St. John's Law Review

Volume 9, May 1935, Number 2 Article 25

Taxation--Deduction of Amortized Commissions on Bonds Issued Prior to 1913

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may not be claimed in a subsequent year;[17] therefore, extraordinary depletion in one year may not be compensated for beyond the sums actually received by the lessor during such year. It would follow from this premise that a lessor would be denied the statutory depletion deduction in cases where the land suffered no actual depletion and would be permitted to claim the full allowance if only a few barrels of oil or a few cubic feet of gas were produced.[18]

The Supreme Court refused to give its sanction to any such unreasonable rule and held that such bonus payments should be subject to a depletion allowance during the year in which they were received,[19] and left open for future determination whether a lessor who has received a bonus on oil and gas lands which were never productive during the term of the lease may in the final year of the lease be obliged to pay a tax upon those sums which had been previously free from taxation as depletion allowances.

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TAXATION—DEDUCTION OF AMORTIZED COMMISSIONS ON BONDS ISSUED PRIOR TO 1913.—Prior to 1913, the taxpayer sold three issues of bonds at a discount and paid to bankers an additional amount as commissions for marketing the bonds. The taxpayer kept its books and made its tax returns on the accrual basis. A deduction from gross income representing the amortized amount of the commissions and discount was disallowed by the Commissioner of Internal Revenue who found a deficiency in each of the taxable years, 1918 to 1923 inclusive. The Board of Tax Appeals ruled that the petitioner was entitled to the deduction for the discount, but not for commis-

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[17] "The tax is an income tax for 1918, and in the absence of express provision to the contrary, it is not to be supposed that the taxpayer is authorized to deduct from this year's income depreciation, depletion, business losses or other similar items attributable to other years." Burnet v. Thompson Oil & Gas Co., 283 U. S. 301, 306, 51 Sup. Ct. 418 (1931).

[18] Dissenting opinion of Sibley, J., in Herring v. Com'r of Int. Rev., 70 F. (2d) 785, 788 (C. C. A. 5th, 1934).

The injustice of the rule may be seen in this supposed case:

L leases oil and gas property to *T* for five years. *L* is to receive 25 per cent. of the income in royalties and is to receive each year $50,000 as a bonus or advance royalty, such amount to be credited upon sum due to *L* from *T* when production is actually commenced. For four years *T* fails to commence drilling. During each year *L* receives $50,000, or a total of $200,000. During the final year *T* produces $800,000 worth of oil. *L's* share of this is one-fourth, or $200,000, which he has already received. Therefore, during the final year *L* has no income from the property and has been deprived of any depletion allowance. Yet, had *T* produced one barrel of oil during each year, *L* would have been entitled to a full depletion allowance.

[19] Herring v. Com'r of Int. Rev., 293 U. S. 322, 55 Sup. Ct. 179 (1934), *rev'g* Herring v. Com'r, *supra* note 18.

sions.[1] The Court of Appeals for the Second Circuit reversed the Board, on appeal of the taxpayer, holding that commissions should be treated in the same manner as discounts.[2] On appeal of Commissioner, *held,* affirmed. Commissions paid for the marketing of bonds may be amortized over the life of the bonds by a corporation reporting on the accrual basis, notwithstanding the fact that the bonds were issued prior to 1913. *Commissioner of Internal Revenue* v. *Union Pacific Railroad Company,* — U. S. —, 55 Sup. Ct. 165, December 3, 1934.

The reflection of income on the accrual basis raises questions of the proper treatment of amortization of discount and commissions in connection with the issue of bonds. While the Revenue Acts of 1918 or 1921 did not specifically authorize the deduction of an amortized part of the discount and commissions,[3] the Board of Tax Appeals has consistently permitted taxpayers to amortize the discount over the life of the bonds, even though the bonds were issued prior to 1913.[4] However, the treatment of commissions paid for the marketing of bonds has resulted in conflicting decisions in the Circuit Courts.[5]

The Supreme Court properly followed the principle that a taxpayer on the accrual basis should be entitled to charge against income of the taxable period, expenses incurred in and properly attributable to the income earned during that period, although payable at a later date.[6] In practice, commissions are taken out of the proceeds of the bonds by the banker.[7] The taxpayer must, at maturity, pay the face value of the bonds. The effect of the transaction in reducing capital

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[1] 26 B. T. A. 1126 (1932).

[2] 69 F. (2d) 67 (C. C. A. 2d, 1934).

[3] REV. ACT OF 1918, §214, 40 Stat. 1057, 26 U. S. C. A. 955; REV. ACT OF 1921, §214, 42 Stat. 227, 26 U. S. C. A. 955. These sections deal with interest as a deduction; the courts have by construction included commissions and discount. *Infra* note 4.

