Cornell Law Review

Volume 25
Issue 2 *February 1940*

Article 3

Income Tax on Gains and Losses in Litigation

William T. Plumb Jr.

Recommended Citation

William T. Plumb Jr., *Income Tax on Gains and Losses in Litigation* , 25 Cornell L. Rev. 221 (1940)
Available at: http://scholarship.law.cornell.edu/clr/vol25/iss2/3

INCOME TAX ON GAINS AND LOSSES IN LITIGATION†

WILLIAM T. PLUMB, JR.*

DEAR SIR:

I am an average lawyer with a broad general practice. I make no pretense of specializing, least of all in that labyrinthine field, taxation. But frequently my clients ask me questions of tax law connected with their cases. Successful plaintiffs want to know whether their recovery is taxable income, and, if so, whether it is taxable in the year the claim arose, or when they got a verdict, or when they won on appeal, or when they finally collected. Defendants who have received income or property, their right to which is questioned, want to know whether they must report it as income when received or may hold it in suspense until their right to it is determined. Defendants who have lost want to know whether they may deduct the loss from their taxable incomes, and, if so, when. And all of them want to know whether they may deduct the attorney's fees and other expenses of litigation.

Although I am not a tax lawyer, I feel that I ought to be equipped to advise upon these questions which are so intimately connected with the cases I handle. Furthermore, in many instances, by a proper selection of the relief to be asked, by insisting upon an apportioument of lump sum settlements covering diverse causes of action, by itemizing my fees so that personal and business services may be segregated, and in other ways, I may assist my client in making legitimate tax savings.

Please advise.

JOHN SMITH.

DEAR MR. SMITH:

1. *Plaintiffs*

a. *If Taxable*

The average taxpayer who is at all capable of preparing his income tax return knows that (with certain well defined exceptions such as gifts, inheritances, life insurance, and the interest on certain bonds[1]) he must report as income virtually all the money or property that he receives or, if he reports income on the accrual basis, that becomes due to him.[2] But when he receives or accrues income from an unusual source, such as litigation, he is perplexed,

†The deductibility of judgments against the taxpayer, and other tax problems of defendants, together with the deductibility of attorneys' fees, will be considered in Part Two, which will appear in an early issue.

*The views expressed herein are entirely those of the writer, and nothing herein contained is to be construed as the official opinion of the Treasury Department.

[1]Internal Revenue Code § 22 (b).

[2]Respecting the cash and accrual methods of accounting, see *infra* notes 109 and 118.

and he naturally turns for advice to the attorney who secured it for him.[3]

Under the Internal Revenue Code, tax is assessed upon income "derived from any source whatever".[4] But this must be read in connection with the concept of "income".[5] The Supreme Court at an early date defined income 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".[6] If a receipt falls within this definition, it is taxable. If it merely replaces preexisting capital (no profit resulting), or if it is a mere voluntary transfer of existing wealth, it is not taxable as income.

The application of these principles to judgments and settlements gained by successful plaintiffs is not free from difficulty. The basic consideration always is, "What was the award . . . or portion of the award made in respect of?"[7] Only if it would have been income if voluntarily paid, is it income when obtained through litigation.[8] This is, of course, equally true whether the litigation goes to final judgment or is compromised, and the two will be treated indiscriminately herein.[9]

The simplest question, of course, concerns ordinary debts and receivables, which may be treated exactly as if voluntarily paid, the only effect of the litigation being to postpone accrual.[10] With respect to such items, there must first be a return of the capital elements they contain, *e.g.*, the principal of a loan. The balance is income.[11]

The proceeds of the ordinary action for breach of contract are income. This is true whether the damages represent lost anticipated profits[12] or merely reimburse expenses and losses sustained by the plaintiff in performing his side of the contract.[13] For, in the latter case, assuming that the expenses were

[3]Owing to limitations of space, it has frequently been necessary to oversimplify statements of the applicable law, but it is hoped that this article will prove useful for ready reference.

[4]Internal Revenue Code § 22 (a).

[5]See the discussion of this concept in 1 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) ch. 5. And see note (1932) 45 HARV. L. REV. 1072.

[6]Eisner v. Macomber, 252 U. S. 189, 207, 40 Sup. Ct. 287 (1920). The definition is a combination of the holdings of two earlier cases. Stratton's Independence v. Howbert, 231 U. S. 399, 415, 34 Sup. Ct. 136 (1913); Doyle v. Mitchell Brothers, 247 U. S. 179, 185, 38 Sup. Ct. 467 (1918).

[7]G. C. M. 9210, X-1 C. B. 129, 130 (1931). The abbreviation "C. B." stands for the Cumulative Bulletin (Internal Revenue rulings).

[8]The effect of litigation in changing the *year* in which income is taxable will be considered presently. See *infra* p. 241 *ff*.

[9]"The results of a compromise of rights, the proceeds of which are not taxable, do not become taxable because the compromise was brought about by an agreement not to litigate." Magruder v. Segebade, 94 F. (2d) 177, 179 (C. C. A. 4th 1938).

[10]See *infra* p. 241 *ff*.

[11]*Cf.* G. C. M. 9210, X-1 C. B. 129 (1931).

[12]Herman J. Sternberg, 32 B. T. A. 1039 (1935).

[13]Burnet v. Sanford & Brooks Co., 282 U. S. 359, 51 Sup. Ct. 150 (1931); Graham-Bumgarner Co., 11 B. T. A. 603 (1928); Dexter Sulphite & Paper Co., 23 B. T. A. 227 (1931); Newman & Carey Subway Construction Co., 37 B. T. A. 1163 (1938).

Such damages are not taxable if the recovery is for wrongful impairment of the value incurred in prior years, they were properly deductible and presumably were deducted in the earlier years.[14]

Since there are special provisions and limitations with respect to the taxation of capital gains[15]—gains derived from the *sale or exchange* of capital assets—it is important to consider whether damages recovered from one who has breached a contract to purchase capital assets are eapital gains or ordinary income. Such damages have been held to be ordinary income. The payments are not made because of the disposition of capital assets but beeause of the *failure* to complete the disposition, and the taxpayer's capital assets are unchanged.[16]

Damages on account of loss of anticipated profits are taxable as income, just as would be the profits for which they are a substitute.[17] Thus, as already indicated, damages covering lost profits upon a contract are income.[18] Damages for breach of a contract not to compete, if they represent lost profits rather than injury to good will, are taxable.[19] Mesne profits recovered in a contest over the title to land are also subject to tax.[20] Similarly, recoveries for torts causing loss of profits are income. The cases have so held with respect to damages for interference with a business,[21] for violations of the anti-trust acts,[22] for discrimination by railroads,[23] for unfair competition,[24] for lost profits resulting from deprivation of the use of property,[25] and for the use by a competitor of designs stolen from the taxpayer, resulting in a loss of business.[26] A judgment against a trustee who improperly disposes of trust property, resulting in a loss of profits, is likewise taxable.[27] Damages re-

of property pending completion of a sale thereof; the recovery then is merely a return of capital, reducing the cost basis of the property. Henri Chouteau, 22 B. T. A. 850 (1931).

[14]The recovery is taxable even though the taxpayer, as a result of net losses in the prior years, gained no benefit from the deduction of the expenses. Burnet v. Sanford & Brooks Co., *supra* note 13. See *infra* note 66. Regulations 101, art. 42-4 (1939) permits the "long-term contract" method of accounting, for certain types of contracts, under which it is possible to report all income and expenses arising from the contract at the time it is completed. Nevertheless, a recovery of damages, covering losses and expenses, is income at a later date if not recovered during the term of the contract. Newman & Carey Subway Construction Co., 37 B. T. A. 1163 (1938).

[15]Internal Revenue Code § 117.

[16]A. M. Johnson, 32 B. T. A. 156 (1935).

[17]*See* 1 Paul and Mertens, Laws of Federal Income Taxation (1934) § 6.48. Note (1936) 101 A. L. R. 1453.

[18]Herman J. Sternberg, 32 B. T. A. 1039 (1935); Swastika Oil & Gas Co., 40 B. T. A. 797 (1939).

[19]Armstrong Knitting Mills, 19 B. T. A. 318 (1930).

[20]Charles P. Hewes, 2 B. T. A. 1279 (1925).

[21]H. Liebes & Co. v. Comm'r, 90 F. (2d) 932 (C. C. A. 9th 1937).

[22]Commercial Electrical Supply Co., 8 B. T. A. 986 (1927).

[23]Buffalo Union Furnace Co. v. Helvering, 72 F. (2d) 399 (C. C. A. 2d 1934).

[24]Armstrong Knitting Mills, 19 B. T. A. 318 (1930).

[25]*Cf.* Miller v. Hocking Glass Co., 80 F. (2d) 436 (C. C. A. 6th 1935), *cert. denied*, 298 U. S. 659, 56 Sup. Ct. 681 (1936) (use and occupancy insurance); O. D. 645, 3 C. B. 89 (1920) (same); Regulations 101, art. 112 (f)-1 (same).

[26]Banta Refrigerator Co., 15 B. T. A. 1038 (1929).

[27]Charles S. Davis, Trustee, 35 B. T. A. 1001 (1937), *rev'd on other grounds on rehearing*, 37 B. T. A. 587 (1938).

covered in a suit for the infringement of a patent are income subject to tax.[28]

The fact that the losses which the taxpayer suffered from the injury are greater than the damages so recovered will not convert the income into a deductible loss.[29] Since the anticipated profits were never received and never taxed, they cannot be deducted as a loss; and the smaller profits, when they *are* received, through litigation, are taxable.[30]

If the claim is not for anticipated profits of which the taxpayer has been deprived but is for an accounting of profits made by a wrongdoer, the taxability of the recovery is not so clear, for there is some inconsistency in the cases. It is settled that, in a patent infringement suit, the fact that the taxpayer elects to demand an accounting of the *infringer's* profits does not alter the taxability of the proceeds.[31] But where a faithless officer, agent, or other fiduciary is sued for an accounting of profits made by him in violation of his fiduciary duty, it has been held that the proceeds are not income derived from the taxpayer's labor or capital but are in the nature of a penalty or windfall, a gratuitous transfer decreed by the court in order to discourage breaches of trust.[32] The cases are apparently distinguishable in that, in the former cases, the patent infringer earned the profits by the use of the taxpayer's capital (the patent), whereas in the latter case he did not. In those situations where the profits so accounted for *are* taxable to the plaintiff, the fact that the defendant had previously paid a tax upon them is of no avail to the plaintiff.[33] The defendant received the profits under a claim of right and paid the tax for his own account, not on behalf of the plaintiff.[34]

---

[28]United States v. Safety Car Heating Co., 297 U. S. 88, 56 Sup. Ct. 353 (1936); Comm'r v. S. A. Woods Mach. Co., 57 F. (2d) 635 (C. C. A. 1st 1932), *cert. denied,* 287 U. S. 613, 53 Sup. Ct. 15 (1932); W. W. Sly Mfg. Co., 24 B. T. A. 65 (1931); Estate of G. A. E. Kohler, 37 B. T. A. 1019 (1938). Of course, if the plaintiff, as part of a settlement, releases his rights to the patent, he is entitled to recover their cost basis, if any, from the proceeds, and to the extent that the gain is attributable to the sale rather than to lost profits, it is taxed as a capital gain under section 117 of the Internal Revenue Code. Estate of G. A. E. Kohler, *supra.*

[29]Banta Refrigerator Co., 15 B. T. A. 1038 (1929); J. R. Knowland, 29 B. T. A. 618 (1933).

[30]Failure to receive expected income is not a loss. Comm'r v. John Thatcher & Son, 76 F. (2d) 900 (C. C. A. 2d 1935); S. M. 2285, III-2 C. B. 87 (1924).

[31]United States v. Safety Car Heating Co., 297 U. S. 88, 56 Sup. Ct. 353 (1936); W. W. Sly Mfg. Co., 24 B. T. A. 65 (1931) (full discussion).

[32]Central R. R. of N. J. v. Comm'r, 79 F. (2d) 697, 101 A. L. R. 1448 (C. C. A. 3d 1935). The case has twice been criticized by the Second Circuit Court of Appeals, in Sterling v. Comm'r, 93 F. (2d) 304, 306 (1937) and Lyeth v. Hoey, 96 F. (2d) 141, 143 (1938). However, the reversal of the latter, in 305 U. S. 188, 59 Sup. Ct. 155 (1938), which also weakens the foundations of the former case (on which *certiorari* was denied, 303 U. S. 663, 58 Sup. Ct. 829 [1938]), may detract substantially from the force of those criticisms.

[33]Central R. R. of N. J., 29 B. T. A. 14, 22 (1933), *rev'd on other grounds,* 79 F. (2d) 697 (C. C. A. 3d 1935); O. D. 26, 1 C. B. 67 (1919).

[34]The defendant was taxable upon the income when received under claim of right and without restriction upon its disposition, and may deduct a loss when it is determined that he must give it up. See *infra* p. 249 and Part Two.

Care must be taken to distinguish payments for injury to good will, which are regarded as a mere reparation for lost capital, not as compensation for profits. The courts incline to look to the complaint, and if the relief asked consists of damages for injury to good will rather than for lost profits, the recovery is not taxable; if the suit is compromised, the settlement likewise is regarded as covering just what was sued for, at least in the absence of other evidence.[35] In a lawsuit of any magnitude, a lawyer should consider these cases, among the other factors bearing upon the question of what relief to seek.

When a judgment or a settlement compensates a plaintiff for an injury to capital or for a conversion thereof, it is not taxable income. Thus, damages for a trespass causing injury to land[36] and for an injury to the good will of a business[37] have been held not taxable. And when a tenant or other person using plaintiff's property pays damages for the breach of his obligation to keep the property in repair, the compensation is regarded as restoring the lost capital value.[38] The same has been held of a recovery for breach of contract, representing wrongful impairment of the value of property pending completion of a sale thereof.[39]

Nevertheless, to the extent that a cost basis that is not wholly speculative can be assigned to the property or portion thereof which has been taken or destroyed,[40] a gain may be computed upon the compensation received just as

[35]Farmers' & Merchants' Bank v. Comm'r, 59 F. (2d) 912 (C. C. A. 6th 1932) (damages to good will); Armstrong Knitting Mills, 19 B. T. A. 318 (1930) (Board determined from allegations of damage that lost profits were sought). *Cf. also* Henri Chouteau, 22 B. T. A. 850 (1931).

[36]Strother v. Comm'r, 55 F. (2d) 626, 632 (C. C. A. 4th 1932), *aff'd on other grounds*, 287 U. S. 308, 53 Sup. Ct. 150 (1932).

[37]Farmers' & Merchants' Bank v. Comm'r, 59 F. (2d) 912 (C. C. A. 6th 1932).

[38]Tenant's failure to keep in repair: *see* Comm'r v. Norfolk Southern R. R., 63 F. (2d) 304, 306 (C. C. A. 4th 1933); Washington Fireproof Bldg. Co., 31 B. T. A. 824 (1934).

