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The Doctor's Federal Taxes

Erwin N. Griswold*

During the period of the first world war, the maximum amount which was raised by taxes in any one year was $5,400,000,000. Our present tax laws are yielding more than five times that amount, and the President's budget message for 1943 asks for additional taxes which will greatly increase the present total. Tax rates have necessarily gone steadily higher while exemptions have gone lower, and there are very few in the community now who do not feel directly the burden of federal tax collection.

The modern income tax dates from 1913, in which year the Sixteenth Amendment to the Constitution was adopted. Since that time Congress has adopted many revenue laws, and at the present time the income tax is a very refined and exceedingly complex instrument. We often hear pleas that the tax laws should be simple so that every citizen might easily know his duties and responsibilities. But experience has shown that this cannot be. A simple income tax could be drawn, but it would be full of harsh unfairnesses on the one hand, and loopholes on the other. As tax rates go higher, it has been necessary to introduce many new provisions into the law to alleviate burdens and prevent escape. Fortunately, however, many of the more complex sections have no application to the ordinary taxpayer.

The body of the tax law is contained in the Internal Revenue Code. This is a codification of the tax statutes which was adopted

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† This article is one of a series of papers being published as a symposium by leading medical and legal journals under the editorship of Dr. Hubert W. Smith of the Department of Legal Medicine of Harvard University. A complete list of authors, the titles of their articles and of the participating publications will be found at the conclusion of this article.

The Sixteenth Amendment provides: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

This was made necessary by the unfortunate decision of the Supreme Court in Pollock v. Farmers' Loan & Trust Co. (1895) 158 U.S. 601.

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by Congress in 1939, and references in this article to sections are to
the sections of the Code, including the numerous amendments which
have been adopted in the past four years. In addition to the statute,
there is a great mass of other materials which may have bearing on
the solution of a tax problem. Pursuant to authority granted in the
statute, the Commissioner of Internal Revenue issues a large quan-
tity of regulations. These represent the official interpretation of the
law, and in many situations have much the same force and effect as
if Congress had itself adopted them. In addition there are many ad-
ministrative opinions and rulings by the Revenue authorities. These
are published weekly in the Internal Revenue Bulletin, and twice a
year are gathered into a volume known as the Cumulative Bulletin.
Finally, there are many thousands of decisions of the courts which
have interpreted and applied the various provisions of the statute.
These start with the Tax Court of the United States, known until
recently as the Board of Tax Appeals, which turns out over a thou-
sand tax decisions a year. But tax cases are also being constantly
decided by the federal district courts, the circuit courts of appeals,
and by the Supreme Court. These are the materials which must be
consulted on any difficult point in the tax law. There is much that is
very difficult; but there is also, fortunately, a large area in which the
application of the tax is fairly certain.

THE INCOME SUBJECT TO TAX

The tax is imposed on net income, which consists of gross income
less certain deductions and credits (or exemptions). Thus we must
start with gross income, and we find that it is defined in very sweep-
ing terms. Sections 22(a) of the Code provides that, "'Gross income'
includes gains, profits, and income derived from salaries, wages, or
compensation for personal service . . . of whatever kind and in what-
ever form paid, or from professions, vocations, trades and businesses,
commerce, or sales, or dealings in property . . .; also from interest,
rent, dividends, securities, or the transaction of any business carried
on for gain or profit, or gains and profits and income derived from
any source whatever."

Specifically, this means that the doctor must include in gross in-
come all of his fees, any salary he may receive, either from a medical
school or clinic, or from anyone else by whom he may be employed,
and also any dividends, interest, rent or other income which he may
have. The Supreme Court has held that this section "indicates the
purpose of Congress to use the full measure of its taxing power within those definable categories.\textsuperscript{2} There are only a few items of receipts which are expressly exempted from the tax. These include gifts and inheritances,\textsuperscript{3} the proceeds of life insurance payable by reason of the death of the insured,\textsuperscript{4} and amounts received as compensation for personal injuries or sickness.\textsuperscript{5} But except for these specific items, the sweep of the definition of gross income is very great, and reaches to every item of receipts of every individual.\textsuperscript{6} And the receipts need not be in cash. The value of any property or benefit received is subject to the tax. Thus the value of board and room is taxable, if it is received as compensation for services,\textsuperscript{7} and the same rule applies to an automobile or other thing of value which might be received from a grateful patient.

\textit{Accounting methods.} Since the income tax is imposed on a periodic basis, it becomes necessary to determine in many cases the period for which an item should be reported as gross income. Two principal methods of accounting are recognized for tax purposes, and either one may be adopted by an individual taxpayer. The method most widely used by individuals is the \textit{cash} method. This means that income is reported for the period within which it was received, and deductions are taken for the period when they were paid. This is the

\begin{footnotes}
\item[3] I.R.C. §22(b)(3). A receipt is not a gift unless it is purely gratuitous. It does not have to be paid pursuant to a strict contract or after sending a bill, to be income. Thus, if a doctor renders professional services, and the patient thereafter sends in a check without any agreement or bill, the entire amount is income, even though it is more than the bill which the doctor would have sent for the services.
\item[4] I.R.C. §22(b)(1). The exemption applies even where the proceeds of the insurance are payable in installments, as in the form of an annuity payable to the decedent's widow for her life. In such a case a portion of each payment to the widow is (from the insurance company's point of view) income on the money left with the company. But several cases have held that the entire amount of such payments is exempt from income tax. Commissioner v. Winslow (C.C.A. 1st, 1940) 113 F. (2d) 418; Commissioner v. Bartlett (C.C.A. 2d, 1940) 113 F. (2d) 766; Allis v. LaBudde (C.C.A. 7th, 1942) 128 F. (2d) 838; Kaufman v. United States (D. Va., 1942) 40 Fed. Supp. 505.
\item[6] I.R.C. §117. The proceeds from the sale of property are not income to the extent that they represent a return of capital or investment. Thus if property costing $800 is sold for $1,000, $1,000 is received, but only $200 is income. The amount to be included in "gross income" may be reduced by the provisions of the statute dealing with capital gains.
\item[7] U. S. Treas. Reg. 103 (1940) §19.22(a)-3 provides: "If services are paid for with something other than money, the fair market value of the thing taken in payment is the amount to be included as income."
\end{footnotes}
simple method, and is usually quite satisfactory for most persons whose income is chiefly from a salary or fees. Some questions can arise. For example, income is received when a check is received, at least if the check was thereafter paid in due course. Thus a check mailed on December 31st and received on January 2nd is taxable as income for the later period. On the other hand, some items are taxable on the cash basis, even though they have not been received. This is called constructive receipt, and applies to items which are unqualifiedly subject to the taxpayer's demand. Examples of such items are savings bank interest which is taxable though not withdrawn, matured bond coupons, and a drawing account, where the taxpayer is taxable on the amount he can withdraw whether he does withdraw it or not.

