***26 T.C. 707 (1956)***

For income tax purposes, the actual agreed-upon price of goods sold, even if the transaction violates a state law, determines gross income, rather than a fictitious price entered in the company's books to conceal the illegal nature of the sales.

**Summary**

The Pittsburgh Milk Company violated Pennsylvania's Milk Control Law by selling milk at prices lower than the mandated minimums. To conceal this, the company recorded sales at the official list prices, then created "advertising expense" entries to account for secret rebates. The IRS argued that taxes should be calculated on the listed prices, but the Tax Court ruled in favor of the company. It found that the taxable income should be based on the net prices the milk was actually sold for (list price less rebates). The court held that the actual, agreed-upon price of a sale, not artificial bookkeeping, is what determines the calculation of taxable income, even when the sale violates the law.

**Facts**

Pittsburgh Milk Company, operating under a license per the Pennsylvania Milk Control Law, sold milk at prices below the state-mandated minimums. It had agreements with customers for specific rebates, concealing these in the books by recording sales at higher list prices and classifying the discounts as advertising expenses. The Milk Control Commission was unaware of this arrangement, but the IRS audited the company's records. The company was dissolved, and transferee liabilities were assessed against the shareholders.

**Procedural History**

The Commissioner of Internal Revenue determined deficiencies in income tax, as well as additions to the tax and transferee liabilities, against the Pittsburgh Milk Company and its transferees. The cases were consolidated in the United States Tax Court for hearing. Some liabilities were eliminated by stipulation. The sole remaining issue was whether the allowances given to customers in violation of the Milk Control Law should reduce the company's gross sales or be considered deductions from gross income.

**Issue(s)**

1. Whether allowances provided to customers in violation of the Milk Control Law of Pennsylvania should be used to reduce the corporation's gross sales for the purpose of calculating income tax.

2. If the allowances are not considered to be a reduction of gross sales, whether they can be considered deductions from gross income.

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## Holding

1. Yes, because the allowances reduced the actual price at which the milk was sold.

2. The Court did not rule on this question because they determined that the allowances should be used to reduce the corporation's gross sales.

## Court's Reasoning

The Court focused on the reality of the sales transactions, not the artificial accounting. The court stated that the actual, agreed price of a sale, even if illegal, determines the tax calculation: "Where gains, profits, and income derived from the sale of property are involved, the tax is computed with respect to 'the amount realized therefrom' (sec. 111 (a), 1939 Code); and such realized amount must be based on the actual price or consideration for which the property was sold, and not on some greater price for which it possibly should have been, but was not, sold." The court noted that the actual net prices, arrived at by deducting the allowances, were the prices for which the milk was actually sold. The court distinguished this situation from cases where the allowances were contingent upon the future actions of the customer. The court also cited earlier cases and the IRS's own instructions that trade discounts reduce gross sales.

## Practical Implications

This case emphasizes that substance over form is the guiding principle in determining taxable income. Accountants and attorneys must look beyond the surface of transactions to their true economic nature. This principle applies in any situation where a party might attempt to use accounting or other artifices to avoid or reduce tax liability. Sales prices, even if illegal, are controlling when computing gross income. This case also shows that the IRS may challenge transactions that attempt to disguise the true nature of an economic exchange. Later cases may cite this precedent where sales are made below listed prices and tax liability is contested. Tax lawyers and businesses must carefully document sales transactions and avoid any misleading accounting.

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