[4] Chicago, Rock Island & Pacific Co. v. Commissioner, 13 B. T. A. 988 (1928); Kansas City Southern Ry. Co. v. Commissioner, 16 B. T. A. 665 (1929); Terminal Railroad Ass'n of St. Louis v. Commissioner, 17 B. T. A. 1135 (1929); Chicago and Northwestern Ry. Co. v. Commissioner, 22 B. T. A. 1407 (1931). In one case the Board refused to allow the amortization on the theory that the bonds were issued not by the taxpayer but by a predecessor corporation. Western Maryland Ry. Co. v. Commissioner, 12 B. T. A. 889 (1928). On appeal by the taxpayer, the Board was reversed. 33 F. (2d) 695 (C. C. A. 4th, 1929). The Commissioner did not seek review.

[5] The instant case as decided by Circuit Court of Appeals, *supra* note 2; Chicago, Rock Island & Pacific Co. v. Commissioner, 47 F. (2d) 990 (C. C. A. 7th, 1931), where the taxpayer while allowed to deduct bond discount was not allowed to deduct from gross income the amortized expenses of a bond issue incurred before 1913. *Cf.* Bonded Mortgage Co. v. Commissioner, 70 F. (2d) 341 (C. C. A. 4th, 1934).

[6] United States v. Anderson, 269 U. S. 422, 46 Sup. Ct. 131 (1925); Miles Bement Pond Co. v. United States, 281 U. S. 357, 50 Sup. Ct. 251 (1930); Aluminum Castings Co. v. Routzahn, 282 U. S. 92, 51 Sup. Ct. 11 (1930).

[7] WILLIS AND BOGEN, INVESTMENT BANKING (1929) 385.

realized, whether through the payment of commissions or the allowance of discount, is the same. It is a loss to the taxpayer and represents the cost of the borrowed capital during the life of the obligation.[8] Where the taxpayer's books are kept upon the accrual basis, its final disbursement is properly anticipated by the annual deduction of an amortized amount.[9]

The Court, speaking through Justice Stone, dismissed the contention of the Commissioner that a prior holding in *Old Colony Railroad Co.* v. *Commissioner* [10] was inconsistent with the rule now laid down. Briefly, the *Old Colony* case held that premiums received by the taxpayer upon the sale of its bonds before 1913 could not be prorated and taxed because they had become a part of the taxpayer's capital before the effective date of the Sixteenth Amendment.[11] The opinion in that case has been criticized as being inconsistent with good accounting theory,[12] since accounting authorities are in agreement that the stated interest rate on bonds does not reflect the true interest which is disclosed only through issue and sale.[13] It is submitted that the holding in the instant case is in definite accord with the theory of "effective rate" of interest as the measure of the permitted deduction, and that it is difficult to discern the distinguishing point relied upon by the Court, "that there can be no question of receipt of a premium where the bonds are sold at a discount." [14]

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[8] United States v. Anderson, *supra* note 6.

[9] See the compulsory proration of fees and commissions paid by a borrower in order to obtain a loan. Lovejoy v. Commissioner, 18 B. T. A. 1179 (1930); S. & L. Building Corp. v. Commissioner, 19 B. T. A. 788 (1930). Compare the requirements that commissions and expenses paid by a lessor in order to secure a tenant be prorated over the term of the lease. Bonwit Teller & Co. v. Commissioner, 17 B. T. A. 1019 (1929); Roby Realty Co. v. Commissioner, 19 B. T. A. 696 (1930); Butler v. Commissioner, 19 B. T. A. 718 (1930); Howard v. Commissioner, 19 B. T. A. 865 (1930); Central Bank Block Association v. Commissioner, 19 B. T. A. 1183 (1930); Clawson v. Commissioner, 19 B. T. A. 1253 (1930); Webb v. Commissioner, 20 B. T. A. 274 (1930); Young v. Commissioner, 20 B. T. A. 692 (1930); Spinks Realty Co. v. Commissioner, 21 B. T. A. 674 (1930).

[10] 284 U. S. 552, 52 Sup. Ct. 211 (1932).

[11] March 1, 1913.

[12] Note (1932) 45 HARV. L. REV. 1116. *Cf.* Note (1931) 41 YALE L. J. 280 wherein the author agreed with the decision of the lower court, 50 F. (2d) 896 (C. C. A. 1st, 1931), subsequently reversed by the Supreme Court, *supra* note 10, stating, "The courts seem to agree that a corporation may deduct as an expense for the taxable year, an aliquot part of any discount at which its bonds were sold in addition to the interest paid its bondholders. And if it be admitted that bond discounts in an original sale are 'deferred interest,' the argument by analogy that bond premiums are 'excess interest' seems to be logically irrefutable."

[13] DICKINSON, ACCOUNTING PRACTICE AND PROCEDURE (1917) 66, 134, 135; SALIERS, ACCOUNTS IN THEORY AND PRACTICE (1920) 169, 171; 2 KESTER, ACCOUNTING THEORY AND PRACTICE (1925) 370, 393; HATFIELD, ACCOUNTING (1929) 90, 227, 228.

[14] Instant case, 55 Sup. Ct. at 168.