939.

The answer to this case is to be found in the nature and distinguishing characteristics of punitive damages on one hand and the historical concept of income as developed by the courts and the Congress on the other. We do not urge, nor did the Court below adopt, any narrow, wooden adherence to language either in the statute or in any reported decision.

We take the statutory levy for what it is—an income tax. The petitioner insists that it is an excise tax upon all "gains", and accordingly the normal concept of income is of no concern. This effort to expand the tax so as to reach "any increase in resources"[5] runs counter to a half a century of decisions that income must be given its ordinary meaning.

A. *Historical concept of income.*

Following the adoption of the Sixteenth Amendment, the Congress enacted the income tax provisions of the Tariff Act of October 3, 1913. (c. 16, 38 Stat. 114, 167) The definition of taxable income in that statute, which has been carried forward without substantial change into the Internal Revenue Code of 1939, was as follows:

> "That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation

[5] Pet. Br. 15.

> for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, * * *"

This Court had occasion to consider the meaning of the term "income" as used in the 1913 statute in *Southern Pacific Co. v. Lowe*, 247 U.S. 330, 335 (1918). In holding that dividends declared out of pre-1913 earnings did not constitute taxable income to the recipient, the Court rejected "the broad contention submitted in behalf of the Government that all receipts—everything that comes in—are income within the proper definition of the term 'gross income.'"

It was against this background that *Eisner* v. *Macomber*, 252 U.S. 189 (1920), was decided. The statute under review was the Revenue Act of 1916 which followed the definition of net income in the 1913 Act with the addition of express inclusion of stock dividends. In reaching the conclusion that the particular stock dividends did not give rise to the realization of taxable income within the meaning of the Sixteenth Amendment, the Court carefully re-examined the concept of income:

> "For the present purpose we require only a clear definition of the term 'income' as used in common speech, in order to determine its meaning in the Amendment; and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue.
>
> "After examining dictionaries in common use (Bouv. L.D.; Standard Dict.; Webster's Internat. Dict.; Century Dict.), we find little to add to the

succinct definition adopted in two cases arising under the Corporation Tax Act of 1909 (*Stratton's Independence* v. *Howbert*, 231 U.S. 399, 415; *Doyle* v. *Mitchell Bros. Co.*, 247 U.S. 179, 185)—'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle* Case (pp. 183, 185)." (at 206-7) (Emphasis supplied.)

In enacting the Revenue Act of 1921 the Congress took note of *Eisner* v. *Macomber*, attributing to that decision the determination to remove from the Act the provision to tax stock dividends.[6] Cognizant of the basic concept of income developed by this Court, the Congress made no change in the statutory definition. Significantly enough, the Congress has never in more than twenty extensive revisions of the income tax law sought to expand the meaning of income beyond the everyday notion adopted by this Court.

The Internal Revenue Code of 1954, adopted after the decisions by the courts below, shows no intent to reach punitive damages either by an express provision or otherwise.[7]

No decision of this Court inconsistent with *Eisner* v. *Macomber* can be cited. On the contrary, that expression of the characteristic attributes of income subject to tax has been approved or applied by this Court on frequent occasions. *Merchants' Loan & Trust*

[6] H. Rep. No. 350 and S. Rep. No. 275, 67th Cong., 1st Sess. (1921).

[7] The revision, designed by the Congress to clarify and not to change the meaning of "gross income", effectively answers the petitioner's contention that all gains are income. See *infra*, pp. 14-15.