The other method of accounting is the *accrual* basis. Most business organizations make their returns on this basis, and an individual can do so if he chooses. On this basis, an item is taxable as income for the period when it *accrued*, and an item may be deducted for the period within which it is *incurred*. The time of receipt or payment is immaterial. This method more accurately reflects the economic return for the efforts of a given period, since the time of actual collection or payment may in many cases be largely fortuitous. Under the accrual method a doctor would report his fees as income for the period within which they were billed, and the time of actual collection would not affect the tax. Of course some of the fees billed will not be collected, and a deduction is allowed for bad debts at the time they become worthless, or a reserve may be set up for bad debts, and reasonable additions to this reserve may be deducted in each period. Where the cash method is used, uncollectible fees do not give rise to any deduction for a bad debt since they have never been included in income. They are simply income which the taxpayer hoped to get but never did, and are thus neither income nor a basis for deduction.

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9 Although either method may be chosen, a taxpayer who has adopted one method may not change to the other unless he obtains the permission of the Commissioner of Internal Revenue. Thus, persons who have heretofore used the cash method must continue on that basis unless they seek and obtain the required permission.

10 I.R.C. §23(k) as amended by Revenue Act of 1942, *supra* note 5, §124(a), 26 U.S. C. (1942) §23(k). Until recently the bad debt deduction was very technical, and required that the debt be both "ascertained to be worthless" and "charged off" during the taxable year. This was changed by the Revenue Act of 1942 (*ibid.*: to allow the deduction simply of "Debts which become worthless within the taxable year."
DEDUCTIONS

After the gross income has been ascertained, there is naturally much interest in determining the deductions. The statute allows the deduction of interest payments, taxes, business losses, and losses of property arising from "fires, storms, shipwreck, or other casualty, or from theft," bad debts, and charitable contributions. Probably the most important deduction in many cases is that allowed for "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ." Under this provision, a doctor may deduct his office rent, fuel, water, light, telephone, and supplies for office use, and any professional expenses, such as dues in medical societies, subscriptions to medical journals,
and traveling and other expenses in attending medical conventions. In an early ruling it was held that the expenses of doctors in taking post-graduate courses in schools were deemed to be personal expenses, and thus not deductible. It is far from clear, though, that this ruling would be followed now.

Another item of expenditure which is clearly deductible on the doctor's income tax return is the amount of wages and salaries paid to any employees. These may be salaries paid to office employees, such as receptionists or nurses, or to technicians or to other doctors who may be in the taxpayer's employ. The only restriction that the statute puts on the deduction of such items is that they be "a reasonable allowance for . . . personal services actually rendered." Thus a salary paid which under the circumstances was so large as to amount to a gift would not be deductible beyond the amount of reasonable compensation. Such a payment would be subject to particular scrutiny where the payee was the taxpayer's wife or other relative. A payment by way of pension is deductible, however, where it is reasonably related to past services rendered.

A new provision added to the Revenue Act of 1942 makes it possible now to deduct expenses incurred in connection with the production of taxable income, even though they are not connected with the taxpayer's trade, business or profession. Under this clause, deductions may be had for costs incurred in connection with the management and protection of investments, such as the cost of a safe.

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18 It has been held in several cases that amounts expended by a physician for railroad fare, hotel accommodations and meals in connection with attending meetings and conventions of medical societies is deductible as an ordinary and necessary expense. Cecil M. Jack (1928) 13 B.T.A. 726; J. Bentley Squier (1928) 13 B.T.A. 1223; Roy Upham (1929) 16 B.T.A. 950; Robert C. Coffey (1931) 21 B.T.A. 1242; Wolfe v. McCaughn (E. D. Pa. 1933) 17 Am. Fed. Tax R. 1007. The Bureau of Internal Revenue now follows this view. I. T. 2602 (1931) X-2 C.B.

19 Of course, the expenses deductible are those of the physician himself. They do not include the expenses of his wife and family who may accompany him. Nor do they include purely recreational expenses, such as the cost of a side trip made on the way to or from the convention.

20 O. D. 984 (1921) 5 C.B. 171.

21 Supra note 16.

22 Compare the decision in Waters F. Burrows (1938) 38 B.T.A. 236, where it was held that expenses of practicing medicine in previous years but paid in the current year by a doctor on the cash basis were deductible, even though he had retired from active practice before the expenses were actually paid.

23 Sec. 23(a) (2) of the Code, added by Revenue Act of 1942, supra note 5, §121(a), 26 U.S.C. (1942) §23(a) (2).
deposit box or the expenses of a custodian or advisor in supervising and handling the investments. This section also makes it clear that the expenses of investment in real estate, including depreciation, may be deducted on the tax return.

