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November 16, 1939

The President,
The White House,
Washington, D. C.

My dear Mr. President:

I enclose herewith a memorandum which attempts to implement your ideas upon an excess profits tax. The memorandum discusses some of the principal problems which the drafting of a statute would involve and suggests a number of problems which need further consideration. The subject is a difficult one and requires more study than could be given to it in the limited time available, but I hope the enclosed memorandum will expedite a clarification of the subject.

Generally speaking, the memorandum adopts two of the basic factors you have suggested, namely, (1) net cost of assets, and (2) capitalized earnings. For reasons given at pages 19 and 34 appraised value and book value are not taken, but the two factors employed in

ascertaining invested capital are to a large degree a duplication of the discarded factors. In other words, net cost of assets amounts to a duplication of correct book values, and capitalized earnings approximates correct appraised value. Thus, we preserve your essential thought of compensating for inaccuracies inherent in the use of one formula for the computation of invested capital or excess taxable earnings.

In a nutshell, the tax discussed is a graduated tax upon excess earnings. Excess taxable earnings are defined as earnings in excess of the earnings of a representative standard period, 1935 to 1938 inclusive, but they may not be taken at less than 8% or more than 12% of the invested capital. This minimum allowance is to protect corporations with low earnings during the representative period. The maximum allowance is to insure the collection of tax from corporations which had large earnings during the representative period, and which should be in the best position to pay.

In order to forestall criticism of the type directed against the World War excess profits tax, the device is adopted of ignoring cost of assets acquired before March 1, 1913, and

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Respectfully yours,
 Randolph S. Paul

MEMORANDUM ON EXCESS PROFITS TAX

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INTRODUCTION

The purpose of this memorandum is to summarize a general plan for the taxation of excess profits expected to be forthcoming as part of the impact of the war upon the American economy.¹ The memorandum will first set forth the fundamental proposal in broad outline; it will then attempt a slightly more detailed exposition of some of the necessary provisions of a statute imposing such a tax. The description of the tax is not intended to be complete, but a number of suggestions are offered in the hope that they may serve as a basis for the framing of a statute that will be fair and workable.

1. No attempt will be made to draft any precise statutory provisions.

The advisability of once more imposing a true
excess profits¹ tax has frequently been stated by impartial
commentators,² often with the further thought that such a
tax, if administratively successful, might be retained as a
permanent part of the tax system.

1. The earliest instance of such a tax in the United States, a 12½% tax on manufacturers of munitions, was imposed by the 1916 Act. A profits tax was imposed by the Act of March 3, 1917, (30 Stat. at Large 1000) which was replaced before it was ever applied by the excess profits tax of October 3, 1917 (Revenue Act of 1917, Secs. 201-210), both of which reappeared in revamped form in the Revenue Act of 1918.

This 1918 Act was a combination of two taxes: one, the excess profits tax proper, and the other, a so-called war profits tax. The first was theoretically on the excess of profits over pre-war average earnings. The two normal rates of return were deducted from actual profits to get the income subject to tax. The normal rate of return under the excess profits tax was 6% of the capital invested in the business during the taxable year. The tax was imposed on the difference between actual profits and normal profits plus an arbitrary allowance of \$3,000. The normal rate of return under the war profits tax was the average profit for the period 1911 to 1913, plus or minus 10% of the increase or decrease in invested capital. The excess profits tax, in other words, assumed an 8% return on capital to be normal. The war profits tax assumed that pre-war earnings were normal, and that 10% profit during war time was normal. The method giving the higher tax was the computation to be used.

2. See, e.g., Twentieth Century Fund, Facing the Tax Problem (1937); Godfrey Nelson, War Profits Taxes and Their Records, 17 Taxes 569 (1939).

I. GENERAL DESCRIPTION OF TAX

The proposal has been made that a tax be enacted along the following general lines:

(1) Allow a return free from the tax of normal profits of the corporation.

(2) Tax any profits above the normal profits or normal return at graduated rates increasing as the profits realized in the taxable year exceeded the normal return.

(3) Profits would be defined, generally speaking,¹ in terms of "net income" for purposes of the existing income tax, thus simplifying administration by taking full advantage of work which has to be done independently of the new statute.

(4) The normal rate of return would be measured by the following factors: (a) equity capital invested in the corporation as of the beginning² of the taxable year, which would

1. Variations are indicated at p. 43 below.

2. Possibly this invested capital should be increased on account of stock dividends paid during the year. See p. 30.

The 1918 excess profits tax used the "average" of the taxable year; 1918 Act, Sec. 326 (d). The "average" of the year referred to capital paid in; no earnings of the year were permitted to be included in invested capital. This rule furnishes a reasonable precedent for the present act.

reflect assets at cost, or depleted¹ or depreciated cost as determined by the Bureau of Internal Revenue for income tax purposes; (b) the average profits over some standard representative period, such as the period from 1935 to 1938, inclusive.