Co. v. *Smietanka*, 255 U. S. 509, 519 (1921); *Goodrich* v. *Edwards*, 255 U. S. 527 (1921); *U. S.* v. *Phellis*, 257 U. S. 156 (1921); *Weiss* v. *Stearn*, 265 U. S. 242 (1924); *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170, 174 (1926); *Taft* v. *Bowers*, 278 U. S. 470 (1929); *U. S.* v. *Safety Car Heating & Lighting Co.*, 297 U. S. 88, 99 (1936); *Commissioner* v. *Culbertson*, 337 U. S. 733, 740 (1949).[8]

The meaning of income, this Court thought in *Eisner* v. *Macomber*, was to be derived from ordinary usage. The very next year, this Court repeated its refusal "to enter into the refinements of lexicographers or economists" and turned instead to "the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution."[9]

The precise definition of *Eisner* v. *Macomber* was repeated in *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170, 174 (1926). Finding a discussion of judicial definitions unnecessary, Justice Holmes held in 1931 that the difference between the amount which a corporation received when it issued its bonds and the price it paid when it repurchased them constituted income "if we take words in their plain popular meaning, as they should be taken here".[10] Similarly, in *United States* v. *Safety Car Heating & Lighting Co.*, 297 U. S. 88, 99 (1936), this Court said that the term "income" should be given the meaning "as the word is known in the common speech of men."

[8] In *Helvering* v. *Griffiths*, 318 U.S. 371 (1943), this Court expressly refused to overrule *Eisner* v. *Macomber*.

[9] *Merchants' Loan & Trust Co.* v. *Smietanka*, 255 U.S. 509, 519 (1921).

[10] *U. S.* v. *Kirby Lumber Co.*, 284 U.S. 1, 3 (1931).

As recently as 1949, the *Eisner* v. *Macomber* test of income was expressly applied in determining whether members of a family had received taxable income under a family partnership agreement. In *Commissioner* v. *Culbertson*, 337 U. S. 733 (1939), the Court cited *Eisner* v. *Macomber*, saying:

> "Furthermore, our decision in *Commissioner* v. *Tower, supra*, clearly indicates the importance of participation in the business by the partners during the tax year. We there said that a partnership is created 'when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses.' *Id.* at 286. This is, after all, but the application of an often iterated definition of income—the gain derived from capital, from labor, or from both combined—to a particular form of business organization. A partnership is, in other words, an organization for the production of income to which each partner contributes one or both of the ingredients of income—capital or services." (at 740) (Emphasis supplied)

There has thus been consistent judicial and legislative acceptance of the basic concept of income. Both avenues lead to the conclusion that gross income subject to tax by Section 22(a) does not extend to "every increase in resources" as petitioner has found it necessary to insist.[11]

[11] Since 1922, the Treasury Regulations, in defining gross income, have consistently incorporated the historic definition of *Eisner* v. *Macomber*. U. S. Treas. Regs. 62, Art. 31 and U. S. Treas. Regs. 111, Sec. 29.22(a)-1. The broad language used to define income elsewhere in the Regulations was apparently regarded as inadequate to express the content of the term "gross income" without further clarification and specificity.

B. *Nature of punitive damages.*

Punitive damages have been designed by the courts as a penal sanction to deter wrongdoers. In effect a fine is imposed, but by the grace of the sovereign, payment is made to the injured party rather than to the public treasury. The same policy has been adopted by legislative practice with respect to anti-trust and other penalties.

As this Court put it in the early case of *Lake Shore & Michigan Southern Railway Co.* v. *Prentice*, 147 U. S. 101, 107 (1893), punitive damages are an award "not by way of compensation to the sufferer, but by way of punishment of the offender, and as a warning to others." The Pennsylvania law under which the punitive damage payment to Glenshaw was made is similarly stated in *Thompson* v. *Swank*, 176 Atl. 211 (Pa., 1934):

> "Where the injurious act is willful, malicious, or wanton, the jury, according to the malignity shown, without bias or feeling, may award a reasonable sum in vindication of the rights of the injured party as exemplary or punitive damages. By so doing they tend to prevent the wrongdoer and others from committing similar acts." (at 211)