Failure of Government properly to maintain railroads during its operation of them: Tunnel R. R. v. Comm'r, 61 F. (2d) 166 (C. C. A. 8th 1932), *cert. denied*, 288 U. S. 604, 607, 53 Sup. Ct. 396, 398 (1933); Comm'r v. Norfolk Southern R. R., 63 F. (2d) 304 (C. C. A. 4th 1933), *cert. denied*, 290 U. S. 672, 54 Sup. Ct. 91 (1933); Chicago & N. W. Ry. v. Comm'r, 66 F. (2d) 61 (C. C. A. 7th 1933), *cert. denied*, 290 U. S. 672, 54 Sup. Ct. 90, 91 (1933); New York, C. & St. L. R. R. v. Helvering, 71 F. (2d) 956 (App. D. C. 1934); Southern Ry. v. Comm'r, 74 F. (2d) 887 (C. C. A. 4th 1935); Kansas City So. Ry. v. Comm'r, 75 F. (2d) 786 (C. C. A. 8th 1935); Ann Arbor R. R. v. Comm'r, 97 F. (2d) 343 (C. C. A. 6th 1938). The variations and apparent conflicts among these cases result from the peculiarity of railroad accounting that capital expenditures for repairs are deductible as ordinary business expenses, so special problems arose respecting the extent to which such expenses, when made on account of prior undermaintenance, had already been reimbursed by the Government. For our purposes, however, the significant point is that such awards are not *income*.

[39]Henri Chouteau, 22 B. T. A. 850 (1931).

[40]In Strother v. Comm'r, *supra* note 36, a trespasser had taken coal and then destroyed the entries, so that the amount of coal taken could not be determined. Since there was no way of determining whether the amount received in settlement exceeded the depletion allowable on the unknown quantity of coal taken, the gain was held to be entirely conjectural and not taxable. The Board of Tax Appeals, 18 B. T. A. 901 (1930), had taxed the *entire* award, placing the burden upon the taxpayer to show that there was any cost basis for the coal taken.

The formula for determining the cost basis of an ascertainable portion of a unit of property is given in Harry Johnson Grant, 30 B. T. A. 1028 (1934).

upon a voluntary disposition of the property.[41] Of course, the cost basis must first be recovered before any taxable gain is realized, and this although by the terms of the award a part is denominated "interest", if in fact the total does not cover the cost.[42]

But it is possible for the taxpayer to avoid a tax upon this gain, where the conversion of his property into cash is not voluntary but results from its complete or partial destruction, or from theft, seizure, or the exercise of the power of eminent domain (or the imminence thereof).[43] He must "forthwith"—which means, not "immediately", but "as soon as by reasonable exertion

---

[41]Lehigh & Hudson River Ry. v. Comm'r, 36 F. (2d) 719 (C. C. A. 2d 1929), *mod. on other grounds,* 38 F. (2d) 1015 (C. C. A. 2d 1930), *cert. denied,* 281 U. S. 748, 50 Sup. Ct. 353 (1930) (Government took supplies of railroad in 1918, paid 1920 prices for failure to restore like quantity in 1920); Helvering v. Gulf, M. & N. R. R., 71 F. (2d) 953 (App. D. C. 1934), *aff'd on other grounds,* 293 U. S. 295, 55 Sup. Ct. 161 (1934) (same); Acme Land & Fur Co. v. Comm'r, 84 F. (2d) 441 (C. C. A. 5th 1936) (compensation for property having no cost to taxpayer); Washington Fireproof Bldg. Co., 31 B. T. A. 824 (1934).

The courts do not appear to have considered the question whether such gains are taxable as ordinary income or as capital gains (Internal Revenue Code § 117). Since a "sale or exchange" is required to make the capital gains provision applicable, it is apparent that a recovery for injury or destruction of capital is not such. On the other hand, an involuntary sale upon condemnation falls within the "capital gains" provision. Seaside Improvement Co. v. Comm'r, 105 F. (2d) 990 (C. C. A. 2d 1939), *cert. denied,* 60 Sup. Ct. 263 (1939). *Quaere,* whether the proceeds of an action, in the nature of trover or assumpsit, for the value of property wrongfully seized or converted, would be considered as derived from an involuntary sale. *Cf.* Comm'r v. Freihofer, 102 F. (2d) 787 (C. C. A. 3d 1939).

[42]Drier v. Helvering, 72 F. (2d) 76, 63 App. D. C. 283 (1934); Comm'r v. Speyer, 77 F. (2d) 824 (C. C. A. 2d 1935), *cert. denied,* 296 U. S. 631, 56 Sup. Ct. 155 (1935); Helvering v. Drier, 79 F. (2d) 501 (C. C. A. 4th 1935). This principle applies where the entire award, including interest, does not cover the cost (Drier v. Helvering, *supra*); and on the "cash receipts" basis, the installments paid upon the award, even if the total is sufficient, will not be apportioned between principal and interest, if the prospect of ultimately receiving the full award is not great (Comm'r v. Speyer and Helvering v. Drier, *supra*); the same would be true on the "accrual" basis if there is no reasonable expectancy of payment, since such items are not accruable; but if there is such a reasonable expectancy, of course, the principal of the award would be accrued at once and the gain computed thereon. *See* Doyle v. Mitchell Bros. Co., 247 U. S. 179, 185, 38 Sup. Ct. 467 (1918); G. C. M. 16166, XV-1 C. B. 175 (1938). In the normal case of interest upon a debt or judgment, lacking the complications here considered, the payments received would first be applied to the full interest due (income) before being applied on principal (which may be capital or income). Barker v. Magruder, 95 F. (2d) 122, 68 App. D. C. 211 (1938); see Helvering v. Drier, *supra,* at 503.

[43]Internal Revenue Code § 112 (f):

"INVOLUNTARY CONVERSIONS.—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended."

confined to the object it may be accomplished"[44]—either spend the money (received from the public authority, insurer, or other person liable) for other property similar or related in use, or spend it in acquiring "control" of a corporation owning such property, or establish a replacement fund (which requires application to the Commissioner and the giving of bond); a mere replacement reserve on the books is not sufficient as a "replacement fund", although, of course, it may be evidence of the continuing purpose to reinvest "forthwith" in other property which is required under the first two alternatives.[45] Although it is not essential to "earmark" the funds received, nevertheless it has been held necessary to trace them and prove that the same funds received were used in replacement; it is not sufficient if the money is spent for general purposes and other money used for replacement.[46] Nor is it sufficient if the taxpayer, before receiving compensation for property condemned, spends other money for the substituted property and later seeks to reimburse himself or a lender when the compensation is received.[47]

If the statute respecting the proceeds of involuntary conversions is complied with, the taxpayer is not taxable upon his gain at the time, but the new property stands in the place of the old property and takes its cost basis, with such adjustments as are necessary.[48] If any part of the money received is not expended pursuant to the terms of the statute, the gain, if any, is taxable in an amount not in excess of the money not so expended. That is, the gain upon the transaction is computed in the usual way, by deducting the cost basis from the proceeds, and that gain is taxable if, or to the extent that, it does not exceed the amount not expended.[49] So far as the gain is thus taxed at the time of the conversion, it is added to the cost basis of the new property so that it

---

[44]August Buckhardt, 32 B. T. A. 1272, 1276 (1935) (two years spent in search for suitable property, held not excessive); Estate of George Herder, 36 B. T. A. 934 (1937), *mod. on other grounds*, Herder v. Helvering, 106 F. (2d) 153 (App. D. C. 1939), *cert. denied*, 60 Sup. Ct. 262 (1939). But if the attempt is abandoned, the gain must be taken in the year when it was realized and not in the year the plan was given up. Herder v. Helvering, *supra*.

The regulations (Reg. 101, art. 112 (f)-1) specify that a "replacement fund" must be applied for in any case where it is not possible "forthwith" to make the replacement. But these cases indicate that that is unnecessary if the requisite continued diligent effort is made.

[45]Regulations 101, arts. 112 (f)-1 and 112 (f)-2; 2 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) §§ 17.114 *et seq.;* M. J. Caldeck Corp., 36 B. T. A. 452 (1937).

[46]Frischkorn Development Co., 30 B. T. A. 8 (1934), *aff'd w. o. op.*, 88 F. (2d) 1009 (C. C. A. 6th 1937); Regulations 101, art. 112 (f)-1. A more liberal attitude may be indicated in Wilmore S. S. Co. v. Comm'r, 78 F. (2d) 667 (C. C. A. 2d 1935), holding the Board's decision "unduly technical".

[47]Bandes v. Comm'r, 69 F. (2d) 812 (C. C. A. 2d 1934), *cert. denied*, 293 U. S. 568, 55 Sup. Ct. 80 (1934). It thus would be necessary to do without the property until the money is received, if one is to take advantage of this provision. *Cf. contra*: Washington Ry. & Elec. Co., 40 B. T. A. No. 185 (Dec. 22, 1939), confining the *Bandes* case to its peculiar facts.

[48]*See* Internal Revenue Code § 113 (a) (9), and regulations thereunder.

[49]*See* Palladium Amusement Co., 37 B. T. A. 149, 151, 155 (1938).

will not again be taxed when that property is sold.[50] If it is necessary to expend *more* for the new property than was received for the old, the excess is not a loss but is additional capital investment, to be added to the cost basis determined as above indicated.[51]

A special problem arises when a part of a condemnation award is used, or is retained by the public authorities, to pay a special assessment for benefits resulting to the remainder of the property from the same project. The regulations issued under the 1938 Act provided that amounts so retained or expended were to be treated as part of the award received for the portion condemned and that the expense for those benefits to the remainder was not an "investment in property similar or related in use"; hence, that gain might be recognized in such a case, and the expenditure for the benefits would be a new and distinct investment adding to the cost basis of the property benefited.[52] But the Second and Ninth Circuit Courts of Appeals, followed finally by the Board of Tax Appeals, disapproved this regulation, not by differently construing "property similar or related in use", but by declaring that, to the extent of the special assessment, *no gain* was realized because it was instantly absorbed in a new cost which arose and was paid without even momentary possession of the "gain".[53] The details of this new rule are only now being worked out by the Board of Tax Appeals. The Board has held that the special assessment no longer may be added to the cost basis of the remaining property (except to the extent that it exceeds the compensation awarded so that the taxpayer is actually out of pocket), for, under this theory of offsetting the award and the assessment, there was no cost incurred for the benefits.[54] It has also been held that the assessment need not be simultaneous with the making of the award, although no case has passed upon what the result would be if the award were not only made but paid before any assessment was levied.[55] At least it is not necessary even that the assessment be

[50]Internal Revenue Code § 113 (a) (9).

[51]Regulations 101, arts. 112 (f)-1 and 113 (a) (9)-1.

[52]Regulations 101, art. 112 (f)-1.

[53]Carrano v. Comm'r, 70 F. (2d) 319 (C. C. A. 2d 1934); Wolf v. Comm'r, 77 F. (2d) 455 (C. C. A. 9th 1935); Christian Ganahl Co. v. Comm'r, 91 F. (2d) 343 (C. C. A. 9th 1937), *cert. denied,* 302 U. S. 748, 58 Sup. Ct. 265 (1937); Central & Pacific Imp. Corp. v. Comm'r, 92 F. (2d) 88 (C. C. A. 9th 1937); Calvin C. Green, 37 B. T. A. 25 (1938); Jamieson Associates, Inc., 37 B. T. A. 92, 115 (1938), *mod. on other grounds, sub nom.* Seaside Improvement Co. v. Comm'r, *supra* note 41; Palladium Amusement Co., 37 B. T. A. 149 (1938); Income Syndicate, Inc., 37 B. T. A. 926 (1938); Langley Collyer, 38 B. T. A. 106 (1938).

The Commissioner acquiesced in these rulings and modified the regulation accordingly. T. D. 4951, (1939) Int. Rev. Bull. No. 42, p. 2, 7 U. S. LAW WEEK 375 (Oct. 17, 1939).

[54]Palladium Amusement Co., 37 B. T. A. 149 (1938), giving formula for computations.

[55]Central & Pacific Imp. Corp. v. Comm'r, 92 F. (2d) 88 (C. C. A. 9th 1937); Jamieson Associates, Inc., 37 B. T. A. 92, 115 (1938), *mod. on other grounds, sub nom.* Seaside Improvement Co. v. Comm'r, *supra* note 41. In these cases, payment of the award was held up until the assessment was made. If, for any reason, the reward were received free and clear before the assessment was made, the cases concerning income received under

paid from the award money or at the same time, if in fact a liability has attached to the taxpayer's property through the issuance of improvement bonds.[56] Special assessments levied on account of other projects than the one for which a portion of the property was condemned, even though retained by the public authorities when paying the award, may not be treated as reducing the net award under this rule, which is limited to assessments arising out of the same transaction.[57]

It was formerly held that so much of a condemnation award as could be allocated to "severance damages"—*i.e.*, injury to the remaining land rather than value of the portion condemned—would not be considered as proceeds of the portion condemned but would be applied to reduce the cost basis of the balance.[58] But after the adoption of the new rule respecting special assessments, the Board held that the *entire* award received, less the special assessment, should be considered in determining the net award upon which to compute the gain realized.[59] However, it is probable that, in cases where there is no special assessment, or where the severance damages exceed the assessment, the older practice will still be applicable, for the real basis of the last mentioned ease seems to be that, because of the benefits (for which the assessment was made), there was no *net* damage to the remaining land and the benefit assessment should be set off first against the severance damages before it is used to reduce the proceeds of the land taken; therefore, it would seem that severance damages awarded, in excess of benefit assessments, would still be applied to reduce the cost basis of the remaining land rather than be treated as proceeds of the land taken.[60]

In some cases, the entire amount of a judgment representing compensation for property seized, stolen, destroyed, or injured may be taxable as income. For the loss may have been deducted by the taxpayer at the time it was sustained.[61] The mere existence of a cause of action for the injury does not

claim of right without restriction on its disposition might apply. (*Infra*, p. 249, and Part Two).

[56]Income Syndicate, Inc., 37 B. T. A. 926 (1938).

[57]Langley Collyer, 38 B .T. A. 106 (1938).

[58]I. T. 2599, X-2 C. B. 170 (1931); G. C. M. 12657, XIII-1 C. B. 80 (1934). It was held, in the latter ruling, that the taxpayer must prove, either from the terms of the award or from evidence of the reduction in value attributable to the condemnation, how much of the award was allocable to severance damages. If he failed to do so, it was all treated as compensation for the portion taken.

[59]Calvin C. Green, 37 B. T. A. 25 (1938). The same principle apparently was applied in Christian Ganahl Co. v. Comm'r, 91 F. (2d) 343 (C. C. A. 9th 1937), *cert. denied*, 302 U. S. 748, 58 Sup. Ct. 265 (1937), for it appears from the report in 34 B. T. A. 126 (1936) that the award, which the circuit court treated as a unit, included an element of severance damages.

[60]It is significant that in Langley Collyer, 38 B. T. A. 106 (1938), the Board did not refuse to treat severance damages as distinct from the proceeds of the property taken, but went off rather upon a failure of proof.

[61]Section 23 (f) of the Internal Revenue Code permits deduction of losses sustained by corporations, if not compensated for by insurance or otherwise. Section 23 (e) permits deduction of losses sustained by individuals if incurred in trade or business, or if incurred

prevent such deduction.[62] Hence, it may often happen that one who has properly deducted a loss may later recoup his loss in court, and in such a case he must report the entire sum as income, for, in an income tax sense, he has already had the benefit of recovering his cost when he took the deduction, and the entire amount is gain.[63] Although perhaps not strictly within the

in any other transaction entered into for profit; or losses of non-business *property* if they arise from *fires, storms, shipwreck, or other casualty, or from theft,* if not compensated for by insurance or otherwise.