**Personal expenses.** The statute expressly provides that "Personal, living, or family expenses," may not be deducted. This prevents the deduction of the cost of the taxpayer's home, his clothes, his food, the expenses of his children, including the cost of their schools, camps, or other care. Similarly, wages paid to household or domestic employees are not deductible. The Treasury has recently ruled that examination fees and other expenses paid by physicians for securing the right to practice their profession are personal expenses and may not be deducted. This applies also to the basic cost of obtaining a medical education. Similarly, the cost of insurance on the taxpayer's house or personal automobile (not used for business) is a personal expense, and is not deductible. For the same reason, life insurance premiums and premiums paid on health and accident insurance policies may not be deducted. But the cost of a doctor's insurance against liability for injuries to patients and claims for malpractice may be deducted, since that is an ordinary and necessary part of the expense of carrying on the profession.

In many cases the line between professional and personal expenses is far from clear. It has been particularly hard to draw this line in the case of uniforms worn by nurses, surgeons and others engaged in medical work. These are the personal attire of the persons wearing them, yet it is equally obvious that they are worn for professional purposes, and represent to a considerable extent an extra professional expense. There is an early ruling that these costs may not be deducted, but there is reason to believe that the official view on this may have changed, at least where the article of clothing is "unsuited to wear outside of working hours."

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24 But only if the box is used for the protection of income producing property. Thus no deduction is allowed for the cost of a safe deposit box used for jewelry, silverware, or for fire insurance policies or the deeds to the taxpayer's own residence. See U. S. Treas. Reg. 103, §19.23(a)-15 added by T. D. 5196 (Dec. 14, 1942) Int. Rev. Bull., 39, 42.


28 See G. C. M. 19662, 1938-1 C. B. 118 and G. C. M. 19790, 1938-1 C. B. 118, where it was held that the cost of uniforms worn by jockeys and baseball players can be de-
Another instance of the line between personal and professional expenses is in the deduction for rent. If a doctor maintains an office separate from his home, the rent of the office is clearly deductible. But the rent of his home is not deductible, even though he receives occasional patients there. If, however, he maintains a separate portion of his home as an office in which patients are regularly received, then he may deduct the portion of his rent that is fairly attributable to the office.\footnote{29 U. S. Treas. Reg. 103, §19.24-1: "...In the case of a professional man who rents a property for residential purposes, but incidentally receives clients, patients, or callers there in connection with his professional work (his place of business being elsewhere), no part of the rent is deductible as a business expense. If, however, he uses part of the house for his office, such portion of the rent as is properly attributable to such office is deductible."}

The situation is similar as to the expenses of operating an automobile. If the car is used partly for personal use, and partly for professional calls, then a proper proportion of the expenses of gasoline, oil, repairs, and other costs of operation may be deducted. The cost of the car itself is not deductible for reasons which are stated in the next paragraph, but a similar proportion of the depreciation sustained on the car may be deducted. If the car is used entirely for professional purposes, then all the expenses of operation are deductible, including all of the allowance for depreciation.

\textit{Capital expenditures.} Another line has to be drawn in the matter of deductions between what may be called current expenses on the one hand, and capital expenditures on the other. "Ordinary and necessary expenses" are deductible, but the cost of anything which amounts to a capital investment may not be deducted at the time of acquisition. The cost is instead recovered for tax purposes through a depreciation allowance spread over the life of the article. It is not always easy to decide whether an item may be deducted or must be capitalized, but a rough and ready test may be found by saying that if it will last more than about three years it must ordinarily be capitalized. A familiar example is an automobile used for business or professional purposes. The investment in an automobile is recoverable through depreciation allowances spread over the life of the car. For an ordinary passenger automobile this period is usually taken as about five years, and thus one-fifth of the cost is deductible in each of the first five years the car is owned. After the full cost has been made up by depreciation allowances, no further deduction can be
had. Similar questions may arise with respect to books, and various items of professional equipment, ranging from typewriters to X-ray machines and other items of a professional laboratory. Occasional books bought from time to time may ordinarily be deducted currently, but large sets or the cost of a professional library must ordinarily be recovered through depreciation.\textsuperscript{30} Similarly, depreciation is allowable on a building owned by the taxpayer and used as an office, or held for investment, or against the proper proportion of the cost of the taxpayer's residence when he maintains an actual office in the building.

Where depreciation is taken against an item of property, the amount of depreciation allowed is deducted from the cost of the property to determine the taxpayer's remaining capital investment in it, for the purpose of computing gain or loss on a subsequent sale. Thus, if an automobile is purchased for $1,000 and used solely for professional purposes for two years, during which depreciation was allowed at the rate of $200 a year, the taxpayer's remaining capital investment would be $600. If he then sold the car for $700, he would have taxable gain of $100, although he sold the car for less than he paid for it. On the other hand, if he traded the car in on a new car for professional use, he would have no gain or loss on the trade,\textsuperscript{31} and the new car would take as its basis for depreciation the sum of the remaining basis on the old car plus the amount paid in cash to complete the trade. The same is true with respect to any other professional capital asset, such as typewriters, desks and other office furniture, and scientific instruments and equipment used for medical purposes.

**Credits**

In addition to the deductions, the statute provides for certain credits in the computation of net income which is subjected to the tax. The chief of these are the personal exemption and the credit for dependents. In the 1942 law the exemption is fixed at $1,200 for a

\textsuperscript{30} The Treasury has published a pamphlet known as Bulletin F (1942 ed.) which deals with depreciation allowances in some detail. The following appears at page 60: "Professional and Scientific Equipment. Under this heading will come libraries and equipment used in professional activities. The life usually applied to professional libraries is 30 years while the life for scientific equipment used by dentists, doctors, etc., is usually 10 years."