(5) There would then be allowed as normal profits or normal return the average profits of the standard or representative period² with the limitation that these profits taken as normal and used as an excess profits tax credit, might³ not exceed 8% of the invested capital, plus 50%, which amounts to 12%. And 8% of the invested capital would be taken as normal profits even if the corporation had average profits⁴ for the standard period of less than that amount.

For example:

(a) If a corporation has average standard period profits of \$200,000, current profits of \$250,000 and an invested capital of only \$200,000, there would be normal earnings of only \$24,000, consisting of \$16,000, being 8% of

1. As to value at March 1, 1913, see p. 25.

2. This period is sometimes referred to below as the "standard period".

3. 1918, 1921 Acts, Sec. 312.

4. There are some who feel that these percentages of 8% and 12% should be 5% and 15%, making for a bigger spread and taking in more corporations. This is a matter which, of course, requires complete study before it is decided. The recent Canadian statute uses an optional rate of 5%.

invested capital plus an increase of 50%, or \$8,000,¹
leaving taxable profits of \$286,000.

(b) If a corporation has average standard period profits of \$200,000, current profits of \$250,000 and an invested capital of \$3,000,000, there would be normal earnings of \$40,000 consisting of 8% of \$3,000,000, and the lower average earnings of \$200,000 would be disregarded, leaving only \$10,000 in the taxable class.

I.(a) Example of Computation of Tax

Before commenting on the above factors entering into the computation of the tax it may clarify discussion to set forth an example of a hypothetical tax liability as follows:²

1. As an alternative method there might be used as normal profits an average of the earnings of the representative period and 8% of the invested capital. For example, if a company had representative earnings of \$200,000 and a capital cost of \$200,000, 8% of which is \$16,000, its normal profits would be 1/2 of \$216,000, or \$108,000.

2. The rates used in this example are merely illustrative.

Invested Capital		\$10,000,000
8% of above	\$800,000	
50% of this percentage	<u>400,000</u>	1,200,000
Average standard profits - 1935 to 1938		2,000,000
Statutory normal return		1,200,000
Actual net income, Sec. 21, Internal Revenue Code		3,000,000
Income tax liability @ 18% (approx.)		<u>540,000</u>
Net income after ordinary corporate tax		<u>\$ 2,460,000</u>

	Amount of Net Income Each Brack- et	Statutory Normal Re- turn(excess To Tax Profits Tax Credit	Balance Subject of Tax	Rate of Tax	Amount of Tax
Not over 15% of invested capital	1,500,000	1,200,000	300,000	10%	30,000
Over 15% but not over 18% of invested capital	300,000		300,000	25%	75,000
Over 18% of invested capital	560,000		560,000	50%	<u>280,000</u>
Total Excess Profits Tax					<u>\$435,000</u>

Average percentage of excess profits
tax on excess income - 34 1/2%

Average percentage of aggregate ex-
cess profits and income tax
liability on total net income - 32 1/2%

There is attached hereto, as Exhibit A, a computation
in another case in which the taxpayer's average standard profits
are insufficient to give exemption greater than 8% of invested
capital.

I. (b) Necessity of Graduated Rates

Naturally the exigencies of revenue needs would be the primary factor in determining the precise rates to be used. The suggested proposal involves the use of a graduated rate scale, - in this respect it is unlike the current British Act, but like the Canadian Act and the American 1918 Act.

Excess profits taxation is grounded on the assumption that extraordinary profits can be regarded as windfall gains. This assumption seems to be the more justified the higher the profits are above the "normal". Profits only a little bit higher than the "normal" may be due to windfalls from war or may be due to other reasons; therefore, it seems justified to leave a large portion of profits which only slightly surpass the "normal" in the hands of business, but to increase the tax rates with increasing profit ratio under the assumption that the higher the profitability the greater the probability that they must be attributed to factors other than special skill of management.

The general rule that the ability to pay principle does not justify a graduation of corporate taxes does not hold true for the excess profits taxes. The general rule is based upon the

1. For example, the legislative history of the 1918 Act shows that that act was expected to yield \$6,000,000,000, of which the excess profits tax was expected to yield \$2,400,000,000. (Senate Finance Committee Report No. 617 (1918)).

It is estimated that the 1917 excess profits tax absorbed about 44% of the increase in annual profit from \$4,123,000,000 to \$9,500,000,000. A group of the largest manufacturing and mining companies in the country paid in taxes (including both the normal income taxes and the excess or war profits taxes) about 25% of their net taxable income for 1917 and about 35% of the same income for 1918. For refinements of these percentages, see Report of Special Committee on Investigation of Munitions Industry, No. 944, Part 2, 74th Cong., 1st Sess., p. 14 (1935).

