

Net Income as a Basis for Deductions of Charitable Contributions

Irving Weinstein

Follow this and additional works at: <https://scholarship.law.stjohns.edu/lawreview>

Recommended Citation

Weinstein, Irving (1935) "Net Income as a Basis for Deductions of Charitable Contributions," *St. John's Law Review*: Vol. 9 : No. 2 , Article 26.

Available at: <https://scholarship.law.stjohns.edu/lawreview/vol9/iss2/26>

This Comment is brought to you for free and open access by the Journals at St. John's Law Scholarship Repository. It has been accepted for inclusion in St. John's Law Review by an authorized editor of St. John's Law Scholarship Repository. For more information, please contact lasalar@stjohns.edu.

NET INCOME AS A BASIS FOR DEDUCTIONS OF CHARITABLE CONTRIBUTIONS.—The United States Supreme Court was recently confronted¹ with the problem of whether deductions on account of charitable contributions are to be taken from net income as defined by Section 21,² or from ordinary net income as defined by Section 101 (c) (7)³ of the Revenue Act of 1928.⁴

It appears that the taxpayer in 1928 had a net income (before any contributions to charity) of approximately \$500,000.00. Of this, some \$211,000.00 was gain from the sale of capital assets, upon which she chose to be taxed at the rate of 12½% in conformity with Section 101 of the Revenue Act of 1928.⁵ In that year the taxpayer made charitable contributions allowable as deductions in the sum of \$44,000.00. The taxpayer deducted in her return the amount of the charitable contributions from her total net income, of \$500,000.00. After the deduction the taxpayer paid a tax on \$211,000.00 at the rate of 12½% and on the balance at normal and surtax rates. The Commissioner of Internal Revenue determined that the taxpayer could not consider the \$500,000.00 as a base upon which to calculate the 15% deductions for charitable contributions, but must first deduct the \$211,000.00 of net gain on sale of capital assets, and use only the balance of \$289,000.00 of

¹ *Helvering v. Bliss*; *Helvering v. Harbison*, 293 U. S. 144, 55 Sup. Ct. 17 (1934). These cases present the same question. The deductions claimed and disallowed differ in amount; however, the principle involved is similar. The statement of facts in this note is taken from the Bliss case.

² Part II—Computation of Net Income.

Sec. 21. Net Income. "Net Income" means the gross income computed under section 22 less the deductions allowed by section 23.

Sec. 22. Gross Income. (a) *General definition*. "Gross Income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, security, or the transaction of any business carried on for gain or profits, or gains or profits and income derived from any source whatever. * * *

Sec. 23. Deductions from Gross Income. In computing net income there shall be allowed as deductions: * * * (n) *Charitable and Other Contributions*. In the case of an individual, contributions or gifts made within the taxable year to or for the use of: * * * (2) any corporation, or trust, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary or educational purposes, * * * to an amount which in all the above cases combined does not exceed 15 per centum of the taxpayer's net income as computed without the benefit of this subsection. * * * 45 STAT. 797, 799, 801, 26 U. S. C. A. §§2021, 2022 (a), 2023 (n) (2).

³ Subtitle C—Supplemental Provisions.

Supplement A—Rates of Tax.

Sec. 101 (c) (7). "Ordinary net income" means the net income, computed in accordance with the provisions of this title after excluding all items of capital gain, capital loss, and capital deductions, 45 STAT. 811, 26 U. S. C. A. §2101.

⁴ 45 STAT. 797, 811, 26 U. S. C. A. §§2021, 2101.