[62]The injury is a closed transaction causing a loss, and the contingency that some other person, who does not now admit liability, may later be held liable does not amount to "compensation". United States v. S. S. White Dental Mfg. Co., 274 U. S. 398, 47 Sup. Ct. 598 (1927) (loss by seizure deducted, later compensated, but deduction held proper); Earle v. Comm'r, 72 F. (2d) 366 (C. C. A. 2d 1934) (loss from theft deductible without showing there was no chance of recovery); Comm'r v. Highway Trailer Co., 72 F. (2d) 913 (C. C. A. 7th 1934), *cert. denied,* 293 U. S. 626, 294 U. S. 731, 55 Sup. Ct. 346, 505 (1935) (fire loss deductible when suffered, not when taxpayer loses action against person allegedly at fault); Comm'r v. John Thatcher & Son, 76 F. (2d) 900 (C. C. A. 2d 1935) (contractor did work after subcontractors defaulted; expense must be taken then and not when he loses suit against sureties); Niagara Share Corp. v. Comm'r, 82 F. (2d) 208 (C. C. A. 4th 1936) (guaranty contract is not "compensation" if liability is disputed); Hinrichs v. Helvering, 95 F. (2d) 117, 68 App. D. C. 206 (1938) (worthless stock deductible although there exists a cause of action against fraudulent seller). *But cf.* Douglas County Light & Water Co. v. Comm'r, 43 F. (2d) 904 (C. C. A. 9th 1930), and American Propeller & Mfg. Co. v. United States, 14 F. Supp. 168, 185, 83 Ct. Cl. 100, 133 (1936), *mod. on other grounds,* 17 F. Supp. 215 (Ct. Cl. 1936), *rev'd on other grounds,* 300 U. S. 475, 57 Sup. Ct. 521 (1937), which are distinguishable but seem inconsistent in principle.

A special rule seems to have been developed by the Board of Tax Appeals with respect to compensation *by insurance* where the insurer denies liability. Even though the insurer not only disputes the amount of the loss (Max Kurtz, 8 B. T. A. 679 [1927]) but denies all liability, so that it becomes necessary to sue to collect—a fact which would prevent a claim from being accrued as income (see *infra,* p. 244), yet it is held that the loss is "compensated" and may not be deducted until loss of the lawsuit or other disposition of the claim fixes the loss. Allied Furriers Corp., 24 B. T. A. 457 (1931). The case seemed much weakened by a reversal of the Board in Cahn v. Comm'r, 92 F. (2d) 674 (C. C. A. 9th 1937), holding a loss not compensated when not only was liability disputed but the insurer would have to be sued in England with little chance of success. But the Board, in Rose Licht, 37 B. T. A. 1096 (1938), confined that case to its facts, and followed the old rule regarding mere disputed liability; however, the case is distinguishable because the dispute did not arise until a subsequent year, so that the loss *was* "compensated" in the taxable year. *Cf.* Broderick v. Anderson, 23 F. Supp. 488 (S. D. N. Y. 1938) (loss in one year, 90 days allowed to report loss, which carried it over to next year; held, no loss sustained until 90 days expired without a report of the loss).

[63]Cooper v. United States, 9 F. (2d) 216, 224 (C. C. A. 8th 1925); Automobile Ins. Co. v. Comm'r, 72 F. (2d) 265 (C. C. A. 2d 1934); Marine Transport Co. v. Comm'r, 77 F. (2d) 177 (C. C. A. 5th 1935); Flynn v. Comm'r, 77 F. (2d) 180 (C. C. A. 5th 1935); W. W. Cleveland, 28 B. T. A. 578 (1933), *aff'd w. o. op.,* 77 F. (2d) 184 (C. C. A. 5th 1935); South Dakota Concrete Products Co., 26 B. T. A. 1429 (1932); Griffiths v. Helvering, 60 Sup. Ct. 277 (1939).

Even though recoupment of the loss occurs before tax liability for the year of the loss has been finally determined, it is to be reported as income when recovered rather than applied as a correction of the former year's return. United States v. S. S. White Dental Co., 274 U. S. 398, 47 Sup. Ct. 598 (1927); Cahn v. Comm'r, 92 F. (2d) 674 (C. C. A. 9th 1937). A different rule applies to tax refunds, *infra* pp. 231-233.

The basis for the rule is thus stated in Estate of William H. Block, 39 B. T. A. 338, 341 (1939):

"Income tax liability must be determined for annual periods on the basis of facts as they existed in each period. When recovery or some other event which is inconsistent with what has been done in the past occurs, adjustment must be made in definition of income, "the duty to make a return of recoupments was implicit in the original right to take the deductions".[64]

Nevetheless, if the taxpayer *might* have deducted the loss when it occurred but failed to do so,[65] he is *not* taxable upon the recoupment; for the recovery is not taxed *qua* income but solely in order to cancel deductions of which the taxpayer has *had the benefit,* when subsequent events occur inconsistent with the facts upon which the deduction was based.[66]

Similar principles apply with respect to bad debts. If once charged off as worthless, whether properly or improperly, the recovery is all income.[67] But if not charged off (or if the taxpayer got no benefit from the charge-off because he had a net loss), the collection of the formerly worthless debt does not result in taxable income.[68]

An entirely distinct line of decisions has grown up with respect to recoveries of *taxes* erroneously paid. Numerous cases have held that money erroneously paid to a government (federal or state, at least) is not a loss, even if no legal remedy for its recovery is available, and therefore the principle just discussed is inapplieable; instead of deducting the tax in the year it accrues or is paid and reporting the refund as income when recovered, the "mistake" (whether

reporting income *in the year in which the change occurs.* No other system would be practical in view of the statute of limitations, the obvious administrative difficulties involved, and the lack of finality in income tax liability, which would result." (Italics supplied.)

[64]Comm'r v. Van Schaick, 83 F. (2d) 940, 941 (C. C. A. 2d 1936) [dictum; the actual holding of the case, refraining from applying this rule to insurance companies, was rendered obsolete by the 1932 Act, broadening the definition of their income. Internal Revenue Code § 204 (b) (1)].

[65]Either through neglect or because he had no net income against which to offset the loss.

[66]The first square holding to this effect was in Central Loan & Investment Co., 39 B. T. A. 981 (1939) (tax refund), followed in Edward H. Clark, 40 B. T. A. 333 (1939). But as early as the case of Theodate Pope Riddle, 27 B. T. A. 1339 (1933), the Board had concurred in the Commissioner's concession of this principle. In Drier v. Helvering, 72 F. (2d) 76, 77, 63 App. D. C. 283 (1934), the Commissioner conceded the point, and the court declared it would "be slow to say" that the full recovery would be taxable when there had been no deduction. A similar result is indicated in G. C. M. 18525, 1937-1 C. B. 80, and G. C. M. 20854, 1939-1 C. B. 102, 6 U. S. LAW WEEK 924 (Mar. 7, 1939), concerning bad debts later recovered. *But cf.* Burnet v. Sanford & Brooks Co., 282 U. S. 359, 51 Sup. Ct. 150 (1931), relating to *expenses* for which the benefit of a deduction had not been enjoyed because of net losses, the Court holding nevertheless that a recovery therefor was taxable.

Of course, these cases by no means establish that one failing to take a deduction at the proper time may later *take a deduction* when he fails in his action to recoup the loss. *See* Comm'r v. Highway Trailer Co., 72 F. (2d) 913 (C. C. A. 7th 1934), *cert. denied,* 293 U. S. 626, 294 U. S. 731, 55 Sup. Ct. 346, 505 (1935); Comm'r v. John Thatcher & Son, 76 F. (2d) 900 (C. C. A. 2d 1935). *Cf. contra*: Douglas County Light & Water Co. v. Comm'r, 43 F. (2d) 904 (C. C. A. 9th 1930). They merely refrain from penalizing him with a tax upon the recoupment of a loss which he did not deduct.

[67]Putnam Nat. Bank v. Comm'r, 50 F. (2d) 158 (C. C. A. 5th 1931); Askin & Marine Co. v. Comm'r, 66 F. (2d) 776 (C. C. A. 2d 1933) (improperly charged off, debt never worthless; taxpayer estopped to rely upon that fact to argue that later collection is not income). Regulations 101, art. 23 (k)-1 (b).

[68]National Bank of Commerce of Seattle, 40 B. T. A. 72 (1939); G. C. M. 18525, 1937-1 C. B. 80 (confined to supervised banks); G. C. M. 20854, 1939-1 C. B. 102, 6 U. S. LAW

of fact, statutory construction, or constitutionality, and no matter how vigorously it is contested) is treated as if it had never occurred, and the income tax of the year the tax was deducted is adjusted to reflect the ultimate result.[69] But the statute of limitations upon the assessment of a deficiency for the earlier year, when the deduction then taken is later found to require correction, necessitates a modification of this rule, and later cases have held it applicable only when the tax liability for the year of the deduction has not been finally determined.[70] If it is no longer possible to correct the tax for the prior year, the recovery is treated like any other recoupment of a loss or expense previously deducted, and is taxable income when recovered.[71] For the deduction

WEEK 924 (Mar. 7, 1939) (extending it to all bad debts). The latter memorandum describes the method of determining whether the taxpayer has had the *benefit* of the deduction, as follows: First take all *other* deductions than bad debts, and determine whether there was a net income. *To the extent that there was,* the bad debt deduction resulted in a benefit. All the bad debts of one year are treated as a unit, and the entire amount of any recovery for such debts is treated as a return of capital until enough is recovered to equal the amount of which he did *not* have the benefit. Thus, if the gross income less all other deductions is $4000, and bad debts are $10,000, he has had the benefit of a $4000 deduction for them, and the first $6000 recovered upon those debts is not taxable. Presumably a similar formula would apply with respect to other losses which are not deducted and are later recouped.

Cf. contra: E. C. Miner Lithographing Co., 1 B. T. A. 588 (1925), holding taxable in full a recovery upon a debt that had been worthless before there was an income tax law, for which, of course, the taxpayer had made no deduction.

Where the taxpayer is assigned a number of claims, some of which have been charged off by the assignor, who, however, received no benefit from the charge-off because of net losses, the rule above stated is not applied. In that case, the *cost* of the claims to the taxpayer is the important factor, and if none of the consideration given is allocable to those claims, the later recovery is taxable in full. The fact that the assignor got no benefit from the charge-off is of no concern to the assignee. National Bank of Commerce of Seattle, *supra.*

[69]Inland Products Co. v. Blair, 31 F. (2d) 867 (C. C. A. 4th 1929) (error of law, federal tax, voluntarily refunded although taxpayer had no remedy available to recover it); Leach v. Comm'r, 50 F. (2d) 371 (C. C. A. 1st 1931) (erroneous assessment, federal tax); Bergan v. Comm'r, 80 F. (2d) 89 (C. C. A. 2d 1935) (same); Bohemian Breweries v. United States, 27 F. Supp. 588, 89 Ct. Cl. — (1939) (same as *Inland Products* case); Philip C. Brown, 10 B. T. A. 1122 (1928) (unconstitutional state tax); Lehigh Valley Coal Sales Co., 15 B. T. A. 1401, 1405 (1929) (same); Joseph V. Horn, 23 B. T. A. 1131 (1931) [subsequent retroactive change of law; seemingly bad on principle, for this is a clear case of the effect of subsequent events upon a *proper* deduction rather than a mistaken deduction; *cf. contra*: Central United Nat'l Bank, 33 B. T. A. 588 (1935), *aff'd,* 99 F. (2d) 568 (C. C. A. 6th 1938); *and see* Estate of William H. Block, 39 B. T. A. 338 (1939)].

This rule has not been applied to ordinary losses, even when recoupment occurs while it would still be possible to adjust the return for the year of the loss. *Supra* note 63.

[70]By the passing of the statute of limitations without the commencement of proceedings, or by a closing agreement.

[71]Houbigant, Inc., 31 B. T. A. 954 (1934), *aff'd w. o. op.,* 80 F. (2d) 1012 (C. C. A. 2d 1936), *cert. denied,* 298 U. S. 669, 56 Sup. Ct. 834 (1936) (customs duties, erroneous classification); Victoria Paper Mills Co., 32 B. T. A. 666 (1935), *aff'd w. o. op.,* 83 F. (2d) 1022 (C. C. A. 2d 1936) (local real estate tax, valuation disputed); Charles W. Nash, 34 B. T. A. 675 (1936), *aff'd,* 88 F. (2d) 477 (C. C. A. 7th 1937), *cert. denied,* 301 U. S. 700, 57 Sup. Ct. 930 (1937) (unconstitutional state tax); Chevy Chase Land Co., 34 B. T. A. 150 (1936) (unconstitutional local tax); Dixie Margarine Co., 38 B. T. A. 471 (1938) (erroneous statutory construction); Estate of William H. Block, 39 B. T. A. 338 (1939) (tax reduced by retroactive law).

was *proper*[72] (although subject to correction in the light of later events), and it is not violative of the statute of limitations for the Commissioner to adjust the tax in the year of recovery when it is no longer permissible to make the adjustment in the year in which it would more truly reflect net income. Here also, of course, if the benefit of a deduction was not enjoyed, the refund is not income.[73]

There are a number of actions involving property the effect of which has yet to be considered. The heir who contests a will successfully in the courts, of course, takes the proceeds of the action by inheritance and is not taxable upon them as income.[74] And it is now settled that amounts paid to an heir to forestall a contest of the will by him are likewise not income.[75]

What little authority there is, in contests over the title to property (other than will contests), holds that when a settlement results in conveyance of the property to the taxpayer, or in a payment of money to him, the money or the value of the land is taxable except to the extent that his claimed interest therein had a cost to him.[76]

A suit to set aside a transfer of property in fraud of creditors, of course,

---

[72]E. L. Bruce Co., 19 B. T. A. 777 (1930); Guitar Trust Estate 34 B. T. A. 857, 873 (1936). Those cases hold that, where an illegal tax is paid and *no refund* is had, the payment is deductible as a business expense or a loss. This is no help when a void *non-business* tax is paid, so it was held in Charles F. Fawcett, 30 B. T. A. 908 (1934), that it was deductible as a *tax*, distinguishing the *Bruce* case, somewhat obscurely, upon the ground that there the payment resulted from a settlement of litigation, whereas in the *Fawcett* case it was voluntarily paid as a tax and the tax statute itself (by its statute of limitations) prevented a refund after the invalidation of the tax. *Quaere,* what the result would be if the facts of the *Bruce* case (litigation) arose in connection with a non-business tax, which could be held deductible only as a tax, not as a *business* expense or *business* loss.

[73]Edward S. Harkness, 31 B. T. A. 1100 (1935); Central Loan & Investment Co., 39 B. T. A. 981 (1939).

[74]Internal Revenue Code § 22 (b) (3). *See* Lyeth v. Hoey, 305 U. S. 188, 196, 59 Sup. Ct. 155 (1938).

[75]Lyeth v. Hoey, 305 U. S. 188, 59 Sup. Ct. 155 (1938); Magruder v. Segebade, 94 F. (2d) 177 (C. C. A. 4th 1938); Thornton Emmons, 39 B. T. A. 75 (1939). *Cf.* Benfield v. United States, 27 F. Supp. 56, 88 Ct. Cl. 486 (1939) (similar treatment of voluntary adjustment, no contest having been made). *See* note (1935) 44 YALE L. J. 1267. This note and the *Lyeth* case discuss the state court decisions, a majority of which had treated a compromise payment as *not* being an inheritance, for *inheritance* tax purposes.