2. It is impossible to determine which profits are due to management and which are attributable to economic conditions or semi-monopolistic advantages.

assumption that corporate taxes are ultimately borne by the stockholder. If there should be any graduation it should be in correspondence to the income bracket to which the stockholder belongs, which of course can be done only through the individual income tax. Excess profits taxation is based on the theory that these profits should be taxed irrespective of whether they would otherwise accrue to a person in the lower or in the higher brackets.

This tax is not based on the principle of the individual ability to pay, but on the theory that gains attributable to extraneous factors be absorbed as much as possible by taxation. It is a tax on the corporation per se and not a tax on individuals through the means of collection at the source.

There are some arguments against graduated rates. All excess profits taxation implies a certain crudeness in the determination of "normal" profits. If a uniform standard ratio is the criterion of "normal" profits, then corporations with a normally high ratio (for instance, because of high risk in the specific branch) would fall into a higher bracket under the principle of graduation. The necessary crudeness of the criterion thereby would be aggravated.

If standard earnings in a base period are chosen as a criterion, then corporations which happen to have extraordinarily low profits in the base period are penalized by a high bracket tax, if graduation is applied.

If an excess profits tax is proposed for a neutral country in a period of war, the rates cannot be too drastic. In such a sit-

uation business is not predominantly determined by the impact of the war, so that all high profits could be regarded as war profits. If the progression, therefore, should not reach very high percentages it may be more advisable to enact a flat rate with a degression for profits just above the criterion of "normal" profits. Such a degression is advisable in order to avoid a too sudden jump from the non-taxable to the taxable profits.

A flat rate tax is more easily administered than a progressive tax.

I.(c) Application of the Tax

The Act should cover virtually all corporations; segregation of war profits industries in the conventional sense of the term would be impractical, since all increased profits will be partly attributable to war activities and to the attendant rise in price levels. It is noteworthy that in the first war act of 1918 munition makers were singled out as the sole object of the tax. But other profits soared at the same time, and all industries were soon drawn within the net of subsequent acts. Specific types of corporations should probably be treated as follows:

1. It is true that a universal application of the tax might lead to harsh consequences in particular cases. For example, in the case of gold mining it was found under the earlier acts that while gold brought the same price regardless of the war, nevertheless the cost of labor and materials went up. Therefore, such mining was exempted by special provisions in the Act of 1918 (Revenue Act of 1918, Sec. 304). There would probably be pressure at the present time for similar special exemptions wherever the prices in the industry in question are regulated by law, as for example, in the case of railroads. But in view of the allowance of a minimum return of 8% before the tax becomes operative, the need of such exemptions is far from clear.

(1) Corporations exempt from the income tax¹ should also be exempt from this tax in order to simplify administration and avoid complaint.

(2) Personal service corporations, in which capital is not a material income-producing factor, might be exempted from the excess profits tax, but might reasonably be taxed as partnerships, as was done under the 1918 and 1921 Acts.²

(3) Some favored treatment might be shown to very small corporations, which are not affiliated or subsidiary units of large corporations. Average statistics under the earlier acts covering profit-earning corporations show that the ratio of net income to capital varied, roughly speaking, in inverse proportion to the size of the company. Larger concerns seldom realize such a high percentage of profit as do successful concerns of moderate or small size. Therefore, to avoid an undue discrimination against small corporations, there might be exempted corporations with a net income of less than \$25,000³ or some other appropriate minimum amount.

1. Internal Revenue Code, Sec. 101.

2. This would be constitutionally more acceptable now than in 1918. See *Helvering v. National Grocery Co.*, 304 U.S. 282 (1939). Moreover, it might be better statutory technique to give such corporations an option to be taxed as partnerships upon consent to certain regulations issued by the Commissioner. This technique might be especially valuable in the case of corporations engaged partly in personal service activities, where allocations of income would be necessary.

3. This was the dividing line under the undistributed profits surtax, as amended by the 1938 Act, Sec. 14(a).

(4) New corporations would also have to be treated somewhat differently, as will be discussed more in detail below. Here the reference to pre-war activities would have to fall away, and an a priori normal return of some figure between 8 and 12% of invested capital would have to be taken.

(5) Foreign corporations might be taxed under a provision similar to the special assessment provisions of the 1918 and 1921 Acts discussed below, or they might be given an option to use the general method of computing normal return¹ as to any capital actually employed within the United States.

(6) Personal holding companies and foreign personal holding companies should be exempted; they are now subjected² to taxes calculated to compel their disintegration.

1. Compare Canadian Excess Profits Tax Act, Sec. 2(c).

2. Titles IA, Supplement P.

(7) Successor Corporations The reorganization sections, which have been embodied in the income tax statute since 1918, render the treatment of reorganizations prior to or after the enactment of the tax much less perplexing than under the old acts. The 1918 and 1921 Acts drew the line at a 50% change in interest or control¹ in determining whether assets should be stepped up for invested capital purposes when there had been a reorganization, consolidation or change in ownership of a trade or business. In computing invested capital for the current taxable year after the imposition of the tax for any corporation reorganized or consolidated within the meaning of the tax-free reorganization sections of the income tax statute,² assets transferred to a new corporation may under the proposed tax be regarded, as for income tax purposes, as if still in the hands of the predecessor corporate owner or at

1. 1918, 1921 Acts, Sec. 331

2. Internal Revenue Code, Sec. 112, 113.

the cost to such previous owner, if the previous owner was not a corporation. Generally speaking, the reorganization-basis provisions would be applicable. Proper adjustment would, of course, have to be made for any cash or property actually paid in as part of the transaction.