⁵ 45 STAT. 811, 26 U. S. C. A. §2101 (a).

ordinary net income. As a result of this ruling there was a reduction of permissible deductions for charitable contributions to about \$40,000.00, and a consequent deficiency in tax of about \$1,000.00. The Commissioner's ruling was upheld by the Board of Tax Appeal⁶ but the Circuit Court of Appeals by a divided Court reversed the Board.⁷ The Commissioner asserted in his appeal to the United States Supreme Court that the basis upon which the 15% deduction for charitable contributions was to be calculated, should be ordinary net income as defined in Section 101 (c) clause 7, that is, as though it directed net income to be computed, "after excluding from the computation all items of capital gain, capital loss and capital deductions." The United States Supreme Court affirmed⁸ the decision of the Circuit Court of Appeals and held that the taxpayer was entitled to include capital net gain in determining the base for the computation of the 15% deduction allowable for charitable contribution, even though the taxpayer elected to be taxed on capital net gain at the flat rate of 12½%.

In arriving at this conclusion, the Court was logically correct and practical. The purpose of all the Revenue Acts since that of 1916 has been to include all income of every sort including capital gain⁹ into what is termed gross income,¹⁰ and to allow certain deductions in order to arrive at net income, which amount is to be considered the base for the calculation of the tax.¹¹ The provision allowing a deduction for charitable contributions from gross income to the extent of 15% of the net income computed without the benefit of this deduction, was brought into the income tax law by Section 1201 (2) of the Revenue Act of 1917.¹² Its evident purpose

⁶ 27 B. T. A. 205 (1932).

⁷ 68 F. (2d) 890 (C. C. A. 2d, 1934). The decision of the Circuit Court of Appeals in the case of *Helvering v. Harbison*, is reported in 68 F. (2d) 1004 (C. C. A. 2d, 1934). In *White v. Atkins*, 69 F. (2d) 960 (C. C. A. 1st, 1934) and in *Blow v. United States*, 5 F. Supp. 737 (D. C. N. D. Ill. 1933) the same result was arrived. The Board of Tax Appeals rulings were at first in conformity with the petitioner's contention; *Elkins v. Commissioner*, 24 B. T. A. 572 (1931); *Livingood v. Commissioner*, 25 B. T. A. 585 (1932); *Harbison v. Commissioner*, 26 B. T. A. 896 (1932). Subsequently the full Board reached an opposite result in *Straus v. Commissioner*, 27 B. T. A. 1116 (1933); see also *Robinette v. Commissioner*, 27 B. T. A. 1426 (1933).

⁸ *Supra* note 1.

⁹ *Supra* note 1, at 146, 55 Sup. Ct. at 19.

¹⁰ "The definition of gross income given in section 22 of the Act includes various specified classes of taxable income * * * it also includes the following 'catch all' provision. Law, Sec. 22, (a), 'Gross Income' includes * * * gains or profits and income derived from any source whatever." MONTGOMERY, FEDERAL TAX HANDBOOK (1934-1935) 85.

¹¹ "Net Income' means the gross income computed under Sec. 22, less the deductions allowed by Sec. 23 * * *. The law devotes one section to the enumeration of the items included and not included in the term 'Gross Income' Sec. 22 and another to deductions Sec. 23 and declares net income Sec. 21 to be the remainder obtained by deducting the sums of the deductions from gross income.' *Supra* note 10.

¹² 40 STAT. 330.

was to encourage gifts for education, charity and science.¹³ It has been included in each successive Revenue Act in substantially the same form.¹⁴

With the Revenue Act of 1921, Congress for the purpose of encouraging the taking of profits on capital assets deemed it advisable to relieve gain thus derived from the heavy surtaxes then applicable and to allow the payment of a tax at a flat rate of 12½% on the portion of the taxpayer's income representing the net gain from such capital transactions.¹⁵

It was thus necessary to add new provisions as to the base for the application of two different rates. Such a division of net income for the purpose of applying different tax rates is not novel in the history of income tax legislation. This is evidenced by the provisions affixing the rates on those portions of the entire net income resulting from dividends, earned income, interest on obligations of the United States and gains from the sale of mines and allowing credit for dependents.¹⁶