[76]In Sterling v. Comm'r, 93 F. (2d) 304 (C. C. A. 2d 1937), *cert. denied,* 303 U. S. 663, 58 Sup. Ct. 829 (1938), a payment to the taxpayer by a devisee's widow, to clear title to land without the necessity of a suit to construe the will, was held income *in toto,* the tax court itself construing the will and finding the taxpayer's claim under the will valueless. Similar reasoning was applied in Lyeth v. Hoey, 96 F. (2d) 141 (C. C. A. 2d 1938), and the *Sterling* case may be considered to have fallen with the reversal of the *Lyeth* case. However, where the claimant (taxpayer) rests his claim not upon his position as heir but upon some other basis, those principles may apply. *See* S. A. Pierce, 8 B. T. A. 1218 (1927), in which the taxpayer made a *gift* of property and later sued to get it back on the theory of constructive trust, which suit was settled; if a constructive trust were *proved,* of course, the property remained his throughout; but if a gift *was* consummated and the later settlement was merely consideration paid to avoid a lawsuit, it would be income; the mere agreement of the parties did not establish the existence of a constructive trust, and no evidence thereof was presented to the Board, so the whole was held to be income.

cannot be considered apart from the claim of the creditor against the transferor. Hence, any property so recovered, or a cash settlement of such an action, will be income or not, depending upon the nature of the plaintiff's basic claim.[77]

There is a class of compensatory recoveries no part of which is taxed as income, since no cost basis can be assigned to the injury which is sustained. Most important of these are recoveries on account of personal injuries. This is now expressly provided for by statute,[78] but the same rule had previously been followed.[79] In the same category, although not covered by the statutory exception, are recoveries for libel and slander,[80] for alienation of affections,[81] or for breach of promise to marry,[82] and sums received in settlement of a child custody suit.[83] For the human body and the reputation which are injured are in no true sense capital or property upon which a value can be placed for the purpose of computing the profit realized; the promise to marry likewise is a personal right not susceptible of appraisal in relation to market values; and the spouse whose affections are alienated and the child whose custody is surrendered are not chattels which are sold.

Also in this category are alimony payments, and the like. In this field, there has been much recent development, and the details of the law are far from settled.[84] But the basic principle is clear. Alimony and separation allowances, and payments for the support of children and for the release of dower, are not taxable as income of the wife.[85] Such payments do not arise from contract

---

[77]Swastika Oil & Gas Co., 40 B. T. A. 797 (1939).

[78]Internal Revenue Code § 22 (b) (5). The statute seems broad enough to cover even periodical payments in the nature of a replacement of earnings. It covers amounts received whether by suit or by agreement. *See* I. T. 3306, (1939) Int. Rev. Bull. No. 32, p. 2, 7 U. S. LAW WEEK 163 (Aug. 22, 1939).

Interest upon a personal injury judgment is taxable, since it is compensation not for the injury but for the delay in paying a debt. Theodate Pope Riddle, 27 B. T. A. 1339 (1933).

[79]31 Op. Atty. Gen. 304 (U. S. 1918); T. D. 2747 (Int. Rev., 1918).

[80]Sol. Op. 132, I-1 C. B. 92 (1922) (covering *personal* libel; reserved question of libel affecting *business* reputation or property rights); C. A. Hawkins, 6 B. T. A. 1023 (1927) (involved *business* reputation). The *Hawkins* case expressly reserved the question of the taxability of special damages representing lost *income* rather than mere injury to reputation. It also reserved the question of exemplary damages, but since those are in the nature of a penalty, a gratuitous transfer designed to discourage improper acts, and not a gain derived from labor or capital, it may be that they are non-taxable. *Cf.* Central R. R. of N. J. v. Comm'r, 79 F. (2d) 697 (C. C. A. 3d 1935), *supra* note 32.

[81]Sol. Op. 132, I-1 C. B. 92 (1922).

[82]I. T. 1804, II-2 C. B. 61 (1923); Mrs. Lyde McDonald, 9 B. T. A. 1340 (1928) (Board emphasized instructions of judge, which had stressed compensatory rather than exemplary damages; but see *supra* note 80).

[83]Sol. Op. 132, I-1 C. B. 92 (1922).

[84]As will be discussed presently, the Supreme Court laid down a new principle respecting alimony *trusts* in 1935, the circuit courts of appeals differed on its application, and the Board followed the Second Circuit—which in 1939 overruled its former decision, leaving a big question mark on the intervening cases in the B. T. A. The Supreme Court has granted *certiorari* (on one of the other cases involving the point).

See a full discussion in Paul, *Five Years with Douglas v. Willcutts* (Nov. 1939) 53 HARV. L. REV. 1.

[85]Gould v. Gould, 245 U. S. 151, 38 Sup. Ct. 53 (1917): Jane B. Coates, 3 B. T. A. 429 (1926); Regulations 101, art. 22 (b) (3)-1. If a note is given for the alimony or

but from the marriage relationship, and represent the portion of the *husband's* estate or income to the enjoyment of which the wife is equitably entitled.

The case of *Douglas v. Willcutts*[86] and its numerous progeny have extended this rule to the income of trusts set up to discharge those obligations.[87] Although the great bulk of the cases here discussed concern the question whether the trust income is taxable to the husband, they rest upon the principle that the income is used to discharge the legal obligation of the husband to the wife, and it follows that in the situations where it is held to be income taxable to the husband, it is not taxable to the wife.[88] The same rules apply whether the settlement or decree pursuant to which the trust is created purports to discharge the husband's obligation of *support* or the wife's marital rights in his *property*.[89] If in fact the trust income discharges such obligation; it is immaterial whether the divorce court adopted or otherwise referred to the trust settlement in its decree.[90]

It is, of course, most clear that when a fixed sum is regularly payable to the wife, the husband guaranteeing against any deficiency in the trust income, the trust income is really used for his benefit, to discharge a fixed and continuing obligation, and the trust is merely security therefor.[91] Likewise, if the divorce

---

other obligation, the interest upon it partakes of the same character as the principal payment. *Cf.* Longyear v. Helvering, 77 F. (2d) 116, 64 App. D. C. 238 (1935) (holding husband may not deduct it as interest upon indebtedness; the reasoning of the opinion would apply to the converse situation, rendering it not taxable to the wife).

[86]296 U. S. 1, 56 Sup. Ct. 59 (1935).

[87]Identical principles apply to the assignment of an interest in an existing trust or the income thereof. Donnelly v. Comm'r, 101 F. (2d) 879 (C. C. A. 7th 1939), *cert. denied,* 59 Sup. Ct. 1043 (1939).

The assignment of one's future income is considered in Blair v. Comm'r, 300 U. S. 5, 57 Sup. Ct. 330 (1937). If the income depends upon the continued activity of the transferor, it continues taxable to him even though it does not pass through his hands; but if a recognized interest in existing property, which is transferable by local law, is transferred (even though in the form of an assignment of future income), the income thereafter is that of the transferee alone, unless the *income* (not the property) discharges a *continuing* obligation of the transferor. *See also* Shanley v. Bowers, 81 F. (2d) 13 (C. C. A. 2d 1936); Clifford v. Helvering, 105 F. (2d) 586 (C. C. A. 8th 1939), *cert. granted,* 60 Sup. Ct. 139 (1939); George O. Knapp, 40 B. T. A. No. 174 (Dec. 19, 1939).

[88]The Board so held in Mary R. Spencer, 20 B. T. A. 58 (1930), and Maud H. Bush, 33 B. T. A. 628 (1935), both of which anticipated the *Douglas* case. Those cases were followed in Princess Lida of Thurn and Taxis, 37 B. T. A. 41 (1938). *See also* G. C. M. 13308, XIII-2 C. B. 184, 186 (1934). But the variants here discussed were all worked out with respect to the husband, and apply to the converse situation only by analogy.

[89]Douglas v. Willcutts, 296 U. S. 1, 56 Sup. Ct. 59 (1935) (in lieu of both alimony and dower); Helvering v. Coxey, 297 U. S. 694, 56 Sup. Ct. 498 (1936), *rev'g w. o. op.* 79 F. (2d) 661 (C. C. A. 3d 1935); Helvering v. Brooks, 82 F. (2d) 173 (C. C. A. 2d 1936) (overruled on other grounds in Helvering v. Leonard, 105 F. (2d) 900 (C. C. A. 2d 1939)); John Ernest Goldring, 36 B. T. A. 779 (1937); E. T. Weir, 39 B. T. A. 400 (1939); Robert Barbour, 39 B. T. A. 910 (1939).

[90]Helvering v. Coxey, 297 U. S. 694, 56 Sup. Ct. 498 (1936), *rev'g w. o. op.* 79 F. (2d) 661 (C. C. A. 3d 1935); Comm'r v. Hyde, 82 F. (2d) 174 (C. C. A. 2d 1936); Alsop v. Comm'r, 92 F. (2d) 148 (C. C. A. 3d 1937), *cert. denied,* 302 U. S. 767, 303 U. S. 666, 58 Sup. Ct. 480, 521 (1938); Albert C. Whitaker, 33 B. T. A. 865 (1935), *appeal dismissed,* 87 F. (2d) 1022 (C. C. A. 4th 1937); E. T. Weir, 39 B. T. A. 400 (1939); Rowe B. Metcalf, 40 B. T. A. 177 (1939).

[91]The guaranty of a fixed income was present in Douglas v. Willcutts, 296 U. S. 1, 56

court has a continuing power to modify the decree, irrespective of any agreement of the parties, the *duty* of support thus *continues* irrespective of the settlement or decree, and the trust income serves to satisfy the continuing obligation of the husband.[92] But if the setting up of the trust absolutely and forever discharges the husband of all further obligation to his wife—if he neither guarantees the income from the property nor may be ordered by the divorce court to supplement it—it is exactly as if he had given her outright a lump sum of money or property, the *income* from which would clearly be the wife's, not the husband's; the circumstance that it is placed in trust does not change it. The obligation was "paid off" once and for all by the transfer of *property*, and there is no continuing obligation which is met by the *income*. In such a case, three circuit courts of appeals have held that the husband is relieved and the wife pays the tax just as upon any other income from her property.[93]

Of course, if there exists no obligation to the wife, or if no obligation is released as a result of setting up the trust, there is an outright gift of an

---

Sup. Ct. 59 (1935); Comm'r v. Hyde, 82 F. (2d) 174 (C. C. A. 2d 1936); Alsop v. Comm'r, 92 F. (2d) 148 (C. C. A. 3d 1937), *cert. denied*, 302 U. S. 767, 303 U. S. 666, 58 Sup. Ct. 480, 521 (1938); Robert Glendinning, 36 B. T. A. 486 (1937), *aff'd*, 97 F. (2d) 51 (C. C. A. 3d 1938); Donnelly v. Comm'r, 101 F. (2d) 879 (C. C. A. 7th 1939), *cert. denied*, 59 Sup. Ct. 1043 (1939); Frank P. Welch, 12 B. T. A. 800 (1928); Frank Turner, 28 B. T. A. 91 (1933), *aff'd w. o. op.*, 71 F. (2d) 1018 (C. C. A. 2d 1934); Princess Lida of Thurn and Taxis, 37 B. T. A. 41 (1938); Cap Andrew Tilles, 38 B. T. A. 545, 548 (1938); E. T. Weir, 39 B. T. A. 400 (1939); Robert Barbour, 39 B. T. A. 910 (1939). *See also* XIII-2 C. B. 184, 186 (1934).

[92]This fact was brought out in Douglas v. Willcutts, 296 U. S. 1, 56 Sup. Ct. 59 (1935). It was also true in Helvering v. Coxey, 297 U. S. 694, 56 Sup. Ct. 498 (1936) (no opinion), and in Helvering v. Brooks, 82 F. (2d) 173 (C. C. A. 2d 1936), but was not mentioned by the courts; it is pointed out in Fitch v. Comm'r, 103 F. (2d) 702 (C. C. A. 8th 1939), *cert. granted*, 60 Sup. Ct. 103 (1939), and Helvering v. Leonard, 105 F. (2d) 900 (C. C. A. 2d 1939).

[93]Comm'r v. Tuttle, 89 F. (2d) 112 (C. C. A. 6th 1937); Fitch v. Comm'r, 103 F. (2d) 702 (C. C. A. 8th 1939), *cert. granted*, 60 Sup. Ct. 103 (1939); Helvering v. Leonard, 105 F. (2d) 900 (C. C. A. 2d 1939). The Second Circuit's holding had been contrary in principle (although the case was actually distinguishable by a fact *dehors* the opinion), in Helvering v. Brooks, 82 F. (2d) 173 (C. C. A. 2d 1936), which the Board had consistently followed, distinguishing or waving aside the *Tuttle* case; when the Board was finally forced to choose between the flatly contradictory *Brooks* and *Fitch* cases, it chose the *Brooks* case [in Rowe B. Metcalf, 40 B. T. A. 177 (1939)], on the very day when that case was repudiated by the Second Circuit in the *Leonard* case. The Board had followed the *Tuttle* case, however, in cases clearly involving a division of property rather than alimony. Ernestine Mitchell, 38 B. T. A. 1336 (1938); Howard S. Dudley, 39 B. T. A. 1170 (1939).

Here also, the rule is the same whether the obligation discharged is for support (Helvering v. Leonard, *supra*) or for property rights (Tuttle v. Comm'r and Fitch v. Comm'r, *supra*).

If the *minimum* amount of the income is not guaranteed by the husband, it is immaterial that he is entitled to all that *above* a fixed amount, for he has no continuing *obligation*. Fitch v. Comm'r, *supra*.

The Treasury has not acquiesced in the cases, and the whole question is now pending before the Supreme Court. [The *Fitch* case was reversed by the Supreme Court, 8 U. S. L. Week 189 (Jan. 29, 1940), for failure to establish that the Iowa court had no power to modify the decree, without disapproving the principle stated.—Ed.]

interest in the trust property and the income is taxable to the wife in any event.[94] But if there is an existing obligation for which the trust income (guaranteed as to amount) is intended as a substitute, the subsequent termination of the underlying obligation does not relieve the husband or shift the tax to the wife, for the release of the existing obligation was a valuable consideration for the substitution of a new obligation lasting for the duration of the trust, which the guaranteed income ever after discharges.[95]

If the other conditions are met rendering the trust income taxable to the wife rather than to the husband, the result is not changed by the fact that the husband retains a large power to direct the investments and to vote the stocks in the trust,[96] or even that he himself is the trustee,[97] for his interest in the trust is not such control of the *economic benefits* as is subject to tax; the *income* is beyond his control and (by hypothesis) serves no purpose beneficial to him.

It should be borne in mind that the foregoing rules apply only to irrevocable trusts. If the husband or a person not having a substantial adverse interest, or the husband together with such a person, has a power to revest the property in the husband, the income is taxable to him (and not to the wife) regardless of the other circumstances just discussed.[98] While a power of revocation would be rare in alimony trusts, it might frequently happen that the trust would be limited to the life of the wife, or until her remarriage, or for a term of years. The regulations specify that if, in such a case, there is a reversion in the grantor (the husband), the income may, in certain circumstances, be taxable to him.[99] But several circuit courts of appeals have held that the term

[94]Shanley v. Bowers, 81 F. (2d) 13 (C. C. A. 2d 1936); Henry Oliver Rea, 35 B. T. A. 1132 (1937) (trust set up pending divorce, but alimony could not be had in that state, and no evidence that any other obligation was released); Edward T. Hall, 36 B. T. A. 398 (1937) (wife had sacrificed rights to alimony and dower because of adultery; trust voluntarily set up).