While the extent of the harm may be taken into account in determining the magnitude of punitive damages, it is not essential to the recovery of punitive damages that the plaintiff should have suffered any harm, either pecuniary or physical.[12] The petitioner suggests that "in a loose sense", the punitive damage payment was derived from Glenshaw's business, or at least from the capital and labor involved in prosecuting the litigation. The first aspect is a typical "but for" argument. Obviously, if Glenshaw had not engaged in business, it could not have been victimized by Hartford, and hence, no right of action

[12] 4 Restatement, Torts, § 908, Comment c, pp. 555-6.

either for compensatory or punitive damages would have arisen. But that falls far short of the notion that Glenshaw's business produced the penalty payment. Nor can it be fairly said that the punitive damages stem from the litigation. The right to punitive damages arose when the gross fraud was perpetrated. The litigation served simply to collect the punitive damages. That litigation no more produced the punitive damages than does a suit to collect a debt produce the amount due. As Chief Judge Biggs concluded, "Certainly the payments to the taxpayers cannot fairly be regarded as products of capital or labor." (R. 37)

The opinion below provides an informative analysis of punitive damages in the present context:

> "Punitive damages seem to be *sui generis*. By definition they are not compensatory. They certainly possess no periodicity. They are not derived from capital, from labor or from both combined and assuredly they are not profit gained through the sale or conversion of capital assets. It is clear they do not fall within the definition of *Eisner* v. *Macomber* and if we could be certain that the definition of that case was controlling we would have no difficulty with the issue at bar. It is easy to say what punitive damages are not but difficult to say what they really are. They smack of donations made to the individual by the State, by operation of law. A person does a prohibited act to another injuring him. The injured individual is subsequently enriched by a gift taken from the pocket of the injuring party by virtue of law. There is no *quid pro quo*. An analogy seems to us to lie in those cases where contributions are made by the sovereign in the general public interest to an individual. Cf. *Edwards* v. *Cuba Railroad Company*, *supra*. Where the injuries were gross, the doctrine of punitive damages come into play. The taxpayers have recovered because the sovereign has seen fit to punish gross behavior for the good of the public. There are naked exactions by the sovereign which go to the injured corporations rather than to the fisc. There is vague likeness to a fine exacted by the sovereign but which goes to the taxpayer.". (R. 36)

The Court of Appeals regarded punitive damages and antitrust penalties as "windfalls", and in this respect the Seventh Circuit did not disagree.[13] Admittedly such payments are not the fruit of either labor or capital but are obtained by the recipient because he had been the victim of grave misconduct. They are capital contributions by process of law.

C. *Punitive damages and penalties are not taxable income.*

Unless punitive damages come within the basic theory of income, they cannot be subjected to the income tax. This approach was first taken by the Court of Appeals for the Third Circuit in 1935. *Central R. Co. of New Jersey* v. *Commissioner*, 79 F. 2d 697 (3rd Cir., 1935) held that a penalty imposed by law upon a faithless fiduciary did not constitute taxable income to the corporate recipient. The Court there adopted the ordinary usage of the term income which had already been endorsed by this Court in a number of cases. The next decision was *Highland Farms Corp.* v. *Commissioner of Internal Revenue*, 42 B.T.A. 1314 (1940). That case held that an award of punitive damages did not constitute taxable income. No appeal was prosecuted. No change was made in the taxing statutes nor in the Treasury Regulations to repudiate or modify the principle applied in these cases.

It was this well established rule to which the Tax Court and the Court of Appeals adhered in the present proceeding. That the primary characteristic of income, as that term is ordinarily understood, is compensation for services

[13] *Commissioner* v. *Obear-Nester Glass Co.*, ... F. 2d ...... (7th Cir., 1954), pending on petition for certiorari as No. 478.

or profits from property or business transactions is not seriously challenged by the petitioner. Nor does he deny periodicity as a frequent attribute of income. Indeed, petitioner's brief does not concern itself with the nature or characteristics of income. The controlling term, according to the petitioner, is not "income" but "gain".[14] The "foundation" of petitioner's position is that every increase in resources is a gain, and every gain is taxable.[15]