(8) Individuals and Partnerships No attempt need be made to apply the excess profits tax to individuals or to partnerships as under the recently-enacted British statute (except as to professions dependent mainly upon personal qualifications) and under our 1917, but not the 1918, Act.¹ While it may be somewhat illogical to exempt individuals,² corporations make up the great body of American business, and the individual surtaxes will take good care of the problem of excess profits so far as individuals and partnerships are concerned. Individual capital gains are another matter; if we have a substantial rise in price levels, capital gains will be war or excess profits in every true sense of the term. But the better road to the taxation of such profits seems to be

1. The excess profits tax of 1917 caused great discontent and was barely endured even as a war measure.

2. Kennedy, Dividends to Pay, p. 1(1929), stating that 385,000 corporations as of 1925 increased to 456,000 in 1929.

through the raising of capital gain rates in the Income Tax
Title.¹

The individual surtaxes will similarly prevent any gross inequality between the tax on corporate and non-corporate business such as might raise an issue of constitutionality on the grounds of arbitrary classification.

I.(d) Duration of Tax

It might be desirable to retain such a tax as a permanent part of the revenue system. Bookkeeping devices might avoid part of the incidence of any temporary excess profits tax. And it may further be said that corporations earning a very large return on their invested capital are able to bear a larger part of the tax burden than other corporations.

One technical problem which would become accentuated with a continued duration of the tax would involve the standard period of earnings to be employed. As time passed on and economic changes occurred, the use of the 1925 to 1933 period would grow more and more antiquated and out of proper comparison with present facts. The use of a moving basis (in other words, the use of the year immediately prior to the taxable year as

1. Sec. 117.

a part of the standard period) is a possible solution; this method, however, would give corporations a vested interest in one year's excess profits by permitting them to reduce their subsequent tax accordingly. Potential errancy in the use of a moving basis would be less serious if, as has been suggested, standard profits (or excess profits tax credit) are deemed to be not less than 8% and not more than 12% of the invested capital. An alternative, and perhaps preferable, solution would be to change the 1935 to 1938 period to some different span of years after industry had passed through a fairly normal period.

II. USE OF INVESTED CAPITAL

While average profits during the standard period would be the criterion usually employed under the suggested proposal, the invested capital would be referred to for the purpose of a minimum and maximum allowance. There is a vital reason for these minimum and maximum allowances which should be set forth at this point. Contrary to popular impression, it appears incontrovertible that a great many of the leading concerns have realized very substantial profits¹ in the so-called depression. A tax which merely reached

1. See Kennedy, Dividends to Pay, Ch. 1 (1939).

profits above these large depression-period profits would permit the escape of large sources of revenue by those best able to bear their share of the tax burdens. On the other hand, there are many concerns which, either because of their position in the industry or because of the nature of the industry in which they are engaged, had low profits in the depression period. Such concerns, the very concerns which should be permitted a reasonable opportunity to recoup losses, would be heavily penalized if excess profits were defined as profits of these low profit years. The only protection which can be reasonably afforded for such concerns is measurement of normal or standard profits by reference to invested capital, which in turn measured by reference to the depreciated or depleted cost of assets employed in the business.

II. (a) The Necessity of Using Invested Capital

The suggested proposal, it will be noticed, combines the concept of standard profits with that of a normal rate of return upon invested capital. From one viewpoint, the value of

1. In this respect it is somewhat similar to the recently enacted British excess profits tax effective April 1, 1938. This tax is fixed at 80% of the amount by which the profits of the taxable year exceed the pre-war standard of profits. The standard profit is determined with reference to the profits of a standard period prescribed according to when the trade or business was commenced. If the business was commenced before January 1, 1936, the standard period is optional to the taxpayer is as follows: either 1935 or 1936, the years 1935 and 1937, or the years 1936 and 1937. In the case of a business started after July 1, 1936, the standard profits are the "statutory percentage" which is 8% of the invested capital in the case of corporations and 10% in relation to non-corporate organizations. Minimum allowances are made in lieu of standard profits. It is also provided that referees may make special allowances for lines of business involving particular risks or other conditions.

the assumed invested capital necessarily depends upon the standard earnings; from another viewpoint the exempted profits depend upon the invested capital. The construction of an "invested capital" based on earnings alone would involve a logical circle. If it were proposed to tax all excess profits on an abstract "invested capital," which itself would be found by capitalizing earnings at a certain percentage, and if that same percentage of return were then permitted to be received free from tax, we would be indulging in circular reasoning.¹ There should obviously