Prior to the passage of Section 101 of the Revenue Act of 1928, charitable contributions was one of the permissible deductions of which the taxpayer could avail himself. The base on which he computed the allowance due him for charitable deductions was net income. To arrive at net income as defined in Section 21¹⁷ the taxpayer deducted items allowable under Section 22,¹⁸ from gross income as defined under Section 23.¹⁹ The taxpayer did precisely this in this case.²⁰ The arguments advanced that the capital gain realized may not be included in net income as defined in Section 21 cannot be sustained, for the purpose of Section 101 was solely to allow a different method for the computation of a special tax on capital gains. In Sections 21, 22 and 23²¹ of the Act of 1928 the concept of net income is retained. Such sections are to be found in Part 2, Title 1 of which deals with "Computation of Net Income." As to Section 101,²² it is found under "Supplemental Provisions"

¹³ CONG. REC. §7 (1917) 1728.

¹⁴ REV. ACT OF 1934 §23 (o), 48 Stat. 688, 26 U. S. C. A. §5023; REV. ACT OF 1932 §23 (n), 47 Stat. 179, 26 U. S. C. A. §3023; REV. ACT OF 1928 §23 (n), 45 Stat. 799, 26 U. S. C. A. §2023; REV. ACT OF 1926 §214 (a) (10), 44 Stat. 26, 26 U. S. C. A. §955; REV. ACT OF 1924 §214 (a) (10), 43 Stat. 239, 26 U. S. C. A. §95; REV. ACT OF 1921 §214 (a) (10), 42 Stat. 239; REV. ACT OF 1918 §214 (a) (11), 40 Stat. 1066.

¹⁵ REV. ACT OF 1921 §206, 42 Stat. 232; REV. ACT OF 1924 §208, 43 Stat. 262, 26 U. S. C. A. §99 n.; REV. ACT OF 1926 §208, 44 Stat. 19, 26 U. S. C. A. §939 n.

¹⁶ See §§25, 31 and 102 of REV. ACT OF 1928, 45 Stat. 802, 804, 812, 26 U. S. C. A. §§2025, 2031, 2102.

¹⁷ *Supra* note 2.

¹⁸ *Ibid.*

¹⁹ *Ibid.*

²⁰ *Supra* note 1.

²¹ *Supra* note 2.

²² *Supra* note 3.

and is titled "Supplement A—Rates of Tax." It is, therefore, obvious that the only purpose of Section 101²³ was not to determine net income, but rather a provision which allows a taxpayer to segregate a particular portion of his entire net income upon which he may compute a special rate, but in no way contravenes or challenges what is defined as net income under Section 21.²⁴

The position taken by the taxpayer had met with the approval of the Board of Internal Revenue for many years.²⁵ The Board of Tax Appeals decided *Elkins v. Commissioner*²⁶ in November, 1931, and held, contrary to the ruling of the Bureau. The Commissioner stated that this decision was "contrary to the position which the Bureau had consistently followed," and would be appealed.²⁷ But the Commissioner withdrew his determination to appeal when the Board of Tax Appeal announced its decision in *Harbison v. Commissioner*²⁸ in August, 1932, and acquiesced in the *Harbison* opinion.²⁹ The consistent administrative rulings by the Commissioner from 1923 to 1932 during which period the provisions in issue were thrice re-enacted may properly be given weight by the Court.³⁰ The re-enactment in later acts of the sections allowing the deductions indicate Congressional satisfaction with this administrative ruling.³¹

The Court further said, "If the meaning of the act were doubtful, we should still reach the same conclusion. The exemption of income devoted to charity and the reduction of the rate of tax on capital gains were liberalizations of the law in the taxpayer's favor, were begotten from motives of public policy and are not to be narrowly construed. Nor should the reduction in the rate of tax on capital gains, first granted in the Revenue Act of 1921, be held to circumscribe the privilege granted in the earlier acts and retained in later ones, with respect to charitable contributions, unless that result be plainly required by the language used."³²

This enunciation is consistent with previous expressions of the Court.³³

²³ *Ibid.*

²⁴ *Supra* note 2.