[95]Alsop v. Comm'r, 92 F. (2d) 148 (C. C. A. 3d 1937), *cert. denied*, 302 U. S. 767, 303 U. S. 666, 58 Sup. Ct. 480, 521 (1938) (remarriage of wife, would have relieved of *alimony*, but *trust* continued with guaranteed income; husband had liquidated his alimony obligation which might have ended upon remarriage, discharging it by fixed payments over wife's whole life, so it is taxable to him); Robert Glendinning, 36 B. T. A. 486 (1937), *aff'd*, 97 F. (2d) 51 (C. C. A. 3d 1938) (state law gave no alimony, but trust income, guaranteed for life, was substituted for existing temporary support order); Clayton G. Dixon, 39 B. T. A. 795 (1939) (trust for life in discharge of existing obligation to support wife, unaffected by subsequent divorce which ends obligation of support in that state). *But cf.* Harry S. Blumenthal, 34 B. T. A. 994 (1936), *aff'd w. o. op.*, 91 F. (2d) 1009 (C. C. A. 2d 1937) (remarriage, trust continued though alimony obligation would have ceased, held no longer taxable to husband; distinguishable in that there was no guaranty of income and the court's power over the decree ceased at remarriage).

[96]Comm'r v. Tuttle, 89 F. (2d) 112 (C. C. A. 6th 1937) (voting rights); Clifford v. Helvering, 105 F. (2d) 586 (C. C. A. 8th 1939), *cert. granted*, 60 Sup. Ct. 139 (1939) (voting and investment); Claude R. Branch, 40 B. T. A. No. 160 (Dec. 7, 1939).

[97]Clifford v. Helvering, 105 F. (2d) 586 (C. C. A. 8th 1939), *cert. granted*, 60 Sup. Ct. 139 (1939); Claude R. Branch, 40 B. T. A. No. 160 (Dec. 7, 1939).

[98]Internal Revenue Code § 166; Regulations 101, art. 166-1.

[99]Regulations 101, art. 166-1. *But cf.* I. T. 3238, 1938-2 C. B. 204.

"power to revest" contemplates a power to put an end to the estate granted, and that a reversion following an absolute trust terminating after a period of years or upon an event beyond the grantor's control is not such; hence that the rules already stated would apply to such trusts, unaffected by this provision of law.[100]

If a trust for alimony or in lieu of dower is of such a nature that its income would be taxable to the husband, it nevertheless becomes taxable to the wife after the husband's death.[101]

This concludes the consideration of the taxability of judgments and settlements in the various kinds of actions. There remain a few general remarks relative to recoveries of all kinds.

The interest upon a judgment, like interest upon any debt, is taxable income, even though the judgment itself be non-taxable.[102]

The fact that a judgment, which is otherwise taxable, is obtained against a state or a subdivision thereof does not make the judgment or the interest thereon exempt from federal income tax.[103]

---

[100]United States v. First Nat. Bank of Birmingham, 74 F. (2d) 360 (C. C. A. 5th 1934) (prior to regulations; treated trust for years as equivalent to estate for years in property); Comm'r v. Tuttle, 89 F. (2d) 112, 115 (C. C. A. 6th 1937) (same); Comm'r v. Wood, 104 F. (2d) 1013 (C. C. A. 2d 1939), *cert. granted,* 60 Sup. Ct. 139 (1939) (no opinion); Clifford v. Helvering, 105 F. (2d) 586 (C. C. A. 8th 1939), *cert. granted,* 60 Sup. Ct. 139 (1939) (repudiates regulations as in direct conflict with plain language of statute, and hence not validated by re-enactment of statute); Claude R. Branch, 40 B. T. A. No. 160 (Dec. 7, 1939).

[101]Thomas v. Comm'r, 100 F. (2d) 408 (C. C. A. 2d 1938). The court is not entirely clear in its reasons, but apparently it rests upon the highly practieal consideration that it would be impossible to collect from anyone but the wife, since the husband's estate might be closed long before the wife died, and it would be impracticable to keep the estate open, subject to an indeterminate demand for annual income taxes throughout the life of the wife. Judge Learned Hand, concurring, remarked that this might be a hardship on the wives at first but that in the future women accepting settlements could take account of this possibility of future taxability when making their demands. Attorneys take heed!

[102]Monell v. Helvering, 70 F. (2d) 631 (C. C. A. 2d 1934) (interest on non-taxable tax refund); Henri Chouteau, 22 B. T. A. 850 (1931); Theodate Pope Riddle, 27 B. T. A. 1339 (1933) (interest on personal injury judgment); G. C. M. 9210, X-1 C. B. 129 (1931). A different rule may apply to the interest upon an alimony claim. *Cf.* Longyear v. Helvering, *supra* note 85.

But if the combined principal and interest *included in* an award for property taken (rather than subsequently accruing upon the judgment) is less than the loss compensated for thereby (if not previously deducted), the designation of part of the award as interest is not controlling, and enough of the award to cover the loss is non-taxable. Drier v. Helvering, 72 F. (2d) 76, 63 App. D. C. 283 (1934).

The interest included in a condemnation award has been held to be a part of the award for the property, and hence taxable as capital gain. Seaside Improvement Co. v. Comm'r, 105 F. (2d) 990 (C. C. A. 2d 1939), *cert. denied,* 60 Sup. Ct. 263 (1939); Estate of Edgar S. Appleby, 41 B. T. A. No. 4 (1940).

[103]To tax the judgment (or condemnation award, to the extent that gain is realized) imposes no burden upon the state or its subdivision, so there is no constitutional objection. Baltimore & Ohio R. R. v. Comm'r, 78 F. (2d) 460 (C. C. A. 4th 1935); *cf.* Fullilove v. United States, 71 F. (2d) 852 (C. C. A. 5th 1934).

The same is true of the interest upon such a judgment. And the statutory exemption of interest upon the obligations of states and their subdivisions [Internal Revenue Code § 22 (b) (4)] has been held to be confined to obligations created under the *borrowing*

If the plaintiff is a non-resident alien or a foreign corporation (whether or not doing business within the United States), special problems arise by virtue of the peculiar structure of the statutory provisions defining their income from sources within the United States. The construction of those statutes, with respect to unusual kinds of income, is still highly unsettled.[104]

power, and not to extend to interest on judgments. United States Trust Co. v. Anderson, 65 F. (2d) 575 (C. C. A. 2d 1933); Baltimore & Ohio R. R. v. Comm'r, *supra*.

[104]Non-resident aliens and all foreign corporations are taxable only upon their income from sources within the United States. Internal Revenue Code §§ 211 and 231. Section 119 (a) specifies that "the following items of gross income shall be treated as income from sources within the United States", and lists interest, dividends, compensation for personal services, rentals and royalties, and gains from sales of real property, with special provisions respecting each. The Board of Tax Appeals has repeatedly held that this is an exclusive list, and that a judgment not fitting into one of these categories is not taxable to a non-resident alien or foreign corporation plaintiff. Consorzio Veneziano di Armamento e Navigazione, 21 B. T. A. 984 (1930) (interest on judgment against United States; held not "interest on *interest-bearing obligation* of a *resident*", both of which elements were held to be requisite to come within the langnage of § 119); Stockholms Enskilda Bank, 25 B. T. A. 1328 (1932) (same); N. V. Koninklijke Hollandische Lloyd, 34 B. T. A. 830 (1936) (judgment covering *lost profits* resulting from tort); Suffolk Co., Ltd., 37 B. T. A. 1156 (1938) (refund of tax previously deducted). The *Stockholms Enskilda* case was affirmed, *sub nom.* Helvering v. Stockholms Enskilda Bank, 68 F. (2d) 407 (App. D. C. 1933), but was then reversed, 293 U. S. 84, 55 Sup. Ct. 50 (1934), solely upon the interpretation of the words "resident" and "interest-bearing obligation", nothing in the opinion suggesting that the list in § 119 (a) was not exclusive. The same is true of Helvering v. British-American Tobacco, Ltd., 69 F. (2d) 528 (C. C. A. 2d 1934), *aff'd*, 293 U. S. 95, 55 Sup. Ct. 55 (1934). Before the Supreme Court had spoken favorably to the Government, the Congress plugged the loophole by adding, in the 1934 Act, "interest from the United States", *etc.* The committee reports declared that the law had been incorrectly interpreted but that it was desired to remove all doubts. (1934) H. R. REP. No. 704, 73rd Cong., 2d Sess., p. 32; (1934) SEN. REP. No. 558, 73rd Cong., 2d Sess., p. 38. But this likewise suggests that only the interpretation of "residents" and "obligations" was disapproved, for there would be more appropriate ways to "remove all doubts" concerning whether the list of kinds of income was intended to be exclusive; in fact, the broadening of the list tends strongly to indicate that the list was exclusive.

But, in 1939, in Helvering v. Suffolk Co., 104 F. (2d) 505 (C. C. A. 4th 1939), reversing the Board (*supra*), this line of cases was disapproved. The court declared that § 119 (a) merely gives special rules for the treatment of certain income categories; that § 119 (c) covers the same categories, from *outside* sources; that unusual kinds (there a tax refund) are in neither subsection and therefore are covered by § 119 (e), as "items of gross income . . . other than those specified in subsections (a) and (c)", which are to be apportioned as provided by regulations. This reasoning had been applied by the Board in dealing with gains upon sales of personal property (not specifieally listed), in Hubert De Stuers, 26 B. T. A. 201 (1932), and Carding Gill, Ltd., 38 B. T. A. 669 (1938), but the Board had refused to extend it to more unusual forms of income. *See also* I. T. 3119, 1937-2 C. B. 227.

If the non-resident alien or foreign corporation is *not* engaged in business in the United States and has no office or place of business therein, his or its taxability is further complicated by the provisions of §§ 211 (a) and 231 (a), new in 1936 and not yet interpreted with respect to judgments. These limit the taxability of income of such taxpayers, even from sources within the United States, to a patently exclusive list of categories ("interest [except interest on deposits with persons carrying on the banking business], dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or *other fixed or determinable annual or periodical* gains, profits, and income"). Although primarily intended to eliminate the tax upon capital gains of such taxpayers, which it had been found impossible to collect [see (1936) H. R. REP. No. 2475, 74th Cong., 2d Sess., p. 9; (1936) SEN. REP. No. 2156, 74th Cong., 2d Sess., p. 22], it may well be that certain judgments will be held to be excluded thereby.

If the plaintiff is an assignee, the cause of action is capital, and he must recover his capital cost before any part of the judgment is taxable to him.[105]

Before leaving this phase of the subject, it is important to call the attention of attorneys to the disadvantages of general verdicts and lump sum settlements covering different kinds of causes of action (*i.e.*, different from an income tax standpoint, as outlined herein). It is highly desirable to make an apportionment of a settlement when a compromise agreement is made, and to refrain from joining diverse causes of action or to demand, if local practice permits, that the jury specify the amount it awards upon each claim. For the burden

[105]Hyatt Roller Bearing Co. v. United States, 43 F. (2d) 1008, 70 Ct. Cl. 443 (1930); Comm'r v. Owens, 78 F. (2d) 768 (C. C. A. 10th 1935). *Cf.* John D. Fackler, 39 B. T. A. 395 (1939).

When the assignee has taken over a number of claims, some of which had been worthless in the hands of the assignor, and the consideration given equals only the value of the sound claims, the assignee's cost basis is zero for the worthless claims and any recoveries thereon are income, even though neither the assignor nor the assignee had the benefit of their deduction as bad debts (*see supra* note 68). National Bank of Commerce of Seattle, 40 B. T. A. 72 (1939).

If the claims are acquired by virtue of a transaction in a reorganization, as prescribed in section 112 of the Internal Revenue Code, no gain or loss is recognized upon that transaction and the assignee takes the cost basis of the assignor [see Internal Revenue Code § 113 (a) (7)]. *Cf.* National Bank of Commerce of Seattle, *supra.*

When a cause of action is transmitted at death, the cost basis to the legatee or distributee is the *value* at date of death. Brewster v. Gage, 280 U. S. 327, 334, 50 Sup. Ct. 115 (1930). The *value*, for income tax purposes, of a cause of action which has not been finally and conclusively adjudicated is zero, because it is contingent. United States v. Safety Car Heating Co., 297 U. S. 88, 56 Sup. Ct. 353 (1936). Hence, no cost basis is deductible from the taxable recovery in such a case. J. R. Knowland, 29 B. T. A. 618 (1933). *See infra* note 125.

The assignee's gain or loss, realized when he collects the claim or gets final judgment thereon, is not governed by the *capital* gain and loss provisions of section 117 of the Internal Revenue Code, for the collection of a debt is not a "sale or exchange" thereof. I. T. 3121, 1937-2 C. B. 138; *cf.* Hale v. Helvering, 85 F. (2d) 819, 66 App. D. C. 242 (1936).

If the cause of action is of a taxable nature, the *assignor* realizes income in the amount received for the assignment. Victoria Paper Mills Co., 32 B. T. A. 666 (1935), *aff'd w. o. op.*, 83 F. (2d) 1022 (C. C. A. 2d 1936). If the claim is of such a nature that a recovery thereon would be ordinary income rather than capital gain, the income received from a sale of the cause of action is also ordinary income. Doyle v. Comm'r, 102 F. (2d) 86 (C. C. A. 4th 1939).

Even if the assignment of the cause of action was by gift (in this case, to the taxpayer's wife), the original owner of the cause of action escapes taxation upon it. Louis Boehm, 35 B. T. A. 1106 (1937); *but cf.* Griffiths v. Helvering, 60 Sup. Ct. 277 (1939) (where tax evasion was the obvious purpose of the transaction). But, if of a taxable nature, the judgment when obtained will be taxable in full to the donee, except to the extent that it had a cost basis to the donor. *See* Internal Revenue Code § 113 (a) (2). If it was assigned to pay an obligation of the assignor, presumably income in the amount of the obligation would be realized at the time of the assignment (assuming a cause of action of taxable nature); but if no actual assignment is found, the original owner of the cause of action is taxable upon the judgment even though, by his direction or by contract, all or a part of the proceeds are diverted to the payment of his obligation without passing through his hands. Newman & Carey Subway Construction Co., 37 B. T. A. 1163 (1938) (taxpayer agreed with creditor that anything he received in a certain damage suit would be paid upon the debt, and it was so paid by the attorney collecting it); *see also* Comm'r v. Field, 42 F. (2d) 820 (C. C. A. 2d 1930) (attorney was to get 15% of recovery, by contract, but no formal assignment of share of cause of action was made; hence taxable in full to plaintiff; point not discussed).

of proof is upon the taxpayer to show what portion of the recovery is for the non-taxable causes of action, and, while the Commissioner's determination must not be arbitrary, he may resolve all doubts against the taxpayer who fails in his proof.[106] Although the contract of settlement might not be conclusive if an attempt at evasion were evident, it would seem that a *bona fide* apportionment by the parties would be strong evidence for the taxpayer who otherwise, if he settles for a lump sum, faces an impossible problem of proof.[107]

b. *When taxable*

Assuming that the recovery upon a particular cause of action, or some

[106]Kentucky & Indiana Terminal Ry. v. Comm'r, 54 F. (2d) 738 (C. C. A. 6th 1931), *cert. denied,* 286 U. S. 557, 52 Sup. Ct. 639 (1932) (court determined from mathematical relation of claims made, some of which were undisputed, that all of taxpayer's disputed claim was allowed as part of lump sum, so taxable although as a net result of settlement taxpayer paid out money); Southern Ry. v. Comm'r, 74 F. (2d) 887 (C. C. A. 4th 1935) (Commissioner upheld in applying entire settlement to taxable item of claim, since claim for that item had been larger than the whole recovery and there was *no proof* that it was not the only claim allowed); Foley v. Comm'r, 94 F. (2d) 958 (C. C. A. 3d 1938), *cert. denied,* 305 U. S. 615, 59 Sup. Ct. 74 (1938) (similar).