1. It is true that the use of capitalized earnings would be one method of valuing invested capital for purpose of an excess profits tax. One difficulty in this connection, however, would be the selection of the capitalization rate for each industry, considering how some businesses involve little and others a very great hazard, as well as how the earnings of some industries fluctuate widely while the profits of others are relatively stable. There would be no yardstick here except the vague general principle that high risk industries should be capitalized on the basis of a higher rate of return than more stable low risk industries. But refined differentiation would complicate administration, and it would probably be necessary to adopt a liberal capitalization rate which would be applicable to all industries. This would favor the high risk industries, which is economically desirable. However, in the interest of consistency it would then be necessary to take the same rate of capitalization in determining how much net income should be exempt from tax altogether. Thus, if it were decided to leave a 6% return free from the tax, average net income during the standard period might be capitalized by multiplying them by $16 \frac{2}{3}$ which would certainly be a reasonably liberal rate of capitalization. The same result, however, can be reached more directly and more simply by merely using the average standard profits as the norm without any attempt at capitalization.

It is a serious question whether the old concepts of comparative risk factors are any longer valid. For instances, the old idea was that the oil and mining industries are extra-hazardous. Are they today? These industries are usually organized on a large scale which averages out dry holes and unprofitable mines; moreover, modern methods of exploration and discovery have greatly minimized old hazards. The man of the

be some contributing measure of capital independent of standard profits. Moreover, as indicated above, the use of the factor of earnings alone would discriminate in favor of corporations which profited materially during the depression years, and would be especially unfair in the case of new and speculative industries. It might also over-accent the factor of good will. A very costly mine shaft may never have produced a single ton of coal during the standard period, and the corporations which achieved good will peaks in the representative period would pay no tax.

Therefore, whatever its difficulties the use of an invested capital concept similar in many respects to that of the 1918 Act seems desirable. As to most assets the invested capital computed would be related directly to the cost basis originally arrived at for depreciation or depletion purposes under the income tax. The use of such a basis is better adapted to a permanent tax than any exemption related in every case only to average

(1 cont'd from p. 17)

street certainly no longer thinks of the stock of the Texas Oil Company as being stock of a hazardous enterprise. He may be up-to-date in his thinking and the old recapitalization formulae may be what are obsolete. On the other hand, perhaps a comparatively new company engaged in a reputedly stable industry should be regarded as subject to a high risk. The man of the street may be up-to-date in his thinking and the old recapitalization formulae may be what are obsolete.

1. See however, p. 27, note 5, as to percentage depletion.

earnings. It is a more responsible figure than book value¹ and is readily available for use, since most of its underlying² material has already been computed for income tax purposes.

1. This would perhaps be the most arbitrary possible basis of value. In the case of most well-conducted corporations book values originate in cost, but many corporations even today carry assets at book values completely out of line, up and down, with depreciated costs and current values. Many assets of great value never get on the books at all; on the other hand, many assets of small value appear on the books at inflated values. Even in the case of corporations whose book values started with genuine cost there would be variances originating in differing ideas and estimates of depreciation, obsolescence, etc. Since a high book value would raise employed capital, the use of this factor would tend to penalize conservative bookkeeping, and there would be high-sounding talk of conflict between New Deal agencies.

The answer may be made that crudities inherent in the use of book values might be compensated by using book value as only one of several factors. This is true, and it is also true that book or asset values are often taken in evidence of value in the absence of other evidence. (See Paul, *Selected Studies in Federal Taxation*, p. 211 (1937)). But this reply is only a partial answer, and any tax which was referable to book values, so often stated by the courts to be merely evidentiary, (see e.g., *Doyle v. Mitchell Bros.*, 247 U.S. 179 (1918)) would be subjected to some justifiable criticism, and much additional unjustifiable criticism as well.

3. True, the use of value at March 1, 1913, for income tax purposes somewhat complicates the point, but this complication need not trouble us. See p. 24

II. (b) Criticism of Earlier Excess Profits Taxes

Before defining invested capital in more explicit terms, it may be well briefly to dispose of the criticisms made of the World War excess profits taxes.¹ Lack of administrative experience, deficiencies in bookkeeping records and unavailability of detailed factual information made invested capital under the old acts an unpopular institution. The computation of invested capital was irritating and costly to taxpayers and delayed the collection of revenue under a procedural system which put a premium on under-payment of tax in the original return. However, the Government and taxpayers were just beginning to understand the statute and its application when Congress repealed the tax, thus throwing away the knowledge we had gained. The old tax had a sound principle underlying it. If we had left it in the revenue laws,

1. Invested capital under our earlier excess profits acts was defined as (a) cash paid in, (b) the actual cash value of tangible property paid in, and (c) paid-in or earned surplus employed in the business. (1916, 1921 Acts, Sec. 326) Patents, trademarks, good will, copyrights and other intangible assets were included up to an amount not exceeding the actual value of such property when paid in, the par value of the stock issued therefor, or 15% of the total par value of the corporation's shares, whichever was the lowest.

its administration would have become relatively simple by this time. Moreover, its graduated rates might have diminished the incentive for tax avoidance by corporate surplus accumulation.