Section 22(a) describes gross income as "gains, profits and income" derived from (1) personal or professional services, (2) ownership or use of property or capital, (3) conduct of a trade or business, and (4) "gains or profits and income derived from any source whatever." Two things seem evident in this definition. The first quoted phrase shows a purpose, by repetition, to reach income in any form, and the closing phrase was obviously designed to assure a liberal and hospitable understanding of the previously recited categories of income. But what is basic is the statutory purpose to develop the meaning of income. It could hardly have been intended to destroy and wipe out that fundamental concept. Yet that is the very purport of petitioner's lifting the single word "gain" out of the final phrase and contending that all gains, whatever their nature or source, constitute taxable income. Had the Congress intended to tax all increases in resources rather than income, it would have been easy to say just that in the statute. It would have been wholly unnecessary either to mention income or to undertake a detailed definition of the term.

The revision of Section 22(a) in the Internal Revenue Code of 1954 throws new light on the weakness of petitioner's entire position. The new Code reflects a desire to

[14] Pet. Br. 11.

[15] Pet. Br. 15.

clarify and simplify the definition of gross income without changing its meaning. To that end, Section 61(a) provides:

> "(a) General Definition. — Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, and similar items; (2) Gross income derived from business; (3) Gains derived from dealings in property; (4) Interest; (5) Rents; (6) Royalties; (7) Dividends; (8) Alimony and separate maintenance payments; (9) Annuities; (10) Income from life insurance and endowment contracts; (11) Pensions; (12) Income from discharge of indebtedness; (13) Distributive share of partnership gross income; (14) Income in respect of a decedent; and (15) Income from an interest in an estate or trust."

The House Ways and Means Committee pointed out that "While the language in existing section 22(a) has been simplified, the all-inclusive nature of statutory gross income has not been affected thereby. Section 61(a) is as broad in scope as section 22(a)." Similarly, the Senate Committee on Finance noted that Section 61(a) "is not intended to change the concept of income that obtains under section 22(a)."[16]

By this simplification, Congress recognized that the term "income" has an accepted, known concept. The repetitious words "gain" and "profits" were eliminated from the primary statement of the definition, and the entire catch-all phrase "gains or profits and income derived from any source whatever" was dropped. This clarification reflects not merely a prospective purpose but an historical intent. It undermines what the petitioner has characterized as the "foundation" of his argument—that the controlling term is "gain" rather than "income."

[16] H. Rep. No. 1337, p. A18, 83rd Cong., 2d Sess. and S. Rep. No. 1622, p. 168, 83rd Cong., 2d Sess.

The reference in the 1939 Code to "gains" was not new. It was in the statute when *Eisner* v. *Macomber* was decided. It remained in the statute without significant change throughout the years and has been paralleled by consistent decisions adhering to the basic concept of income. In no decision and in no administrative ruling has the idea that every increase in resources is taxable income heretofore been suggested.

What Congress was endeavoring to do in Sec. 22(a) was perfectly clear to this Court in *Helvering* v. *Clifford*, 309 U.S. 331, 334 (1940), when it said:

> "The broad sweep of this language indicates the purpose of Congress to use the full measure of its taxing power within those definable categories." (Emphasis supplied)[17]

Obviously, "economic gain is not always taxable income."[18] In a long list of categories, gains not specifically exempted and unrelated to the restoration of capital have been excluded from taxable income. Among these are:

1. Alimony. *Gould* v. *Gould*, 245 U.S. 151 (1917).
2. Insurance proceeds. *U. S.* v. *Supplee-Biddle Co.*, 265 U.S. 189 (1924).
3. Subsidy payments for capital investment. *Edwards* v. *Cuba Railroad Co.*, 268 U.S. 628 (1925).
4. Community contribution to induce location of a plant. *Brown Shoe Co.* v. *Commissioner*, 339 U.S. 583 (1950).
5. Forfeiture of stock subscriptions upon non-payment of other deferred installments. *Commissioner* v. *Inland Finance Co.*, 63 F. 2d 886 (9th Cir., 1933).