But cf. Tunnel R. R. v. Comm'r, 61 F. (2d) 166 (C. C. A. 8th 1932) (claim and counterclaim for same matter, each party claiming balance was in his favor; settlement wiped slate clean; Commissioner maintained that taxpayer's claim had been allowed and offset by other items, but court found this entirely unsupported by evidence, declaring it "sheer guesswork" to say that the adjustment liquidated any particular claims); Ann Arbor R. R. v. Comm'r, 97 F. (2d) 343 (C. C. A. 6th 1938) (by settlement of mutual claims, taxpayer paid out money, and asserted that this showed that nothing was allowed upon the claim involved in the tax case, but so to hold would require the assumption that all its other claims were allowed in full and the particular one disallowed in full; neither that assumption nor that of the Commissioner, that all of the other party's claims were allowed in full and set off against the full amount of taxpayer's claim, was justified by the evidence, for the whole was a compromise; the court rejected both assumptions and made its own determination from the record).

If there is no doubt that some, at least, of the amount received was of a non-taxable nature, it cannot all be held taxable merely for lack of exact apportionment, but all doubts may be resolved against the taxpayer. *Cf.* [George M.] Cohan v. Comm'r, 39 F. (2d) 540, 543 (C. C. A. 2d 1930), in which Judge Learned Hand declared (with respect to certain business expenses of which no account had been kept):

> "Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent. . . . The amount may be trivial and unsatisfactory, but there was basis for some allowance, and it was wrong to refuse any. . . . It is not fatal that the result will inevitably be speculative; many important decisions must be such. We think the Board was in error and must reconsider the evidence."

Cf. also Burnet v. Houston, 283 U. S. 223, 228, 51 Sup. Ct. 413 (1931).

[107]No case has been found in which the apportionment of a settlement by agreement of the parties was questioned by the Commissioner or specifically considered by the court. The taxpayer may not avail himself of the common law right of the creditor to make application of payments if the debtor does not, for that relates only to the question of which claim is extinguished by the payment, whereas by a lump sum settlement *all* claims are extinguished. Therefore, the taxpayer cannot bind the Commissioner by his *unilateral* act. Southern Ry. v. Comm'r, 74 F. (2d) 887 (C. C. A. 4th 1935). But the taxpayer himself may be bound by his bookkeeping entries in apportioning the settlement. Lehigh & Hudson River Ry. v. Comm'r, 36 F. (2d) 719 (C. C. A. 2d 1929), *mod. on other grounds,* 38 F. (2d) 1015 (C. C. A. 2d 1930), *cert. denied,* 281 U. S. 748, 50 Sup. Ct. 353 (1930).

portion of such recovery, would be taxable as income, at what time does it become taxable? At first glance, this might seem to be of little importance, since, in one year or another, it is taxable anyway. But a great volume of litigation has concerned this problem, because taxpayers seek to report the recovery as income in a year when the tax rate was lower, or when their income was in lower brackets of the graduated scale of rates, or when they had a net loss against which to offset the income—or they seek to escape tax entirely by assigning the income to a year for which the tax is already barred by the statute of limitations.[108]

When the taxpayer makes his return upon the cash receipts and disbursements basis, the problem is relatively simple.[109] The recovery is taxable when the taxpayer receives cash or the equivalent of cash.[110] A negotiable note received in payment of a claim is tbe equivalent of cash to the extent of its fair market value, but only if it is of marketable quality so that the taxpayer could at once convert it into cash if he so elected.[111] But a judgment is *not* the equivalent of cash, for it is not given as property or as payment, and, while sometimes marketable, it is not negotiable and is sold subject to all defenses existing against the seller.[112]

If a payment on account of a claim or a judgment is for any reason tied up in escrow or otherwise made unavailable to a taxpayer on the cash basis, it is not income to him until released.[113]

A payment to the taxpayer's attorney is the equivalent of payment to him,[114] unless the attorney asserts a lien thereon in an unliquidated amount so that it

---

[108]This last feat was accomplished in Helvering v. St. Louis Southwestern Ry., 66 F. (2d) 633 (C. C. A. 8th 1933), *cert. denied,* 292 U. S. 626, 54 Sup. Ct. 632 (1934), which result drew the fire of the dissenting judge. It was also attacked in Maguire and Zimet, *Hobson's Choice and Similar Practices in Federal Taxation* (1935) 48 HARV. L. REV. 1281. *Cf.* Stone v. White, 301 U. S. 532, 57 Sup. Ct. 851 (1937).

The opportunities for thus escaping taxation will be much reduced, though not entirely eliminated, by section 820 of the 1938 Act, now Internal Revenue Code, § 3801. The purpose and effect of this provision are discussed in (1938) SEN. REP. No. 1567, 75th Cong., 3rd Sess., p. 48; (1938) H. R. REP. No. 2330, 75th Cong., 3rd Sess., pp. 57-59; Regulations 101, article 820-1; 1 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (Supp. 1938) ch. 11A.

[109]The cash basis is discussed in Magill, *When Is Income Realized?* (1933) 46 HARV. L. REV. 933, 934-940; 1 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) ch. 10 and §§ 11.19 to 11.63.

[110]Flynn v. Comm'r, 77 F. (2d) 180 (C. C. A. 5th 1935); William F. B. Koelle, 7 B. T. A. 917 (1927) (taxable when check received, not when settlement completed); Regulations 101, art. 42-1.

[111]Percy K. Hexter, 8 B. T. A. 888 (1927). *See also* Magill, *loc. cit. supra* note 109, at 936; Regulations 101, art. 22 (a)-4; I. T. 2046, III-2 C. B. 56 (1924).

[112]Kyle v. Comm'r, 43 F. (2d) 291 (C. C. A. 3d 1930), *cert. denied,* 282 U. S. 896, 51 Sup. Ct. 181 (1931).

[113]Walker v. Comm'r, 63 F. (2d) 349 (C. C. A. 5th 1933); Crews v. Comm'r, 89 F. (2d) 412 (C. C. A. 10th 1937); Sara R. Preston, 35 B. T. A. 312 (1937). *See* 1 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) § 11.26.

[114]Julia A. Strauss, 2 B. T. A. 598 (1925); Samuel E. Diescher, 36 B. T. A. 732, 744 (1937).

is impossible to determine to how much of it, if any, the taxpayer is entitled.[115]

When a person reporting on the cash basis receives payments upon a judgment in installments, the payments are applied first to the interest due (which is taxable) and then any balance is applied upon the principal (which may or may not be taxable).[116] But if the principal of the judgment is of very doubtful collectibility, none of the payments will be regarded as interest until the principal has been recovered.[117]

If the taxpayer reports income upon the accrual basis, different principles apply.[118] Income, in that case, becomes taxable when there arises "a fixed and unconditional right to receive it, if there is a reasonable expectancy that the right will be converted into money or its equivalent".[119]

In certain instances, income may accrue in the year in which a cause of action arises, if within the taxable year the other party admits liability, even though the exact amount thereof is left to later negotiations, if there is a reasonable basis upon which it may be estimated.[120] The estimated income is accrued at once, subject to correction when the amount due is agreed upon. If the *amount* of the liability is litigated, however, even though *liability* is admitted, it has been held that income does not accrue until the litigation is finally terminated.[121]

---

[115] A. L. Voyer, 4 B. T. A. 1192 (1926). The dissent in this case, however, seems the better, for the taxpayer's right to receive the *income* was not contested by the attorney. Income must be reported in gross; the taxpayer's right to the *gross* was uncontested, and it was received for him by his agent. Attorney's fees, if deductible at all on the facts of the case, are deducted from this gross income, and the dispute with the attorney in that case concerned this expense item, not the *income*.

[116] Barker v. Magruder, 95 F. (2d) 122, 68 App. D. C. 211 (1938); *see* Helvering v. Drier, 79 F. (2d) 501, 503 (C. C. A. 4th 1935); *cf.* 1 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) § 5.34.

[117] This would, of course, be of importance only when the principal of the judgment is not itself taxable as income. Comm'r v. Speyer, 77 F. (2d) 824 (C. C. A. 2d 1935), *cert. denied*, 296 U. S. 631, 56 Sup. Ct. 155 (1935); Helvering v. Drier, 79 F. (2d) 501 (C. C. A. 4th 1935); G. C. M. 16166, XV-1 C. B. 175. *Cf.* Burnet v. Logan, 283 U. S. 404, 51 Sup. Ct. 550 (1931). *See* PAUL AND MERTENS, *loc. cit. supra* note 116.

[118] The accrual method is discussed in Magill, *When Is Income Realized?* (1933) 46 HARV. L. REV. 933, 940; 1 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) §§ 11.64 to 11.100; *see also* H. Liebes & Co. v. Comm'r, 90 F. (2d) 932, 937 (C. C. A. 9th 1937).

[119] H. Liebes & Co. v. Comm'r, 90 F. (2d) 932, 938 (C. C. A. 9th 1937).

[120] Continental Tie & Lumber Co. v. United States, 286 U. S. 290, 52 Sup. Ct. 529 (1932); Comm'r v. Old Dominion S. S. Co., 47 F. (2d) 148 (C. C. A. 2d 1931); Comm'r v. Midland Valley R. R., 57 F. (2d) 1042 (C. C. A. 10th 1932); Helvering v. St. Louis Southwestern Ry., 66 F. (2d) 633 (C. C. A. 8th 1933), *cert. denied*, 292 U. S. 626, 54 Sup. Ct. 632 (1934); Helvering v. Gulf, M. & N. R. R., 71 F. (2d) 953 (App. D. C. 1934), *aff'd on other grounds*, 293 U. S. 295, 55 Sup. Ct. 161 (1934); Southern Ry. v. Comm'r, 74 F. (2d) 887 (C. C. A. 4th 1935); Texas & Pacific Ry., 9 B. T. A. 365 (1927); Crowinshield Shipbuilding Co., 24 B. T. A. 925 (1931). *See* Magill, *When Is Income Realized?* (1933) 46 HARV. L. REV. 933, 942; note (1936) 45 YALE L. J. 948.

[121] United States v. Safety Car Heating Co., 297 U. S. 88, 56 Sup. Ct. 353 (1936) (after decree, affirmed on appeal, had *fixed right* to damages for patent infringement, referred to master to determine damages, which were not determined until years later; held, not accrued until master's report confirmed): Patrick McOuirl, Inc. v. Comm'r, 74 F. (2d) 729 (C. C. A. 2d 1935), *cert. denied*, 295 U. S. 748, 55 Sup. Ct. 827 (1935) (taxpayer

But if liability is not admitted, income does not arise from the mere accrual of a cause of action.[122] The income may not be accrued until a settlement is made[123] or, if the claim is litigated, until all possible appeals have been taken or the liability has become final by the expiration of time to appeal from a judgment for the taxpayer.[124] It is not permissible to relate the recovery back to the years the profits of which the recovery replaces, or in which were

---

contested amount awarded for property condemned; since amount, therefore, depended upon a judicial proceeding involving valuations of experts, *etc.*, held too indefinite to accrue); Baltimore & Ohio R. R. v. Comm'r, 78 F. (2d) 460 (C. C. A. 4th 1935) (same); First Bancredit Corp. v. Flexlume Corp., 10 F. Supp. 1015 (W. D. N. Y. 1935) (like *Safety Car Heating* case). *But cf.* Comm'r v. Midland Valley R. R., 57 F. (2d) 1042 (C. C. A. 10th 1932), in which the question of the amount of an admitted liability had been carried to the Court of Claims, yet it was held to accrue when the claim arose; distinguishable in that a statute fixed the basis of compensation, and all the facts from which the amount of the liability was to be determined were in existence and in the plaintiff's books.

[122]"The distinction between the liquidation of a determined right [as in the cases just discussed], and the determination of a disputed right, is familiar throughout the law, though for practical purposes one may be as incalculable as the other." Judge Learned Hand, dissenting, in Comm'r v. Brooklyn Union Gas Co., 62 F. (2d) 505, 507 (C. C. A. 2d 1933).

"Income . . . is the fruit that is born of capital, not the potency of fruition." Mr. Justice Cardozo, in United States v. Safety Car Heating Co., 297 U. S. 88, 99, 56 Sup. Ct. 353 (1936).

A right that is subject to the hazards of litigation is too contingent to be accrued as income. *Cf.* Lucas v. American Code Co., 280 U. S. 445, 50 Sup. Ct. 202 (1930).

[123]U. S. Cartridge Co. v. United States, 284 U. S. 511, 52 Sup. Ct. 243 (1932); Kentucky & Indiana Terminal Ry. v. Comm'r, 54 F. (2d) 738 (C. C. A. 6th 1931), *cert. denied,* 286 U. S. 557, 52 Sup. Ct. 639 (1932); Buffalo Union Furnace Co. v. Helvering, 72 F. (2d) 399 (C. C. A. 2d 1934); Faust v. United States, 65 Ct. Cl. 676 (1928); Gilbert Butler, 4 B. T. A. 756 (1926); Peninsula Shipbuilding Co., 9 B. T. A. 189 (1927); Dexter Sulphite Pulp & Paper Co., 23 B. T. A. 227 (1931); A. M. Campau Realty Co., 35 B. T. A. 687 (1937); Swastika Oil & Gas Co., 40 B. T. A. 797 (1939).

When the taxpayer keeps a down payment for property as damages for breach of a sale contract, it is income when the right so to retain it is fixed, for until that time it stands merely as a payment for capital. Dexter Sulphite Pulp & Paper Co., 23 B. T. A. 227 (1931); Harry F. Doyle, 39 B. T. A. 940 (1939); *cf.* Miles Realty Co., 31 B. T. A. 443 (1934) (not income until steps taken to abandon contract and enforce forfeiture for breach).