\textsuperscript{31} I.R.C. §112(b)(1) provides: "No gain or loss shall be recognized if property held for productive use in trade or business . . . is exchanged solely for property of a like kind to be held for productive use in trade or business . . . ."
married couple or for the "head of a family," and $500 for a single person. In addition to this a credit of $350 is allowed for each dependent child under the age of eighteen, or for any dependent person, regardless of age, who is incapable of self support because of mental or physical defects.\textsuperscript{2}

\textit{Earned income}. The other credit allowed to individuals is the earned income credit.\textsuperscript{3} This is available against the normal tax only, and is a credit of ten per cent of the earned net income, and is deducted in the computation of net income subject to that tax. There are certain rather arbitrary limitations on the computation. The first $3,000 of net income is treated as earned income regardless of its actual source, and in no case is more than $14,000 allowed as earned net income. With the normal tax rate at the present six per cent, the effect of the earned income credit is to reduce the tax payable by six per cent of ten per cent of the amount of the earned net income. Thus the earned income credit never results in a saving of more than $84 at the present rates, because of the top limit of $14,000. The income received by a doctor from fees or salary is earned income even though a part of the work is done by employees and assistants under his general direction.\textsuperscript{4}

\textbf{TAX REDUCTION}

With tax rates already at unprecedented heights, it is natural that there should be much interest in devices which will help in tax reduction. During the past decade there has been a good deal of activity to this end, but much of it has saved no taxes and caused much expense and grief in the process. Some tax reduction is fairly obvious. Taxes can be saved by not going to the movies, staying off trains, and not making long distance calls. It is also desirable for a taxpayer in these days to keep an adequate memorandum book in which he may

\textsuperscript{2}I.R.C. §25(b).

\textsuperscript{3}I.R.C. §25(a).

\textsuperscript{4}U. S. Treas. Reg. 103, §19.25-2: "The entire amount received as professional fees may be treated as earned income if the taxpayer is engaged in a professional occupation, such as a doctor or a lawyer, even though he employs assistants to perform part or all of the services, provided the clients or patients are those of the taxpayer and look to the taxpayer as the person responsible for the services performed."

The same rule applies to income received through a professional partnership provided the patients are those of some active member of the partnership and look to him as responsible for the services performed. Mim. 3802 (1930) IX-1 C.B. 121. See also G. C. M. 9716 (1931) X-2 C.B. 304. The income of a physician from his practice was held to be income from a trade or business under the 1917 excess profits tax which was applicable to individuals. A. R. M. 40 (1920) 2 C.B. 266.
make proper record of all items of deduction which he may claim on his return, such as all taxes paid, and items of business and professional expense, such as postage used at the office for sending out bills, and so on. A substantial percentage of all of these items can be saved when they are deducted from income at the present rates.

Beyond this the quest for tax reduction leads into the realm of trusts and transfers of property, and this is a field into which no layman should venture without the very best of experienced advice. This is not a plug for the lawyers, but merely a statement that a doctor should not try to deal with such a question on casual suggestions from a friend or a “tax expert” with a service to sell, any more than a lawyer should undertake self-medication if he is confronted with a serious or complicated illness. It is also a field in which highly trained advice is eminently desirable. Most doctors doubtless know members of their own profession to whose ministrations they would not want to submit themselves; and lawyers cannot be regarded as fungible either. Finally, it may be fairly said that the field of trusts and taxes is full of uncertainties which only an expert can keep within his grasp, and the best he can do often is to guess. In about three-fourths of the cases, the best advice that can (and will) be given is—do not.

There is one thing that a married man can do if he has full confidence in his wife, or is willing to take the chance that she may run off with money he may give her. If the doctor has made some accumulation from his profession, and has invested this in securities, the income from the securities is included in his income and is in effect taxed in his highest bracket. If his total income is above the bottom bracket of surtax, he may save income tax (under the law as it stands today) by transferring the securities to his wife. Then the income from the securities will be taxable to her and in the lower brackets if she has no other income. The gift will be subject to gift tax if it exceeds the annual exemption of $3,000 a year, or the general exemption of $30,000. And it must be clearly understood that an outright

Such a transfer is unnecessary in the eight community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington; and optionally in Oklahoma). In those states the income of a doctor from his profession is community property, and is taxable half to him and half to his wife. This results in a substantial discrimination in favor of taxpayers in these states, which would not be tolerated by the residents of other states, if they were fully aware of it. But to date determined efforts to eliminate this unfair arrangement have always fallen before the solid phalanx of sixteen Senators from the community property states.
unqualified gift to the wife is required. There must be no reservations or strings or understandings of any sort. The transfer will also have the effect of taking the property out of the husband's taxable estate at the time of his death (unless the gift is found to have been made in contemplation of death). But the property will be taxable in the wife's estate on her death, and the husband may have to pay tax then to get his property back. And, of course, the income tax saving would be lost if the Treasury should be successful in its efforts to have compulsory joint returns of the income of husband and wife; but so far Congress has consistently rejected that attempt.

SPECIAL PROBLEMS

There are several special situations dealt with in the law which seems worthy of mention, and which may occasionally arise in connection with a doctor's tax returns. The first two of these to be dealt with relate to the problem of allocating income to a proper period for the purpose of computing the tax payable.

Income accrued at date of death. When a doctor in active practice dies he will ordinarily have a substantial amount of fees due to him for work he has done but for which he has not received payment during his lifetime. This is a situation which is not peculiar to doctors, but applies also to lawyers, architects, insurance men, and many others. These items represent assets of the estate of the person who has performed the services. The question is then presented as to how they should be treated when they are eventually collected by the executor after the decedent's death. In some early cases it was held that the amounts collected by the executor were not income to the estate, since they were merely the collection of the estate's assets, in the form of debts due to the estate. This led the Treasury in 1934 to secure the adoption of a clause in the statute which provided that all such items earned but not collected at death should be included as income of the taxpayer for the period ending with his death. In other words they were treated as having accrued at the date of death, and the taxpayer was put on the accrual basis with respect to these items. In due course, this provision was sustained by the Supreme Court, and it was held that the items which must be so accrued included the fair value of all services performed whether they had

36 Sec. 42(a) of the Revenue Act of 1934, continued into §42(a) of the Internal Revenue Code.
37 Helvering v. Estate of Enright (1941) 312 U.S. 636.
been billed or not. With the rapid increase in tax rates in the follow-
ing years, this provision became very unfair, for it resulted in throw-
ing into the taxable income of the final return items of income which
might have been earned over a period of several years. As the rates
are sharply graduated, this caused a much greater tax than would
have been the case if the tax had been spread over a period of several
years. This tax would materially reduce the amount which a man in
active professional practice could count on leaving to his dependents,
since the tax would be a heavy liability against his estate at the time
of his death.