[17] Six years later, this statement was quoted with approval in *Commissioner* v. *Wilcox*, 327 U.S. 404, 407 (1946).

[18] *Helvering* v. *Bruun*, 309 U.S. 461 (1940).

6. Recovery for libel *per se*, without special damages. *C. A. Hawkins* v. *Commissioner*, 6 B.T.A. 1023 (1927); also *MacDonald* v. *Commissioner*, 9 B.T.A. 1340 (1928), where damages recovered for breach of promise to marry were held non-taxable.
7. Board and lodging received by an employe, when furnished for the convenience of the employer. Reg. 118, Sec. 39.22(a)-3.

The exclusion of these gains demonstrates that the meaning of taxable income is to be found not in the superficial test of economic gain but in the rational concept to which *Eisner* v. *Macomber* gave practical expression. An examination of some of the authorities falling within the foregoing categories yields further guides in its application.

Gould v. *Gould*, 245 U.S. 151 (1917), established two significant principles: (1) despite the general language of Section 22(a), Congress did not intend to treat all economic gains as taxable income; and (2) in interpreting "statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used," and doubts are to be resolved "most strongly against the government and in favor of the citizen."[19]

It is worthy of repetition that the definition of net income in the 1913 Act was substantially the same as Section 22(a) of the Internal Revenue Code of 1939. It contained the words "gains or profits and income derived from any source whatever." Yet this Court held that alimony, which is certainly a gain within the literal purview of that catch-all phrase, was not embraced by the definition of income taken as a whole.

Insurance proceeds certainly constitute an economic gain. The wealth of the recipient is augmented and generally by

[19] *Gould* v. *Gould*, 245 U.S. 151, 153 (1917).

an amount in excess of the premiums, whether paid by the decedent or the beneficiary. But the ordinary notion of income can hardly be said to embrace insurance proceeds. *U. S.* v. *Supplee-Biddle Co.*, 265 U.S. 189 (1924), involved the taxability of the proceeds of life insurance received by a corporation. In construing the statutory exemption given to an individual beneficiary as extended to a corporation despite the absence of clear language, Chief Justice Taft said:

> "* * * The benefit to be gained by death has no periodicity. It is substitution of money value for something permanently lost either in a house, a ship, or a life. Assuming without deciding that Congress could call the proceeds of such indemnity, income, and validly tax it as such, we think that in view of the popular conception of the life insurance as resulting in a single addition of a total sum to the resources of the beneficiary, and not in a periodical return, such a purpose on its part should be express, as it certainly is not here." (at 195)

D. *Contentions and authorities relied upon by petitioner.*

The contention that every accession to wealth, not specifically exempted, is taxable income rests primarily upon the assumption that *Eisner* v. *Macomber* has been scrapped by subsequent decisions. We have already seen that in a long line of decisions, this Court has utilized and given vitality to the *Eisner* v. *Macomber* notion that income is to be determined in its ordinary sense, and indeed, the specific guideposts were invoked as late as the *Culbertson* case.[20]

The specific cases cited by the petitioner yield no support for his contention. *U. S.* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931), held that the purchase of bonds by the issuer at less than the par value initially received produced taxable income. This was an obvious profit arising in trade and from the use of the taxpayer's capital. The Treasury Regulations, in effect during repeated enactments of the statutory definition of gross income, had expressly covered this type of profit and were cited by the Court as a basis for its decision.