Without attempting at the moment any discussion of such technical problems as the exclusion of borrowed capital,¹ the limitations to be put upon the inclusion of intangible property,² and inadmissible assets,³ and the treatment of reorganizations,⁴ reference may be briefly made to the troublesome problem of valuation for purposes of invested capital. There was no special difficulty under the old acts with respect to cash paid in, but corporate stock is frequently issued for property, both tangible and intangible. The method of computing invested capital used under the earlier acts therefore involved a valuation of property paid in to the corporations at the time paid in. Such a valuation, as

1. Holmes, Federal Taxes, p. 1275 (1922 Ed.); see p. 32

2. Holmes, Federal Taxes, p. 1257 (1922 Ed.); see p. 28

3. Holmes, Federal Taxes, p. 1255 (1922 Ed.); see p. 34

4. Holmes, Federal Taxes, p. 1291 (1922 Ed.). See also discussion of the Old Dominion case, Report of Special Committee on Investigation of Munitions Industry No. 944, Part 2, 74th Cong., 1st Sess., pp. 19, 21 (1935).

of the time paid in, even though previous to March 1, 1913, was presumably once made by the Treasury for corporations old enough to have been subject to the tax imposed by the 1913 and 1921 Acts (except corporations granted special assessments), though it may be a question to what extent details of the valuations so made could now be recovered from old files. There would not be the same problem in the case of newer corporations since the Bureau of Internal Revenue presumably has sufficient cost records. But for reasons indicated below, these difficulties may be avoided by ignoring acquisition cost before March 1, 1913.

Unless we do so, the violent, and often bitter, criticism of the old excess profits tax, particularly in its use of invested capital as a base for the exemption and, again, particularly in connection with the difficulties involved in valuations, made by such experts as Mr. Arthur Ballantine, former Assistant Secretary of the Treasury, the late Dr. Thomas S. Adams, former Advisor to the

1. Another more theoretical problem under this method of computation would be the determination of a basic theory of value. The 1913 and 1921 Acts used the term "actual cash value" (Sec. 326 (a)), and perhaps this term is as good as any that may be found, for in the end value is a question of fact the answer to which can never be determined with mathematical accuracy; the question must always be determined by a process of compromise with practical reference to a composite of complex circumstances, and the basic terms used in the statute are a generality of little practical consequence. (Paul, Selected Studies in Federal Taxation, p. 168 (1937)).

Treasury, and others would no doubt be repeated.¹ This criticism seems to have been considerably exaggerated, but it was sufficiently telling to accomplish the repeal of the old excess profits tax. The task of government and taxpayers under a new act would not be as difficult as it was under the 1918 and 1921 Acts for several reasons, among which are:

- (a) Corporate records are in better shape than they were in the last war;
- (b) The Bureau is more adequately manned and more experienced than it was in the last war; corporate advisors in the legal and accounting fields are also more competent and experienced;
- (c) It should be possible to re-utilize considerable old valuation work; and
- (d) The Bureau of Internal Revenue is in the possession of much data which would be useful, and so perhaps are other branches of the government, such as the S.E.C.

1. See Report of Special Committee on Investigation of Munitions Industry No. 944, Part 2, 74th Cong., 1st Sess., p. 19 (1935).

II.(c) The Influence of Depreciated Cost

There is a further and more fundamental reason why the determination of invested capital will be easier today than it was in the World War years. The capital (including paid-in surplus) and earned surplus¹ of a corporation, or its net worth,² consist, when all is said and done, of nothing else but the difference between (a) the cost of the corporate non-depreciable and non-depletable assets plus (b) the net cost of the corporate depletable and depreciable assets after depletion and depreciation and (c) the borrowed capital of the corporation, both funded and current. The conventional approach is from the liability side of the balance sheet. But there is another

1. Of course, adjustment of earned surplus has to be made for reserves which are mere subdivisions of the surplus account. Reserves for contingencies, reserves for self insurance and reserves for Federal income and profits taxes are properly to be considered parts of surplus. This is not generally true of any reserves the additions to which may be deducted in computing net income. Among such latter type of reserves are reserves for depreciation (which are presumed to offset the loss in value of assets) and reserves for state or local taxes where the corporation reports on the accrual basis and the amounts carried to such reserves have been deducted. (See generally on this subject Reg. 45, Art. 839).