Fortunately this difficulty was remedied by Congress in the Rev-

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enue Act of 1942. That statute adds a new section to the Code,\textsuperscript{38} which makes such income taxable to the person who actually collects
it after the decedent's death, less an allowance for the estate tax
which may have been paid by reason of the claim being included as
an asset of the decedent's estate at his death. This amendment was
made retroactive, so that the pyramided tax may be eliminated in
the case of any professional person who died before the recent amend-
ment was passed.

Income earned over a period of more than thirty-six months.
Sometimes work is performed over a long period of time, and pay-
ment for the services is not received until at or after the close of the
period. Very likely this happens to lawyers and others more often
than it does to doctors, but there must be many cases where doctors
have to wait more than three years for a fee while performing ser-

\textsuperscript{38} Revenue Act of 1942, \textit{supra} note 5, §134, 26 U.S.C. (1942) §126. The previous
provision in §42(a) was eliminated.

vices during the period. If the fee, when received, is substantial, the
tax may be very much greater if it is taxed in full in one period than
would have been the case if the fee had been divided up and paid
equally during each year in the period, for the tax on a sum received
in each of three years is less than the tax on three times the sum
received all in one year. This is the result of the sharply graduated
rates of taxation.

This difficulty has been alleviated to some extent by a provision
included in Section 107 of the Code. Under this section, where at least
eighty per cent of the total compensation for personal services cover-
ing a period of thirty-six months or more is received in one taxable
year, then the amount so received may be treated for tax purposes as
if it had been received ratably over the entire period. In this way the
amount received may be spread over the three or more years involved and the total tax due with respect to it shall not exceed the aggregate of the taxes which would have been due if the proportionate amount of the total compensation had been included in each of the years of the period. This is a complicated provision; but it is a fair one. Many of the complications in the tax laws result from efforts of Congress and the taxing authorities to be fair. And the use of this section may save a substantial amount of tax in the occasional case where it is applicable.

Victory tax. The Revenue Act of 1942 includes a new tax known as the Victory tax. This has given rise to a good deal of confusion, chiefly because of the provisions which it includes for collecting the tax at the source from wages and salaries. Because the tax is withheld only from salary and wage income, the impression has sometimes arisen that only wages and salaries are subject to the tax. Specifically, some doctors have thought that their fees were not subject to the Victory tax. This impression is, however, quite unfounded. The Victory tax is applicable to all taxable income received by any taxpayer, whether derived from salaries, wages, fees, commissions, dividends, interest, rent, or any other source except capital gains. The tax is collected in advance, it is true, only from salaries and wages. But this is merely a collection device. All taxpayers will make a report of Victory tax when they file their returns on March 15, 1944. To the extent that the tax has been collected at the source from salaries and wages, the amount so collected will be a credit against the Victory tax due. But in the case of taxpayers whose income has not been subjected to collection at the source, the entire amount of the Victory tax will be due at that time.

A portion of the Victory tax is in effect a compulsory loan to the government to be returned after the close of the war. In the case of single persons, this is twenty-five per cent of the tax, not to exceed $500; and for married persons, it is forty per cent of the tax, not to exceed $1,000. An additional credit of two per cent (limited to $100) is allowed for each dependent. This credit may in effect be taken in advance, because amounts invested in war bonds, or used to pay off debts, or paid on life insurance premiums may be applied against it at the time the return is filed.

If the doctor has employees of any sort, whether office of professional, he is required to act as a withholding agent, and deduct the Victory tax from the wages or other compensation which he pays.
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(Withholding is not required from the wages of domestic or agricultural employees.) The amount to be deducted is five per cent of all of the compensation in excess of $12 a week. The employer is personally liable for the amount of the tax withheld from his employees, and must pay it with a return on the proper form to his local Collector of Internal Revenue after the close of each quarter of the year. The employer must also furnish to each employee after the close of each year (or after the termination of employment) a receipt for the tax withheld on a form prescribed by the Commissioner of Internal Revenue. This is the form which the employee then files with his tax return so that he may secure credit against his Victory tax for the amounts which the employer has paid in advance on his behalf through the withholding collections.

Men in the armed services. The salaries of army officers are subject to tax just the same as other income, including the Victory tax (although there is no collection at the source of Victory tax from military and naval personnel on active duty). There has grown up a rule, however, under which the allowances of army and navy officers for quarters, as distinguished from their pay, are not subject to income tax. This arises from the difficulty of drawing a distinction between cases where quarters are furnished primarily for the benefit of the government and the much more frequent situation where an allowance is made in lieu of quarters. It crept into the regulations when tax rates were low and it did not make very much difference. Under present conditions it results in a very considerable saving of tax, since taxpayers outside of the military forces have to pay full tax on that part of their incomes which they use to cover their rent, food and other living costs. It is thus an indirect increase in the compensation of army and navy officers, which may well be fully warranted, but would be better done directly.

Although an army or navy officer remains fully liable for income tax and Victory tax, the law allows him to defer the payment of any tax falling due during his period of military service if his "ability to pay such tax is materially impaired by reason of such service." 40

39 U. S. Treas. Reg. 103, §19.22(a)-3: "... The value of quarters furnished to the commissioned officers, chief warrant officers, warrant officers, and enlisted personnel of the Army, Navy, Coast Guard, Coast and Geodetic Survey, and Public Health Service, or amounts received by them as commutation of quarters, are to be excluded from gross income."