Helvering v. *Bruun*, 309 U.S. 461 (1940), held that a building erected by a tenant constituted a taxable gain to the lessor upon the forfeiture of the leasehold. The lease provided that all buildings erected would be surrendered to the lessor. Hence the gain was in the nature of rent. The Court said:

> "While it is true that economic gain is not always taxable as income, the forfeiture of the building was a realized gain on property in a business transaction."[21]

Rutkin v. *U. S.*, 343 U.S. 130 (1952), in holding that money obtained by extortion is taxable, simply established the principle, without applicabilty here, that the reach of the taxing statute is not confined to legitimate earnings but extends as well to profits from unlawful enterprises.

Irwin v. *Gavit*, 268 U.S. 161 (1925), merely held that income from a testamentary trust was not within the statutory exemption accorded to bequests and was taxable to a beneficiary entitled to receive the income for a period of years. This Court emphasized that the payments were income "by the common understanding of that word" and by "popular speech."

U. S. v. *Safety Car Heating & Lighting Co.*, 297 U.S. 88 (1936), equates recovery of lost profits in a patent infringement action with profits earned in the operation of the business. *Robertson* v. *U. S.*, 343 U.S. 711, 713

[20] *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949).

[21] 309 U.S. at 469.

(1952), construed a prize to a composer in a symphony contest as "payment for services rendered," carefully noting that there would be no taxability if an award were made "in recognition of past achievements or present ability."

Petitioner also leans upon the decisions of the Court of Claims and the Court of Appeals for the Second Circuit taxing the recovery by a corporation of short-swing profits of a fiduciary under Section 16(b) of the Securities Exchange Act of 1934.[22] There is a very sharp distinction between the windfall character of punitive damages and the profit recovery under Section 16(b). The essence of that provision of the Securities Exchange Act is that a corporate fiduciary ought not to use for his personal gain the confidential information that rightfully belongs to the corporation and all its shareholders. When profits are realized in the course of short term trading, there is a statutory presumption that those profits were derived from the inside information that belongs to the corporation. Accordingly, the fiduciary insider is required to account to the corporation for such profits. Recovery under Section 16(b) can fairly be regarded as a profit arising out of the use of a corporate asset.[23]

[22] *Park & Tilford Distillers Corp.* v. *United States*, 107 F. Supp. 941 (Ct. Cl. 1952) cert. denied 345 U.S. 917; *General American Investors Co., Inc.* v. *Commissioner*, 211 F. 2d 522 (2nd Cir., 1954) cert. pending, No. 114.

[23] The purpose and underlying principles of Section 16(b) as described above are set out in S. Rep. 1455, pp. 55, 68, and H. Rep. No. 1383, p. 13, 73rd Cong., 2d Sess. (1934). Also see Cook and Feldman, *Insider Trading under the Securities Exchange Act* (1953) 66 Harv. L. Rev. 385, 408, where it is said of Section 16(b): "It appears to proceed on the principle that the confidential information which a corporate insider automatically obtains by virtue of his position belongs to the corporation. Having availed himself personally of this information, the insider is made liable to the corporation for the profits he realizes."

No court has subjected to income tax a gain not derived from labor or capital or not expressly specified in the Code except the Seventh Circuit, in *Commissioner* v. *Obear-Nester Glass Co.* That case was decided after certiorari had been granted in this proceeding and is now pending on petition for certiorari, No. 478, this Term. The principal thrust of the opinion is that an individual should be taxed according to his ability to pay and that the question is, "has he realized an economic gain, from whatever source, which leaves him better able to contribute to the support of his government?" This is patently an effort judicially to fashion the tax pattern. Obviously, one receiving a huge gift is "better able to contribute to the support of his government," but that does not subject the gift to an income tax. No income tax is imposed upon the beneficiary of life insurance, even if under the Code the insurance proceeds are not even subject to the estate tax. One who obtains large capital gains is "better able" to pay a high tax than the millions of wage earners required to rely exclusively upon their earnings. Tax-free corporate distributions represent a fertile source that might be tapped by the "ability to pay" doctrine. It is for the Congress to weave the tax pattern and to choose how the burden shall be spread. It is not for the courts to select those who can best afford to pay the tax but rather to determine what statutory levy the Congress intended to impose.