2. The "net worth" of a corporation consists of the excess of assets over liabilities (to creditors, as distinguished from the proprietorship account). See Kohler and Morrison, Principles of Accounting (1931) p. 33; Kester, Accounting (1925) Vol. II, pp. 398, 412; Kester, Advanced Accounting, 3rd Ed. (1933) Ch. 21. In its broadest sense, "surplus" represents the excess of net worth over the capital stock of the corporation, with certain exceptions (as where the capital stock was originally issued at a discount). Hatfield, Accounting (1931) p. 296; Kester, Accounting (1925) Vol. II, p. 439. See also Kester, Advanced Accounting, 3rd Ed. (1933) Ch. 25.

approach - namely, from the asset side of the balance sheet. The capital and earned surplus may more easily be determined today than in the World War years, because we are dealing in the main with assets purchased or acquired during a period in which cost depreciation affected net income. For most corporations the Bureau and taxpayers must be in the possession of data fixing the cost of assets,¹ including assets purchased with stock. Valuation problems are therefore reduced, and we have available a current depreciated cost of assets on the asset side which fixes the surplus on the liability side. Where property was acquired before the advent of the income tax, the basis used should be the 1913 value (unlike the treatment under the old act which took original acquisition cost in the case of assets acquired prior to March 1, 1913) rather than attempting any retrospective appraisal as of the date contributed. No similar net cost basis may be currently available as to non-

1. In some cases the basis may be the March 1, 1913 value.

depreciable assets, such as non-mineral lands and stocks representing the assets of subsidiary or other corporations. But undepreciated cost is a safe enough basis for such lands, and gross cost will usually be available, particularly where there has been a reorganization.¹ Where such cost was not available, the figure at which non-mineral land is carried on corporate books is usually not unrepresentative of its current value; and in the interest of simplicity the book value of the land at the date of the introduction of the bill into Congress might be used for this purpose, although this would work occasional injustice where a company had rigorously scaled down its book value without obtaining any income tax benefit from the reduction.² If we disregard cost of assets acquired prior to March 1, 1913, an asset-side amount is therefore reasonably available as to a large proportion of corporate assets, which establishes a firmer surplus account than was available at the time of administration of the earlier acts and thus minimizes to a remarkable degree the difficulties of computing invested capital which made these earlier acts so unpopular.

1. See Reg. 101, Art. 112(g)-6.

2. Stocks, or inadmissible assets, will be dealt with separately below.

III. THE CALCULATION OF INVESTED CAPITAL

(a) In General

Reference has been made to the simplicity of determining the first element of invested capital, - cash paid in. Apart from intangibles the paid-in and earned surplus accounts are plainly referable to the assets of the corporation; if these assets are correctly valued, surplus is a balancing figure.¹ For purposes of computing the correct surplus such assets as cash, and notes and accounts receivable, could be taken at their face value;² inventories might be valued, as for income tax purposes and as for purposes of invested capital under the old excess profits tax,³ at cost, or cost or market, whichever is lower.⁴ All depletable and depreciable property, including the fixed property account, could be taken at the net original cost⁵

1. See authorities cited in note 2, page 24.
2. There should perhaps be some discount for accounts and notes receivable which were not worth face value, but this is a matter of detail.
3. Holmes, Federal Taxes, p. 1268 (1923 ed.)
4. Variations might be allowed where some other inventory basis is allowed to the taxpayer.
5. A special problem is presented by the percentage depletion deduction allowed to oil and gas producers and certain mining companies. (Sec. 114 (b)). It is a question to be decided whether the excess of percentage depletion over cost or March 1, 1913, value depletion should be allowed as part of invested capital. The same question arises as to discovery depletion.

for income tax purposes, or net value at March 1, 1913,¹ a figure already generally available to the Bureau of Internal Revenue and taxpayers. This would leave such non-depreciable and non-depletable assets as land (except mineral lands) to be taken at book value. Any assets, such as tax-exempt bonds, the income from which is exempt, should, of course, be inadmissible as part of invested capital.²

III(b) Intangibles

The question of including intangible assets, such as patents, good will, etc., also needs special consideration. Intangibles, as well as tangibles, may contribute materially in some industries to the profits of a corporation. Where intangible values are in large part the result of deductible advertising and promotional expense, then inclusion beyond the recognition they obtain through the profits formula is hardly justified by considerations of equity. A better case can be made out for the inclusion of intangibles purchased for cash or stock, the value of which the taxpayer has not built up by deductible expenses. Such intangibles should be to some extent included in invested

1. This alternative basis for property acquired prior to that date is not a significant complication. It helps corporations organized prior to that date, but simplifies administration enormously.

2. This was done under the 1913 Act.

capital, perhaps to a greater extent than is recognized in the standard earnings formula.¹ This may lead to some discrimination between a corporation which acquires such assets by outright purchase, securing a substantial allowance therefor, and a corporation which has built up similar good will gradually by enterprise and activity; and with a heavy tax such discrimination, may, of course, cause serious inequity. But it must be remembered that most intangibles (such as patents, copyrights or franchises) purchased for cash or stock have a depreciable basis for income tax purposes. To fail to allow the inclusion of such intangibles would make for a departure from income tax practice.