²⁵ The Deputy Commissioner on February 6, 1923, telegraphed in response to an inquiry, "Contributions; 15% limitation; capital net gain, 15% limitation for deductions account charitable contribution applies to total net income inclusive of gain from sale of capital assets." C. C. H. FED. INCOME TAX SERVICE (1924) par. 2033. In 1924 a corresponding ruling as to capital losses was made, "Capital losses cannot be excluded in computing net income for the purpose of determining the amount of charitable contribution deductions." I. T. 404, III-2 CUM. BULL. 152.

²⁶ *Supra* note 7.

²⁷ XI-7 INT. REV. BULL. 5386; Min. 3931.

²⁸ *Supra* note 7.

²⁹ XI-49 INT. REV. BULL. 5896; Min. 3986.

³⁰ *Brewster v. Gage*, 280 U. S. 327, 50 Sup. Ct. 115 (1930).

³¹ *Supra* note 1, at 151, 55 Sup. Ct. at 21.

³² *Supra* note 1, at 150, 55 Sup. Ct. at 20.

³³ *Infra* notes 34 and 35.

"In the law of taxation it is frequently reiterated that 'statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved most strongly against the Government and in favor of the citizen.'³⁴ Where the statute, however, contains no ambiguity it must be taken literally and given effect according to its language.³⁵ But the expounding of a statutory provision strictly according to the letter without regard to the other part of the act and legislative history, would often defeat the object intended to be accomplished."³⁶

IRVING WEINSTEIN.

INTERGOVERNMENTAL IMMUNITY FROM TAXATION.—The problem of intergovernmental immunity from taxation is constantly assuming a more important place in the law of taxation.¹ With mounting deficits in national and state budgets due to tremendous relief expenditures, new sources of income must be found. To meet this need, governments have undertaken new fields of activity, such as liquor selling,² furnishing electric power³ and the running of railroads.⁴ With both Federal and State Governments engaging in these activities the question naturally arises, will each or either be immune from taxation by the other? The answer lies, if anywhere, in the decisions of the Supreme Court on the subject.

The roots of the problem are in the famous decision of Chief Justice Marshall in *McCulloch v. Maryland*⁵ decided in 1819 on purely political grounds.⁶ The rule established, there being no express provision in the Constitution,⁷ was that a state could not tax the business and functions of the Bank of the United States, chartered by the Federal Government. The keynote of the decision was

³⁴ *Gould v. Gould*, 245 U. S. 151, 153, 38 Sup. Ct. 53, 55 (1917); *United States v. Merriam*, 263 U. S. 179, 188, 44 Sup. Ct. 69, 71 (1923); *Reinecke v. Northern Trust Co.*, 278 U. S. 339, 348, 49 Sup. Ct. 123, 125 (1929); *Tyler v. United States*, 281 U. S. 497, 503, 50 Sup. Ct. 356 (1933); Note (1931) 6 *ST. JOHN'S L. REV.* 172, and cases cited therein.

³⁵ *Bates Refrigerating Co. v. Sulzberger*, 157 U. S. 1, 37, 15 Sup. Ct. 508 (1895); *Commissioner of Immigration v. Gottleib*, 265 U. S. 310, 313, 44 Sup. Ct. 528 (1924).

³⁶ Note (1934) 9 *ST. JOHN'S L. REV.* 222.

¹ Note (1934) 44 *YALE L. J.* 326.

² FOSDICK AND SCOTT, *TOWARD LIQUOR CONTROL* (1933).

³ THOMPSON, *PUBLIC OWNERSHIP* (1925) 20, 204.

⁴ *Supra* note 3.

⁵ *Wheat*, 316 (U. S. 1819).

⁶ BEVERIDGE, *LIFE OF JOHN MARSHALL* (1919) 302.

⁷ *Supra* note 5.