[124]United States v. Safety Car Heating Co., 297 U. S. 88, 56 Sup. Ct. 353 (1936) (cause of action arose before 1913, liability determined in 1915, but master's report of damages not finally confirmed and appeal decided until 1925; held, income in 1925); Kales v. Woodworth, 32 F. (2d) 37 (C. C. A. 6th 1929), *cert. denied,* 280 U. S. 570, 50 Sup. Ct. 27 (1929) (suit by Dodge brothers to compel Ford dividend, ordered by lower court in 1917, stayed pending appeal, affirmed in 1919, at which time dividend was declared *as of* date of 1917 decree; held, not income until 1919, for until then it was in the doubtful realm of litigation); Baltimore & Ohio R. R. v. Comm'r, 78 F. (2d) 460 (C. C. A. 4th 1935) (not income until New York Court of Appeals affirmed); H. Liebes & Co. v. Comm'r, 90 F. (2d) 932, 938 (C. C. A. 9th 1937) (accrues when judgment entered and time to appeal expires); Dodge v. United States, 64 Ct. Cl. 178 (1927) (same as *Kales* case, *supra*); W. W. Sly Mfg. Co., 24 B. T. A. 65 (1931) (accrued when Supreme Court denied *certiorari*); Regulations 101, art. 42-1. Other cases apparently reaching a contrary result must, so far as inconsistent with the *Safety Car Heating* case, be considered overruled. Kyle v. Comm'r, 43 F. (2d) 291 (C. C. A. 3d 1930), *cert. denied,* 282 U. S. 896, 51 Sup. Ct. 181 (1931); Park v. Gilligan, 293 Fed. 129 (S. D. Ohio, 1921); Julia A. Strauss, 2 B. T. A. 598 (1925); C. C. Harris Oil Co., 13 B. T. A. 937 (1928); Niels V. Christensen, 33 B. T. A. 79 (1935).

incurred the expenses or losses reimbursed thereby, even though a distortion of income might be avoided by doing so.[125]

The accrual of interest *included in* a judgment goes along with the accrual of the principal and may not be spread over the period in respect of which it is awarded, for it, like the principal, was contingent until final judgment.[126]

As a result of the Supreme Court's interpretation[126a] of the language of what is now section 162 (b) of the Internal Revenue Code,[126b] a contrary rule has been developed with respect to trust income when its distributability is contested in court. That section provides that the trustee may deduct and the beneficiary shall be taxed on income which "is to be distributed currently", whether distributed or not. It has been held (under all the variations in the language of the section) that when a subsequent court decree declares that income withheld by the trustee should have been distributed "currently", it is taxable to the beneficiaries only in the years when they should have received it.[126c]

---

[125]Burnet v. Sanford & Brooks Co., 282 U. S. 359, 51 Sup. Ct. 150 (1931); United States v. Safety Car Heating Co., 297 U. S. 88, 56 Sup. Ct. 353 (1936); Comm'r v. Southeastern Express Co., 56 F. (2d) 600 (C. C. A. 5th 1932); Peninsula Shipbuilding Co., 9 B. T. A. 189 (1927). *Cf.* U. S. Cartridge Co. v. United States, 284 U. S. 511, 52 Sup. Ct. 243 (1932).

A different rule seems to apply to recoveries upon insurance which, even though litigated, are offset against prior losses unless the chance of recovery was very remote at the time. See *supra* note 62.

Even though a cause of action existed on March 1, 1913, or at the time it was received by bequest or inheritance, it had no "value" at that time if it was disputed and hence not "unconditional", so the whole recovery is income. United States v. Safety Car Heating Co., *supra.* The contrary case of Buffalo Union Furnace Co. v. Helvering, 72 F. (2d) 399 (C. C. A. 2d 1934), was distinguished by the Supreme Court in the *Safety Car Heating* case, at p. 98, upon the ground that the claim was not for profits but for out-of-pocket expenses (which, not having been deducted in the period before 1913, when there was no tax, are not taxable as income when recovered; *but cf.* Burnet v. Sanford & Brooks Co., *supra,* and see *supra* note 14).

[126]American Viscose Corp. v. Comm'r, 56 F. (2d) 1033, 1034 (C. C. A. 3d 1932); Baltimore & Ohio R. R. v. Comm'r, 78 F. (2d) 460 (C. C. A. 4th 1935).

[126a]In Freuler v. Helvering, 291 U. S. 35, 54 Sup. Ct. 308 (1934), under the 1921 Act.

[126b]This section has undergone several verbal changes, but the interpretation of all the Acts has been uniform in this respect. Section 2 (b) of the Act of 1916 provided that the entire income was taxed to the trustee but the rate was made dependent on the individual shares, so far as the income "is to be distributed annually." Section 219 (d) of the Act of 1918 taxed to the beneficiaries their "distributive share". Section 219 (d) of the Act of 1921 taxed to the beneficiary the income "which pursuant to the instrument or order governing the distribution is distributable". All subsequent acts have allowed the trustee a deduction for income which "is to be distributed currently," and taxed to the beneficiary "the amount so allowed as a deduction".

[126c]McCaughn v. Girard Trnst Estate, 19 F. (2d) 218 (C. C. A. 3d 1927) (1916 Act); United States v. Arnold, 89 F. (2d) 246 (C. C. A. 3d 1937), disapproved on other grounds in Stone v. White, 301 U. S. 532, 57 Sup. Ct. 851 (1937) (1928 Act); DeBrabant v. Comm'r, 90 F. (2d) 433 (C. C. A. 2d 1937) (1928 Act); Albert J. Appel *et al.,* Ex'rs, 10 B. T. A. 1225 (1928) (1916 and 1918 Acts). *But see* I. T. 1733, II-2 C. B. 169 (1923) (1921 Act).

Similarly, when the trustee has distributed income and this is later approved by the court, the subsequent decree is held conclusive. Letts v. Comm'r, 84 F. (2d) 760 (C. C. A. 9th 1936) (1926 Act); Lawrence Fox *et al.,* Ex'rs, 31 B. T. A. 1181 (1935) (1928 Act).

Unusual methods of accounting,[127] such as the "long-term contract",[128] "completed voyage",[129] and "crop" bases,[130] require special mention. Those methods are used when it would distort net income to report gross income and expenses even on the accrual basis because the ventures of the taxpayer are not completed in a single year. Under those methods, the net profit upon a particular contract, voyage, or crop (which takes more than a year from commencement to completion) is reported in the year of completion, and a taxable judgment recovered on account of such a contract, voyage, or crop is not taxable until such time.[131]

When personal property is transmitted at death, by a general or residuary bequest or by inheritance, the legal proceedings incident to administration of the estate delay the acquisition of legal title by the legatee or distributee. Of course, since such receipts are not taxable as income,[132] there is no problem of *when* they are taxable. But there is an analogous problem in connection with the determination of the value at the time of "acquisition"[133] and the period

Similarly, where the trustee's withholding is later approved by a court, the decree is conclusive that the trustee alone is taxable. Hubbell v. Helvering, 70 F. (2d) 668 (C. C. A. 8th 1934) (1924, 1926 and 1928 Acts); Comm'r v. Dean, 102 F. (2d) 699 (C. C. A. 10th 1939) (1928 Act); Susan B. Armstrong, 38 B. T. A. 658 (1938) (1932 Act).

When income is actually distributed and a court later decrees that the distribution was improper and must be restored, the income was never "distributable" to the beneficiary and is not taxable to him, although he had unrestricted use of it. Freuler v. Helvering, 291 U. S. 35, 54 Sup. Ct. 308 (1934) (1921 Act); *cf.* Marguerite Hyde Suffolk & Berks, 40 B. T. A. No. 172 (Dec. 15, 1939) (1932 and 1934 Acts; holding beneficiary is taxable on sums later withheld pursuant to a court decree ordering reimbursement, since the income is then "distributable" although charged with the obligation to restore the trust corpus; the adjustment in "distributable" income must be made in the returns for the years when the improper distributions occurred).

[127]Section 41 of the Internal Revenue Code authorizes the use of the taxpayer's regular method of accounting, unless it does not clearly reflect net income.

[128]Approved in Regulations 101, art. 42-4; Badgley v. Comm'r, 59 F. (2d) 203 (C. C. A. 2d 1932). Used particularly in construction contracts taking more than a year to perform.

[129]Approved in Planet Line, Inc. v. Comm'r, 89 F. (2d) 16 (C. C. A. 2d 1937), *aff'g* 34 B. T. A. 253 (1936); Falketind Ship Co., 6 B. T. A. 44 (1927). Used principally by single-ship companies whose voyages may consume more than a year.

[130]Approved in Kekaha Sugar Co. v. Burnet, 50 F. (2d) 322 (App. D. C. 1931); Kahuku Plantation Co., 12 B. T. A. 977 (1928), *mod.,* 13 B. T. A. 292 (1928). Used for crops that take more than a year to mature.

[131]Kahuku Plantation Co., 12 B. T. A. 977 (1928), *mod.,* 13 B. T. A. 292 (1928); Waimanalo Sugar Co., 12 B. T. A. 1241 (1928), *mod.,* 13 B. T. A. 323 (1928); Oahu Sugar Co., 13 B. T. A. 404 (1928); Ewa Plantation Co., 13 B. T. A. 625 (1928) (in all of those cases, damages were awarded for lost profits applicable to part of sugar crop injured, received in cash, but not taxable as income until subsequent year in which crop is sold and net profits can be determined upon the crop).

But if the accounts for the contract, voyage, or crop have been closed in a year *prior* to the recovery, that year's return may *not* be reopened to reflect the later recovery upon a claim which was then contingent. Newman & Carey Subway Constr. Co., 37 B. T. A. 1163 (1938). *But cf.* Carolina Contracting Co., 32 B. T. A. 1171 (1935). Just as under the accrual method, it is improper to treat as income claims which are contested at the time of completing the contract, National Contracting Co. v. Comm'r, 105 F. (2d) 488, 495 C. C. A. 8th 1939).

[132]Internal Revenue Code § 22 (b) (3).

[133]Internal Revenue Code § 113 (a) (5). This applies not merely to capital gains and losses but to other losses, depreciation, etc., wherever a value base is used.

for which an asset has been "held",[134] for the purpose of taxation of capital gains and losses. It is settled that, even though the specific property was not set aside for the taxpayer until distribution and although he had no certainty of getting anything, his right to an indeterminate share in the estate vested at the *death* of the decedent. The decree of distribution gave him no new right, merely identifying the property to which his right attached, the legal title then relating back to the date of death. Hence, the value base of property so acquired is the value at the date of decedent's death,[135] and the tax rate applicable, which varies with the length of time during which the property has been held, is dependent upon the time elapsed since that date.[136] It appears that even if the delay in obtaining possession is occasioned, not merely by the normal legal proceedings, but by the taxpayer's action to invalidate the decedent's will (under which he got nothing), nevertheless the date of death is considered the time when he acquired the property, for purposes of those provisions of law.[137]

Once a taxpayer on the accrual basis has a final judgment or settlement, income accrues even though actual payment be delayed.[138] Nor is it material that the agreement provides that the settlement shall be called off and the suit reinstated if payments are not made; for the *right* to the payments is then fixed, and a condition *subsequent* does not prevent accrual of income.[139] The fact that a judgment against the Federal Government can not be collected unless and until there is an appropriation available for its payment does not raise sufficient uncertainty of collection to prevent accrual, for there is a reasonable expectancy that the claim, once put in judgment by a court, will be honored by the Congress.[140]

---

[134]Internal Revenue Code § 117 (a).

[135]Brewster v. Gage, 280 U. S. 327, 334, 50 Sup. Ct. 115 (1930). Before that decision, the Congress had decided that the word "acquisition" was too indefinite, and had changed the section, in the Act of 1928, to fix the controlling date as the date of *distribution*, except with respect to real property and specific bequests of personal property. But when *Brewster v. Gage* showed that the Court was able satisfactorily to define "acquisition" in all cases in terms of the date of death, the Congress restored the former language, in the Act of 1934, for the sake of uniformity. (1934) H. R. REP. No. 704, 73rd Cong., 2d Sess., p. 28; (1934) SEN. REP. No. 558, 73rd Cong., 2d Sess., p. 34.

[136]McFeely v. Comm'r, 296 U. S. 102, 56 Sup. Ct. 54 (1935).

[137]I. T. 2379, VI-2 C.B. 116 (1927). The ruling dealt with real property, but under the reasoning of Brewster v. Gage, *supra* note 135, the same result would follow with respect to personal property.

[138]Lichtenberger-Ferguson Co. v. Welch, 54 F. (2d) 570 (C. C. A. 9th 1931).

[139]Estate of G. A. E. Kohler, 37 B. T. A. 1019 (1938); *cf.* Helvering v. Russian Finance & Constr. Corp., 77 F. (2d) 324 (C. C. A. 2d 1935).

[140]H. Liebes & Co. v. Comm'r, 90 F. (2d) 932 (C. C. A. 9th 1937). *Cf.* Automobile Insurance Co. v. Comm'r, 72 F. (2d) 265 (C. C. A. 2d 1934) (award of Mixed Claims Commission against Germany, payment dependent upon continued willingness and ability of Germany to pay and upon continued cooperation of United States in collecting installments; held accruable, for mere possibility of change in legislative policy is not enough to make the claim contingent—and *later* events do not affect accrual).

Among the rare cases in which the Congress has refused to honor a judgment of the Court of Claims are Pocono Pines Hotels Co. v. United States, 69 Ct. Cl. 91 (1930), in

But if there is not a reasonable expectancy that the judgment can be collected in any reasonable time, income does not accrue even though it is entered upon the taxpayer's books.[141] The requirements for *preventing the accrual* of income are thus less stringent than those for deducting debts as worthless once they have accrued, for less evidence of uncollectibility is required[142] and no charge-off on the books is necessary.[143]

On the other hand, if there was a reasonable expectancy of payment at the time the right accrued, the income is taxable even though subsequent events proved the judgment valueless, and the taxpayer must comply with all the requirements of law respecting charging off bad debts if he desires to deduct the loss.[144] It is, of course, impossible here to discuss the complex problems involved in the bad debt deduction.[145]

---

75 CONG. REC. 1306 (1932), *s. c.*, 73 Ct. Cl. 447 (1932); and Dalton v. United States, 71 Ct. Cl. 421 (1931), in 75 CONG. REC. 1233, 1307 (1932) and 79 CONG. REC. 10816 (1935).

[141]Corn Exchange Bank v. United States, 37 F. (2d) 34 (C. C. A. 2d 1930); Helvering v. Drier, 79 F. (2d) 501 (C. C. A. 4th 1935); Great Northern Ry., 8 B. T. A. 225, 265 (1927), *aff'd on other grounds*, 40 F. (2d) 372 (C. C. A. 8th 1930), *cert. denied*, 282 U. S. 855, 51 Sup. Ct. 17 (1930); Northwestern Improvement Co., 14 B. T. A. 79 (1928); Sowers Mfg. Co., 16 B. T. A. 268 (1929); American Cigar Co., 21 B. T. A. 464 (1930), *aff'd on other grounds*, 66 F. (2d) 425 (C. C. A. 2d 1933), *cert. denied*, 290 U. S. 699, 54 Sup. Ct. 209 (1933); Atlantic Coast Line R. R., 31 B. T. A. 730, 747 (1934), *aff'd on other grounds*, 81 F. (2d) 309 (C. C. A. 4th 1936), *cert. denied*, 298 U. S. 656, 56 Sup. Ct. 676 (1936); American Central Utilities Co., 36 B. T. A. 688 (1937); Marguerite Hyde Suffolk & Berks, 40 B. T. A. No. 172 (Dec. 15, 1939); G. C. M. 9466, X-1 C. B. 133 (1931).

[142]Corn Exchange Bank v. United States, 37 F. (2d) 34, 35 (C. C. A. 2d 1930).

[143]American Central Utilities Co., 36 B. T. A. 688 (1937) (taxpayer entered the income in its books and did not write it off, but it was held that book entries cannot make that income which in fact is not income).

[144]Llewellyn v. Electric Reduction Co., 275 U. S. 243, 48 Sup. Ct. 63 (1927); Spring City Foundry Co. v. Comm'r, 292 U. S. 182, 54 Sup. Ct. 644 (1934) (debtor bankrupt in same year claim accrued; *held*, taxable on income; and failed to meet requirements for deducting bad debts); American Cigar Co. v. Comm'r, 66 F. (2d) 425 (C. C. A. 2d 1933), *cert. denied*, 290 U. S. 699, 54 Sup. Ct. 209 (1933); Peyton Dupont Securities Co. v. Comm'r, 66 F. (2d) 718 (C. C. A. 2d 1933); Automobile Insurance Co. v. Comm'r, 72 F. (2d) 265 (C. C. A. 2d 1934); Barker v. Magruder, 95 F. (2d) 122, 68 App. D. C. 211 (1938); Finucane v. United States, 21 F. Supp. 122, 85 Ct. Cl. 663 (1937); Broderick v. Anderson, 23 F. Supp. 488 (S. D. N. Y. 1938).