That the Seventh Circuit argument should have been addressed to the Congress is highlighted by the corollary question of whether the wrongdoer should be permitted a deduction for the payment of punitive damages or penalties. Cf. *Heininger* v. *Commissioner*, 320 U.S. 467, 473 (1943). When this Court faced the problem with respect to alimony, it declined to extend the ordinary concept of income to alimony which had roots in neither labor nor capital. On the other hand, when the Congress elected specifically to tax the receipt of periodic alimony payments, it provided a corresponding deduction to the payer.

The second argument urged by the petitioner is that the tax here under scrutiny is not an income tax under the Sixteenth Amendment but an excise levy under Article 1 of the Constitution. This suggestion, nowhere supported, had not been urged either before the Tax Court or the Court of Appeals. It was only when this Court granted certiorari that the petitioner discovered that the statute his office had been administering since 1913 was not a levy on income but an excise tax on gain.

We do not argue (for it is not necessary for our position) that penalties and punitive damages are outside the constitutional reach of an excise levy by the Congress without apportionment. Suffice it to say that the Congress has not enacted such excise levy but has imposed a tax upon income. This is made perfectly clear by the House Committee Report accompanying the Act of October 3, 1913. Under the caption, "Income Tax," the Committee on Ways and Means wrote:

> "Section 2 of the bill imposes a tax upon the annual net incomes of individuals and corporations. This is in response to the general demand for justice in taxation, and to the long-standing need of an elastic and productive system of revenue.
>
> "For 25 years a contest has been waged throughout the country in behalf of the adoption of a national income tax as a permanent part of our fiscal system, and the sentiment in favor of this movement finally became so strong that the people overturned a decision of the Supreme Court of the United States by writing into the Constitution the first amendment within 40 years." [24]

[24] H. Rep. No. 5, 63rd Cong., 1st Sess., (1913).

Text writers have uniformly concluded that the income tax statutes since 1913 are exercises of the power of the Congress under the Sixteenth Amendment. Magill says:

> "So far as the federal government is concerned, each income tax statute since 1913 purports to be an exercise of the power conferred upon Congress by the Sixteenth Amendment 'to lay and collect taxes on incomes, from whatever source derived.'" [25]

Mertens emphasizes that the income tax is a levy under the Sixteenth Amendment and that "the income or receipts which the statute may properly reach and tax is limited to such receipts as fall within the term 'income' as used in the Sixteenth Amendment." [26] In its decisions exploring and determining the scope of profits and receipts subject to the income tax, this Court has made frequent use of the Sixteenth Amendment but has never suggested that the levy under scrutiny had its constitutional roots in Article I. This is a new thought alien to the language and reports of the Congress and unrelated to judicial analysis.

We seek no static adherence to judicial definition. Our resort is to the fundamental concept of income. We would look to the ordinary meaning of the word and the guideposts of *Eisner* v. *Macomber* that have stood the test of time and experience. We accept the decisions of this Court as charting the general framework of income. We reject as a perversion of the statute the transformation of the levy from a tax upon income into a tax upon any receipt of money or property. That is the extreme position into which the petitioner has been driven and which he cannot sustain either by authority or rational justification.

[25] Magill, *Taxable Income* (1945) p. 5.

[26] Mertens, *Law of Federal Income Taxation*, (1942) Sec. 1.10, pp. 22-23.

II. The Long Standing Rule That Punitive Damages Do Not Constitute Taxable Income Should Not Be Changed Except by Legislative Action.