This deferment extends until six months after the termination of military service, and no interest is due for the period of deferment, and no penalty may be collected for nonpayment. The statute of limitations is, however, kept open for the period of deferment and for nine months thereafter. Deferment in such cases is not automatic, but may be had on application and a proper showing to the Collector of Internal Revenue. A similar deferment is now given in effect to any person, whether in the armed forces or not, who for more than ninety days "is continuously outside the Americas."41

QUESTIONS CONNECTED WITH THE PATIENT'S TAXES WHICH MAY BE OF INTEREST TO DOCTORS

The doctor is, of course, primarily interested in his own taxes. When tax rates were low and exemptions were high, there could be very few situations where the patient's tax bill could seriously interfere with the patient's obtaining proper treatment or with the doctor's being paid. Where tax rates are higher, however, the taxpayer would in effect get a substantial rebate against his medical expenses if they could be deducted, and this might have some effect on the doctor's collections. But with one important exception to be noted later, it is quite clear that medical costs are personal expenses and are not deductible in the ordinary case.

Where medical or related work has some connection with the taxpayer's trade or business, it has been occasionally argued that the cost could be deducted. In one case, a deduction was allowed to an actor for the cost of dental work required to replace teeth knocked out in making a prize fight picture.42 But generally such deductions have been denied. An early ruling refused to allow the deduction by a professional singer of amounts paid to a throat specialist for throat treatments.43 The Board of Tax Appeals refused to allow a motion picture actress to deduct the cost of a tonsillectomy although she contended that it was necessary for the improvement of her voice.44 In another case an actor and radio performer was denied a deduction of the sum of $3,500 paid for new artificial dentures, although he claimed that the new teeth were necessary to eliminate a hiss and

41 Sec. 3804 of the Internal Revenue Code, added by the Revenue Act of 1942, supra note 5, §507(a), 26 U.S. C. (1942) §3804.
42 Reginald Denny (1935) 33 B. T. A. 738. The Commissioner of Internal Revenue has refused to acquiesce in this decision. XV-1 C. B. 30 (1936).
43 O. D. 1032 (1921) 5 C. B. 172.
44 Madge Evans (1939) 39 B. T. A. 1241.
restore perfect enunciation which was required in the conduct of his work. A lawyer sought to vary the claim by contending that the substantial expense of caring for his arthritis was deductible as a "loss" or as a damage by "casualty"; but he was unsuccessful.

Certainly, ordinary medical bills would seem to be a clear case of "personal, family, and living expenses," which are not deductible. But the doctor is familiar with many cases where there is a medical catastrophe with hospital and other costs which are overwhelming even to a family which is ordinarily able to pay its way. It does not require imagination to picture a case where the family income is, say, $4,000 a year, and an accident or illness to a child or other member of the family results in costs aggregating the entire family income of $4,000. In such a case, it is rather harsh to tell the taxpayer that he must not only find a way to pay his ordinary living expenses, and the medical bills, but also a sizeable amount for income tax as well. He will find it hard to feel that he has had income when he has finished the year at a substantial loss through no fault of his own.

Recognizing the reality of this situation, and its impact at the present high tax rates, Congress has undertaken to meet it by a new provision in the Revenue Act of 1942. This allows the deduction of what may be called extraordinary medical expenses. Specifically, it is a deduction for that part of the expenses of medical care which exceeds five per cent of the taxpayer's net income. Anything less than five per cent is treated as an ordinary personal expense, but medical expenses larger than that are deductible. There is, however, a top limit on the amount which may be deducted of $2,500 for a married couple or the head of a family, and $1,250 for a single person. "Medical care" is defined for this purpose as including "amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body."

This deduction should be of real benefit to many persons who are confronted with heavy medical expenses. There will doubtless be attempts to abuse it by persons who seek to deduct the costs of their annual vacations in Florida on the ground that their health requires it or that their doctor has ordered it. But most of the claims will be

45 Sparkman v. Commissioner (C. C. A. 9th, 1940) 112 F. (2d) 774.
47 Sec. 23(x) of the Code, added by Revenue Act of 1942, supra note 5, §127(a), 26 U.S.C. (1942) §23(x).
legitimate, and the relief afforded will be a real contribution to the problem of the costs of medical care.

PROCEDURE

Income tax returns are due the fifteenth day of the third month after the close of the taxable year. Most individuals make their returns on the basis of a calendar year, and their returns are thus due on March 15th. But returns can be made on the basis of a fiscal year ending on the last day of any month, and in some cases it is desirable to use a fiscal year. The return must be filed with the Collector of Internal Revenue for the district in which the taxpayer resides or has his principal place of business. Formerly the return had to be made under oath, but this was changed by the Revenue Act of 1942, and they may now be filed with a simple signature under the statement printed on the return form that the signing is made under the penalties of perjury. The tax may be paid in full at the time the return is filed, or it may be paid in quarterly installments, the first paid with the return, and the rest at three-month intervals thereafter.

In addition to the return of taxable income, each person must file an information return disclosing the amount and payee of all payments made in the amount of $500 or more in any taxable year. (In the case of payments made to employees from which Victory tax has been withheld, the receipt furnished to the employee takes the place of the information return.) Information returns must be filed with the Commissioner of Internal Revenue in Washington, and are due by February 15th of each year. Patients and others making payments to physicians of amounts of $500 or more in any calendar year are likewise required to file information returns, so that the gov-

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48 I.R.C. §48. But the taxpayer cannot change from one accounting period to another without the approval of the Commissioner of Internal Revenue. Ibid. §§46, 47.