[145]*See* 3 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) ch. 28; PAUL, *Suggested Modification of the Bad Debts Provision* in STUDIES IN FEDERAL TAXATION (1937) 235 (reprinted from (1937) 22 CORNELL L. Q. 196).

Excellent recent discussions of the whole problem by the courts may be found in Sabath v. Comm'r, 100 F. (2d) 569 (C. C. A. 7th 1938); Moore v. Comm'r, 101 F. (2d) 704 (C. C. A. 2d 1939); Comm'r v. MacDonald Engineering Co., 102 F. (2d) 942 (C. C. A. 7th 1939); *see also* Duffin v. Lucas, 55 F. (2d) 786, 795 (C. C. A. 6th 1932), *cert. denied*, 287 U. S. 611, 53 Sup. Ct. 14 (1932).

The mere running of the Statute of Limitations upon a debt or a judgment does not conclusively establish worthlessness, if other circumstances indicate that the defense would not be raised. Duffin v. Lucas, *supra*; Comm'r v. Burdette, 69 F. (2d) 410 (C. C. A. 9th 1934); Leo Stein, 4 B. T. A. 1016 (1926); Warner L. Colvert, 6 B. T. A. 623 (1927); Alfred K. Nippert *et al.*, Exec'rs, 32 B. T. A. 892 (1935); 3 PAUL AND MERTENS, *op. cit. supra*, § 28.59. On the other hand, the taxpayer may not refrain from charging off the debt until the Statute runs if in fact it is worthless prior thereto. Sabath v. Comm'r, *supra*. In H. D. Lee Mercantile Co. v. Comm'r, 79 F. (2d) 391 (C. C. A. 10th 1935), the court declared that no deduction could be had for a claim against a solvent debtor

The principle that income does not accrue upon a litigated claim until there is a final judgment from which no further appeal may be taken, must be qualified. For if, in fact, the plaintiff *receives* the income before that time, or if it is made available to him, he is taxable even though he may later have to restore the equivalent if his action is ultimately unsuccessful. This results from the rule, laid down by the Supreme Court, that income received under claim of right and without restriction upon its disposition is taxable when so received.[146] Therefore, if the successful plaintiff obtains payment, he is taxable upon the amount thus obtained, regardless of whether the defendant appeals.[147] Or if he assigns his cause of action or judgment before his right becomes finally fixed thereunder, he is then taxable upon the consideration received, whether or not he is contingently liable upon a guarantee that it will be affirmed and collected.[148] Attachment or garnishment prior to the final determination of the litigation does not constitute receipt of income, however, for it is not "received without restriction upon its disposition".[149] And if pay-

which the taxpayer by his own delay has allowed to lapse; it was, however, a dictum.

A remote possibility that a suit by minority stockholders against the taxpayer's directors, charging fraud in connection with the debt, may recoup the loss for the taxpayer does not prevent a charge-off. Chicago, R. I. & P. Ry., 13 B. T. A. 988 (1928), *rev'd on other grounds,* 47 F. (2d) 990 (C. C. A. 7th 1931), *cert. denied,* 284 U. S. 618, 52 Sup. Ct. 7 (1931).

The fact that the debtor makes a claim of set-off does not render the obligation worthless. Hamler Coal Co., 4 B. T. A. 947 (1926); Bula E. Croker, 27 B. T. A. 588 (1933).

When taxpayer drops a suit against a solvent debtor because of the difficulty and expense which it would entail, on the advice of counsel, it may be that the debt may then be charged off. The court in Harmonnt v. Comm'r, 58 F. (2d) 118 (C. C. A. 6th 1932), avoided opinion on this question because of insufficient evidence that circumstances were any different in that year than for years before.

[146] North American Oil Co. v. Burnet, 286 U. S. 417, 52 Sup. Ct. 613 (1932). This will be more fully discussed in Part Two.

[147] *Cf.* North American Oil Co. v. Burnet, 286 U. S. 417, 52 Sup. Ct. 613 (1932), and Comm'r v. Brooklyn Union Gas Co., 62 F. (2d) 505 (C. C. A. 2d 1933), in which the defendant's right to certain income was contested and the income was impounded; upon getting judgment in the lower court, it was released, and it was held taxable although it might have to be restored after an appeal; in the latter case, a bond had to be given in order to get the income, but this did not affect its taxability.

But cf. Alamitos Land Co., 40 B. T. A. 353 (1939), where the plaintiff was paid, pending an appeal by the defendant, but held the funds in a segregated account which was not used by it; the Board fonnd that by the law of the state, upon receiving anything upon a judgment before the time to appeal expires or before an appeal is determined, the plaintiff holds as *trustee* until the right is finally determined, and hence it was not received "without restriction upon its disposition".

The gain realized by a conditional seller upon a foreclosure sale may not be held in suspense pending the outcome of litigation between the parties over his right thereto. R. A. Rowan & Co., 13 B. T. A. 975 (1928). *But cf.* Great Southern Life Ins. Co., 33 B. T. A. 512, 522 (1935), *aff'd on other grounds,* 89 F. (2d) 54 (C. C. A. 2d 1937), *cert. denied,* 302 U. S. 698, 58 Sup. Ct. 16 (1937) (pledgee was notified that pledged securities had been embezzled by pledgor; court later decreed that pledgee must give up proceeds, he having meanwhile disposed of securities; held that income was not realized when securities were sold, even though he claimed right to it, upon the theory that taxpayer was *constructive trustee* and *never* got title to it).

[148] Victoria Paper Mills Co., 32 B. T. A. 666 (1935), *aff'd w. o. op.,* 83 F. (2d) 1022 (C. C. A. 2d 1936).

[149] A. M. Campau Realty Co., 35 B. T. A. 687 (1937).

ments are tied up in escrow pending final outcome of the litigation, the rule likewise does not apply.[150]

When a plaintiff loses his action or settles a claim for less than he had demanded, or gets a judgment for less, it is not often that a deductible *loss* is sustained. For in most instances a cause of action has no *cost* basis from which a loss could be determined. A cause of action in the hands of an assignee might, of course, have a cost basis to him;[151] and under certain circumstances income might have been properly accrued before the dispute arose, so that there would be a cost which must be recovered.[152] Or the claim may have capital elements which would give it a cost, if it is claim for money loaned or advanced.[153] In those cases, since the settlement or judgment is a closed transaction, exhausting all means of collecting the claim, the loss, if any, is deductible without regard to the requirements respecting *bad debts*.[154] The loss is an ordinary loss, not subject to the special provisions of law respecting *capital* losses,[155] for the *payment* of a claim by the debtor is not a "sale or exchange" thereof; the claim is extinguished rather than transferred.[156] A corporation may deduct a loss of any kind,[157] but an individual must fit his loss into the category either of business losses or losses incurred in a transaction entered for profit.[158] Hence, a loss upon the compromise of a claim of a personal nature is not deductible.[159]

But, in the normal case, no deductible loss is sustained when the plaintiff

---

[150]*Cf.* Crews v. Comm'r, 89 F. (2d) 412 (C. C. A. 10th 1937); Sara R. Preston, 35 B. T. A. 312 (1937). *Cf. also* Alamitos Land Co., *supra* note 147.

[151]Comm'r v. Owens, 78 F. (2d) 768 (C. C. A. 10th 1935); Hyatt Roller Bearing Co. v. United States, 43 F. (2d) 1008, 70 Ct. Cl. 443 (1930). See *supra* note 105.

[152]Hale v. Helvering, 85 F. (2d) 819, 66 App. D. C. 242 (1936); George C. Peterson Co., 1 B. T. A. 690 (1925); Russell Wheel & Foundry Co., 3 B. T. A. 1168 (1926). But if the income was accrued improperly, because disputed at the time, no deductible loss occurs when the plaintiff fails to recover it by suit. National Contracting Co. v. Comm'r, 105 F. (2d) 488, 495 (C. C. A. 8th 1939).

[153]Llewellyn v. Electric Reduction Co., 275 U. S. 243, 48 Sup. Ct. 63 (1927); American Cigar Co., 21 B. T. A. 464 (1930), *aff'd on other grounds*, 66 F. (2d) 425 (C. C. A. 2d 1933), *cert. denied*, 290 U. S. 699, 54 Sup. Ct. 209 (1933).

If the settlement covers a counterclaim asserted by the other party, the loss may nevertheless be deductible, if the counterclaim is of a kind which would be deductible (*see* Part Two). George C. Peterson Co., 1 B. T. A. 690 (1925); Russell Wheel & Foundry Co., 3 B. T. A. 1168 (1926); *but cf.* Hamler Coal Co., 4 B. T. A. 947 (1926), and Bula E. Croker, 27 B. T. A. 588 (1933) (*not* deductible as *bad debt*).

[154]American Cigar Co., 21 B. T. A. 464 (1930), *aff'd on other grounds*, 66 F. (2d) 425 (C. C. A. 2d 1933), *cert. denied*, 290 U. S. 699, 54 Sup. Ct. 209 (1933).

[155]*See* Internal Revenue Code § 117, dealing with gains and losses upon the "sale or exchange" of capital assets.

[156]Hale v. Helvering, 85 F. (2d) 819, 66 App. D. C. 242 (1936); Bingham v. Comm'r, 105 F. (2d) 971 (C. C. A. 2d 1939); James R. Stewart, 39 B. T. A. 87; Charles T. Carlson, 39 B. T. A. 185 (1939), *vacating* 38 B. T. A. 1361 (1938).

[157]Internal Revenue Code § 23 (f).

[158]Internal Revenue Code § 23 (e). It plainly is not the third type of allowable loss, a loss of property from "casualty". *Cf.* Fred J. Hughes, 1 B. T. A. 944 (1925).

[159]Thomas v. Comm'r, 100 F. (2d) 408 (C. C. A. 2d 1938); *cf.* Long v. Comm'r, 96 F. (2d) 270 (C. C. A. 9th 1938), *cert. denied*, 305 U. S. 616, 59 Sup. Ct. 74 (1938).

loses his suit or gets less than he had demanded. If the claim is for something strictly in the nature of income—lost profits, and the like—it, of course, has no *cost* basis; the failure to receive expected income, therefore, is not a loss.[160] Likewise, if the claim represents expenses incurred in the past, the settlement or loss of the action merely prevents profitable utilization of those expenses, and since the expenses were deductible when incurred, they may not again be deducted when the taxpayer fails to recover them.[161] And when he sues to recoup a loss from fire, embezzlement, or similar causes, the loss may be deducted only when the wrong occurred, and (whether or not deducted at that time) no deduction may be taken at the conclusion of the litigation.[162] In certain circumstances, too, a claim (which has a cost basis and might otherwise be deductible) may arise from a capital expenditure, to be added to the cost of the property to which it relates rather than currently deducted.[163]

Mere failure to sue upon a claim, however, has been held not to give rise to a deductible loss, even though the claim had a cost and all possibility of collection had vanished;[164] but a different result might follow if good business reasons, such as the cost and difficulty of suit, were established for the failure to sue.[165]

[160]Comm'r v. John Thatcher & Son, 76 F. (2d) 900 (C. C. A. 2d 1935); S. M. 2285, III-2 C. B. 87 (1924).

[161]Comm'r v. John Thatcher & Son, 76 F. (2d) 900 (C. C. A. 2d 1935); S. M. 2285, III-2 C. B. 87 (1924).

[162]Comm'r v. Highway Trailer Co., 72 F. (2d) 913 (C. C. A. 7th 1934), *cert. denied,* 293 U. S. 626, 294 U. S. 731, 55 Sup. Ct. 346, 505 (1935) (suit for damages for causing fire; held, loss sustained at time of fire, not when lost suit); Hinrichs v. Helvering, 95 F. (2d) 117, 68 App. D. C. 206 (1938) (fraudulent stock sale, stock worthless in 1930, sued defrauder and lost in 1934; held, loss in 1930); Peterson Linotyping Co., 10 B. T. A. 542 (1928) (embezzlement in 1914, sued embezzler; embezzler bankrupt in 1921, taxpayer claims bad debt; but cause of action for embezzlement was not a debt; it was a loss, which must be taken when "sustained", *i. e.,* when embezzlement occurred). *But cf.* Douglas County Light & Water Co. v. Comm'r, 43 F. (2d) 904 (C. C. A. 9th 1930).

But the Board has applied a different rule to recoveries upon insurance, because of its view that a loss covered by insurance is "compensated" even though liability is disputed. So a compromise of an insurance claim for less than the amount demanded (if that amount had been treated as "compensation" for the loss) results in a loss of the difference at that time, Rose Licht, 37 B. T. A. 1096 (1938).

[163]Wadsworth Mfg. Co. v. Comm'r, 44 F. (2d) 762 (C. C. A. 2d 1930) (building contractor defaulted, taxpayer completed work at greater cost than the contract price, and sued contractor and surety, but unable to collect; not a debt, hence not deductible as such; and his expenses in completing the building were expenditures for a capital asset, not deductible either when spent or when found uncollectible; court distinguishes cases in which, having *paid* the contractor, the taxpayer then is compelled to redeem the property from the liens of subcontractors, the *double* payment resulting in a present loss); H. R. MacMillan, 14 B. T. A. 1367 (1929), *appeal dismissed,* 67 F. (2d) 1003 (C. C. A. 9th 1934) (taxpayer purchased judgment from his transferor's creditor, who had threatened to sue to set aside the transfer as fraudulent; judgment proved worthless; payment was made to remove a cloud upon taxpayer's title and is a capital expense rather than an ordinary business expense; however, it is suggested in the opinion that proof of worthlessness might make it deductible as a bad debt).

[164]H. D. Lee Mercantile Co. v. Comm'r, 79 F. (2d) 391 (C. C. A. 10th 1935); *cf.* Harmount v. Comm'r, 58 F. (2d) 118 (C. C. A. 6th 1932).

[165]*See* Harmount v. Comm'r, 58 F. (2d) 118 (C. C. A. 6th 1932).

c. *Summary*

A recovery in litigation is taxable as income if a voluntary payment of the claim would have been taxable, or if the recovery is of damages taking the place of lost income. Damages for injury to capital or for the conversion thereof are not taxable as income except to the extent that the recovery exceeds the cost basis of the property it replaces, but if the loss of the property has already given rise to a deduction of its cost, the recoupment of the loss is taxable in full; refunds of taxes previously deducted are, however, differently treated. Amounts received in settlement of a will contest are not income. Recoveries in actions of a personal nature (personal injuries, libel and slander, marital actions, etc.) are not taxable.

If the recovery in a particular cause of action is taxable, it is so taxed when received, if the taxpayer is on the cash receipts basis, while if he is on the accrual basis the recovery is taxable when his rights become fixed and unconditional, either by a contract of settlement or by the obtaining of a final and conclusive judgment upon which no further appeals are possible. But income does not accrue if there is no reasonable expectancy of collecting upon the judgment. On the other hand, if the plaintiff receives payment before the judgment is thus final, he is taxable upon it even though he may have to repay it at a later date. When the plaintiff loses in an action, or receives less than his demand, he suffers a deductible loss only to the extent that his claim had a cost to him.