At the time that respondent settled its litigation with Hartford-Empire Co., the law was settled that punitive damages do not constitute taxable income.[27] The decision to that effect by the Court of Appeals for the Third Circuit in 1935 was followed by the Tax Court in *Highland Farms Corp. v. Commissioner*, 42 B.T.A. 1314 (1940). No review of the *Central R. Co.* case was sought in this Court. With respect to the *Highland Farms* case, the Commissioner noted non-acquiescence but took no appeal. Respondent was entitled to rely upon that undisturbed rule of law in negotiating settlement. The non-taxability of a portion of the settlement payment was a proper factor for respondent to consider in its decision to compromise claims fairly valued at over one and one-half million dollars for little more than half that amount.

Here is a rule of tax law that has been in effect for twenty years. No effort has been made to accomplish a statutory change. Under these circumstances there is ample precedent for holding that the harsh consequences of a retroactive reversal should not be visited upon a taxpayer in the absence of express legislative direction.

Petitioner argues that "on its facts" the Fifth Circuit's decision in *Arcadia Refining Co. v. Commissioner*, 118 F. 2d 1010 (5th Cir., 1941), was directly contrary to the *Central R. Co.* decision. That case held that the recovery of profits earned on embezzled funds represented profits from capital subject to tax; the case did not deal with the question of whether penalties or punitive damages are subject to tax.

[27] *Central R. Co. of New Jersey v. Commissioner*, 79 F. 2d 697 (3rd Cir., 1935).

Similarly, the Second Circuit decisions[28] questioned whether the recovery in *Central R. Co.* should in fact have been characterized as a penalty rather than profit recovered, but did not consider whether a penalty constituted taxable income. Nor did any of the cases decided by this Court abandon the common sense approach to income upon which *Eisner v. Macomber* and, in turn, *Central R. Co.* were based.

In *Helvering v. Griffiths*, 318 U. S. 371 (1943), the Supreme Court was asked to overrule its holding in *Eisner v. Macomber* because of a change in the income tax law enacted in 1936. In refusing so to do the Supreme Court said:

> "We are asked to make a retroactive holding that for some seven years past a multitude of transactions have been taxable although there was no source of law from which the most cautious taxpayer could have learned of the liability. If he consulted the decisions of this Court, he learned that no such tax could be imposed; if he read the Delphic language of the Act in connection with existing decisions, it, too, assured him there was no intent to tax; if he followed the Congressional proceedings and debates, his understanding of nontaxability would be confirmed; if he asked the tax collector himself, he was bound by the Regulations of the Treasury to advise that no such liability existed. It would be a pity if taxpayers could not rely on this concurrent assurance from all three branches of the Government. But we are asked to brush all this aside and simply to decree that these transactions are taxable anyway." (at 402)

Fondren v. Commissioner, 324 U. S. 18 (1945), related to the question of whether certain future interests were gifts under the gift tax statute. A Treasury Regulation

[28] *Sterling v. Commissioner*, 93 F. 2d 304 (2nd Cir. 1937) cert. denied 303 U.S. 663; *Lueth v. Hoey*, 96 F. 2d 141 (2nd Cir., 1938), reversed 305 U.S. 188 (1938).

promulgated prior to the re-enactment of the statute by the Congress was held to be controlling. This Court said:

> "The regulation has received the construction now reaffirmed with substantial consistency. The statute, with the meaning thus settled, has been reenacted by Congress. The construction should be followed until Congress sees fit to change it." (at 29-30)

The tax treatment of alimony payments also presents a forceful analogy. For many years the courts held such payments to be nontaxable until a change in the Internal Revenue Code was made to cover them. In *Gould v. Gould*, 245 U. S. 151 (1917), the Supreme Court, holding that alimony was not taxable to the recipient prior to the change in the Code, said:

> "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen." (at 153)

If, as has always been understood, the settlement of litigation is to be fostered and encouraged as a matter of public policy, a taxpayer who has acted in furtherance of that policy should not be penalized by the unexpected imposition of a heavy tax burden.

Conclusion.

For the foregoing reasons, it is respectfully submitted that the decision of the United States Court of Appeals for the Third Circuit should be affirmed.

Respectfully submitted,

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