50 A discount for advance payment may in effect be obtained through the purchase of Treasury Tax Savings Notes. These may be bought at any time, by reserving a portion of current earnings, for instance, and may then be used for the payment of subsequent income tax. They return interest of 16 cents a month on each $100, or 1.92 percent a year, on amounts up to $5,000 a year. They may be purchased direct from any Federal Reserve Bank, or through the taxpayer's own local bank.

51 I.R.C. §147.

52 U. S. Treas. Reg. 103 (1940) §19:147-1: "... Fees for professional service paid to attorneys, physicians, and members of other professions come within the meaning of the term 'fixed or determinable income' [in §147 of the Code] and are required to be reported in returns of information as required by this section."
ernment has a record of any such items in a medical man's income. This may be some incentive against carelessness in making out a tax return.

Once the tax return has been filed, it is checked and examined by the revenue authorities. In many cases it is accepted as correct and nothing more is heard of it by the taxpayer. In other cases, however, there are two possibilities. The taxpayer may have paid too much, or the government may think that he has paid too little. If the taxpayer thinks that he has paid too much, either because he has included something in income which was not properly taxable as income, or because he has not taken a deduction to which he was entitled, he may file a Claim for Refund with his local Collector of Internal Revenue. This claim must be on a blank known as Form 843, obtainable from any Collector's office, and it must state the grounds on which the claim is based. The claim cannot be considered unless it is filed within three years from the due date of the return (or within two years after the tax was paid, in case the payment was delayed for some reason). After the claim is filed, it will be considered by the revenue authorities, and may be allowed. If it is allowed, the overpayment of tax is refunded with interest at the rate of six per cent. If it is denied, then the taxpayer's only alternative (unless he can get a reconsideration of the claim, and that is unlikely) is to bring suit in the appropriate court. The suit must be brought within two years from the date of denial of the claim. It may also be brought at any time more than six months after the time of filing the claim, even though the Commissioner has not acted on it.

Probably the more frequent event is that the revenue officers have some question about the return. In that event, they usually write to the taxpayer and ask him to come in with such records as he may have. In many cases a simple interview is all that is required. There may be some ambiguity on the return which is easily and satisfactorily explained, or the revenue officer may be seeking substantiation of some item claimed as a deduction. If the explanations are not satisfactory to the revenue officer, however, he writes another letter to the taxpayer in which he says that he proposes to find that there is a deficiency in the tax payment, and the taxpayer is given formal opportunity to protest this finding if he feels that he has reason to do

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54 I.R.C. §3772(a)(2).
so, and so desires. If the matter is not then satisfactorily adjusted, the Commissioner's staff sends the taxpayer a formal determination of a deficiency. The taxpayer may then either pay the tax determined, or within ninety days he may file a petition with the Tax Court of the United States seeking a redetermination of the Commissioner's ruling. From the decision of the Tax Court, either side may appeal to the higher federal courts.

Whenever it is finally determined that the taxpayer owes an additional tax, the Collector's remedies for collection are very powerful and summary. He does not need to obtain any process from a court. After giving ten days' notice, he has authority to distrain (that is, to seize) any property of the taxpayer, including bank accounts and any other assets, and with the most meager and antiquated exemptions. It should also be pointed out that any deficiencies in tax must be paid with interest at the rate of six per cent.

**PENALTIES**

**Civil penalties.** The tax laws work fairly smoothly when they are fully and fairly complied with. But they contain rather harsh provisions which come into operation when there is serious default in meeting the obligations of the statute. The mildest of these take the form of civil penalties which can be asserted and collected in the regular proceeding for the collection of the tax. The first of these is applicable to the failure to file a return on time. If the return is not filed when it is due, a penalty may be assessed of five per cent for each thirty days (or portion of thirty days) that the return is late, up to a maximum penalty of twenty-five per cent. Even though a return

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65 In the ordinary case, this notice must be sent within three years from the due date of the return. But if there is an omission of items amounting to 25 percent of the gross income, then the notice may be sent within five years. And if the return is false and fraudulent, there is no time limitation on the determination and collection of the tax. I.R.C. §§275, 276.

66 I.R.C. §3690.

67 The exemptions allowed by I.R.C. §3691(a) include arms for personal use, 1 cow, 2 hogs, 5 sheep and wool thereof, household furniture to an amount of $300, and the “books, tools, or implements of a trade or profession, to an amount not greater than $100.”

68 I.R.C. §291(a) as amended by Revenue Act of 1942, supra note 5, §172(f)(4), 26 U.S.C. (1942) §291(a). The Commissioner has power to relieve against this penalty where “it is shown that such failure is due to reasonable cause and is not due to willful neglect.” This takes care of the situation where the failure to file the return is due to the taxpayer’s illness or other disability. The penalty is of course not due where the failure to file return is during a period of military service or while the taxpayer is “outside the Americas,” as indicated in notes 40 and 41, supra.
is properly filed, a penalty of five per cent may be collected where there is a deficiency in the tax shown due on the return, and any part of the deficiency "is due to negligence, or intentional disregard of rules and regulations but without intent to defraud." The major penalty, however, is the fifty per cent fraud penalty. This is due, "If any part of any deficiency is due to fraud with intent to evade tax." With tax rates where they are now, this penalty may impose a very severe burden. In one leading case, the Supreme Court sustained a fraud penalty in the amount of $364,354.92 determined against a taxpayer, although the taxpayer had previously been acquitted by a jury of the criminal charge of filing a false return.

**Criminal prosecutions.** In addition to the civil penalties, the government may also proceed by way of criminal prosecution. Any person who willfully fails to pay a tax, file a return, keep proper records, or supply information may be found guilty of a misdemeanor, and subjected to a fine up to $10,000 and imprisonment for not more than one year. The penalty may be even more serious where a person "willfully attempts in any manner to evade or defeat any tax." That is a felony, and may be punished by a fine of $10,000 and imprisonment up to five years. Similarly, any person "who willfully makes and subscribes a return which he does not believe to be true as to every material matter" is guilty of a felony and may be subjected to the penalties prescribed for the crime of perjury.

These provisions have been the downfall of many characters of notoriety. They have also been applied a good many times in the cases of less prominent personalities, enough times to show the wisdom of playing square with the tax collector, even if a man cannot say with Justice Holmes that he likes to pay taxes. The Justice said that he liked to pay taxes, because that was the way he bought civilization, and there has never been a time when that was more true.

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50 I.R.C. §293(a).
51 I.R.C. §293(b).
53 I.R.C. §145(a). See Spies v. United States (1943) 63 Sup. Ct. 364, 87 L. ed. Adv. Ops. 342, decided by the Supreme Court on January 11, 1943, where it was held that a willful failure to file a return without more must be prosecuted as a misdemeanor under this clause, and not as a felony under §145(b), referred to below.
54 I.R.C. §145(b).
55 I.R.C. §145(c) as amended by Revenue Act of 1942, supra note 5, §136(c), 26 U.S.C. (1942) §145(c).
56 See for example the case of Capone v. United States (C.C.A. 7th, 1931) 51 F. (2d) 609, cert. den. (1931) 284 U.S. 669.
than now. The opinion has been held by some that tax evasion is not unknown in the medical profession, because it may be thought to be easier to get away with there than in some other fields of activity. Doctors usually receive their fees from many persons in relatively small amounts, and if a doctor is not honest, he may think that he can keep two sets of books, and return only part of the checks as income, or he may omit to return some or all of the cash fees that he receives, figuring that there will be no way to check up on them.

Admittedly, such action can impose a difficult problem on the tax collecting officers. But it has been solved, more than once, and an example may prove of interest. In the case of *Wiggins v. United States*, the defendant was a dental surgeon who had filed returns for two years showing income of $18,000 and $20,000, when in fact his income was over $30,000 for each year. It appeared that the defendant had kept two sets of books, one a secret “true book,” and another “false book.” Only a portion of the fees were included in the latter, and only this portion was returned. The government learned about this through anonymous telephone calls which turned out to come from the defendant’s nurse and secretary who had had charge of his office and books for several years. The defendant put his trust in her, and eventually she turned him in. He received a substantial prison sentence.

**ESTATE AND GIFT TAXES**

Brief mention may be made of the estate and gift tax provisions, for any doctor may at least hope to become subject to these taxes. The federal estate tax now allows an exemption of $60,000, but all property in excess of this is subject to fairly high and rapidly graduated rates of tax. The tax is imposed on the net estate, and as in the income tax, the net estate is determined by defining a gross estate against which certain deductions are allowed. The gross estate includes all the property which the decedent owns when he dies, including any dower or marital interest which his wife may take in his property. It also includes any property which he may have transferred during his life time, either in contemplation of his death, or where he has reserved a power or other interest in it. The amount of life insurance payable by reason of death is included in full in the gross estate where the decedent either paid the premiums or retained incidents of ownership in the policy, such as the right to borrow, or

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66 (C. C. A. 9th, 1933) 64 F. (2d) 950, cert. den. (1933) 290 U.S. 657.
take the surrender value, or change the beneficiary. The entire value of property held jointly by the decedent and his wife is also included, if the property came originally from the decedent himself.

Against this property included in the gross estate, there is allowed the exemption of $60,000 and two principal deductions. All debts, including funeral and administration expenses, and the expenses of the last illness may be deducted, and a full deduction is likewise allowed for all gifts and bequests to charity. The only other deduction is of property which has previously been subjected to the estate tax within five years. The estate tax is in effect a periodic property levy, and the government says that it should not be imposed oftener than once in five years.

Parallel with the estate tax is the gift tax. This applies to all gifts made while the taxpayer is living. There are two exemptions, one of $30,000, and the other which allows a gift of $3,000 each to be made to any persons every year. In this way, a taxpayer can over a period of time give away a substantial amount of property without incurring the gift tax. If his gifts exceed these exemptions, then the tax applies. It is imposed at graduated rates on the taxable gifts made since the gift tax went into effect in 1932. The rates are in general about three-fourths of those under the estate tax. There is thus a substantial inducement to make gifts in the case of wealthy persons, and this inducement has been rather freely accepted by many persons. There are others, however, who do not have to concern themselves very greatly with the gift tax. But the gift tax exemptions and the estate tax exemptions are steadily moving lower and lower, and these taxes may soon follow the income tax in being made applicable to a much larger group of taxpayers.

If the doctor's wife has independent means, estate tax may be saved under the law as it stands at present if she takes out the insurance on his life and pays all the premiums and takes all the incidents of ownership in the policy with no rights given to him in any event. In such a case, the proceeds payable on his death will not be taxable in his estate, nor will they be taxable as income to the wife. If the wife should die first, however, the value of the policy would be an asset of her estate and subject to tax there if her estate exceeded the allowable exemptions and deductions. The premium payments must be paid wholly from the wife's own separate property. It will not do for the husband to give the wife the money to pay the premiums, for then they would be paid "indirectly" by him. It is probably sufficient, however, if the husband gives the wife property freely and with no strings attached, and she then uses the income from the property to pay the insurance premiums. This is most likely to be true when the gift to the wife is made wholly independently of any plan to use the income to pay insurance premiums.

This includes the reasonable charges of a physician who may have attended the decedent. The bill for such services is a "claim against the estate" of the decedent and is thus deductible. See Lucius N. Littauer (1931) 25 B. T. A. 21, 28.
SCIENTIFIC PROOF AND RELATIONS OF LAW AND MEDICINE
A SYMPOSIUM SERIES ON LAW-SCIENCE PROBLEMS WITH PARTICULAR REFERENCE TO LAW-MEDICINE PROBLEMS.

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