Intangible values are to some extent recognized through the use of standard profits in the cases of corporations which have had earnings attributable to intangibles in the years prior to the incidence of the tax. But there are many instances in which a corporation did not own, or had not sufficiently developed intangible assets to produce earnings in the representative period. There are also cases in which intangibles might have been dormant in the standard or re-

1. If standard earnings reflect earnings on intangibles, as they will in the case of many corporations, the result under the proposed tax approaches the inclusion of intangibles pro tanto in invested capital.

presentative period. It seems desirable, therefore, to give greater recognition to intangibles than is afforded by the use of the standard profits formula. On the other hand, the arbitrary par value formula for the recognition of intangibles contained in the 1918 Act seems highly undesirable. A compromise would be the allowance of the entire amount of intangibles acquired for cash and the partial inclusion of intangibles acquired for stock. The inclusion of intangibles acquired for stock might be limited to the actual value of any stock given in exchange or by a provision that the figure used as their cost basis should not exceed 20%, or some other proportion, of the total cost basis.

III (c) Capitalized Earnings of Taxable Year

As an incentive to equity financing, and the distribution of stock dividends, earnings capitalized during the current taxable year, at least up to the middle of the year,¹ might be included in invested capital by an express statutory provision, though this was not done under the earlier acts.² Such a provision would recognize, to the extent of capitaliza-

1. See page 3

2. Reg. 45, Art. 350.

tion, the indubitable fact that undivided profits of the early part of a taxable year contribute to the production of the profits of the later part of the year. The addition would contemplate the addition only of earnings of the current year, since the earnings of past years are already in invested capital. It must be admitted, however, that this mechanism involves difficulties of proof as to the amount of earnings, which difficulties might be excessive in comparison with what could be achieved. The inclusion of earnings capitalized during the first 6 months of the year should be limited to cases in which the capitalizing stock dividend was taxable to stockholders.

III. (d) Assets Not Employed in the Business

A further question arises as to whether there should be included in invested capital only assets which are actually employed in the business, which might in many cases be far from equal to the totality of assets. It may be plausibly argued that in a tax intended to fall upon the excess profits of business, only business assets should be considered. Also, a corporation with large accumulations of surplus would otherwise have an undue advantage, since it could invest that surplus in bonds yielding only a small but safe percentage of return and offset the high returns from its business operations with the relatively low return from investments. However, previous acts attempted no such differentiation and the attempt should be avoided due to the insurmountable practical difficulties which it would entail.

III (e) Borrowed Capital

Borrowed capital should be excluded from invested capital as under the earlier acts,¹ since the bondholders are not the equity owners or the distributees of the corporation. It is true that if borrowed capital is excluded, there is likely to be a considerable number of corporations with no invested capital or not more than a relatively nominal capital - for example, concerns with large intangible assets built up by deductible expenses, or those whose tangible property has appreciated hugely since the original investment. However, to permit the inclusion of borrowed capital would confer an unmerited advantage upon corporations deriving large profits from funds borrowed at a low rate of interest, which would be deductible in computing the taxable income.² Moreover, from the incentive standpoint

1. Section 209 of the 1917 Act provided that where the corporation had no invested capital or only a nominal capital, the net income in excess of a stated exemption should be taxed at 3%. Using this provision was jumping out of the frying pan into (not the fire) relative immunity. A rate of 3% would be much too low in many instances. The 1918 Act provided that where the amount of borrowed capital was abnormal, the taxpayer might apply for special assessment under Section 328.

2. This deduction would, however, be paralleled in the case of other corporations if a dividends paid credit is allowed in computing income subject to the excess profits tax. See page 50

it is desirable to encourage equity financing, and a corporation with a large funded debt should be tempted to retire the debt in favor of a stock issue. Therefore, borrowed capital should be excluded.

The exclusion of borrowed capital would be only of the actual amount borrowed, including both funded debt and current indebtedness; any assets purchased out of profits from borrowed capital would be included in invested capital. Any so-called "preferred stock" should be treated as borrowed capital if the holders rank either with or prior to general creditors as to either "dividend" payments or principal amount; this involves essentially the same considerations as the frequently-litigated question whether the annual payments on such securities are to be treated as dividends or deductible interest. The hard cases of corporations with an abnormally high borrowed capital would have to be handled under a special assessment section, or by a provision giving a corporation the option of including borrowed capital as part of its invested capital provided that its standard profits should then not be permitted to exceed a lesser percentage of invested capital (such as 5%).

III (f). Stock of Other Corporations and Tax-Exempt Bonds

Under the 1918 Act stock in other corporations owned by the taxpayer was inadmissible in computing invested capital on the theory that the dividends on such stock were deductible in computing the net income of the corporation. Today, however, since 15% of the dividends received from other corporations are taxable,¹ a corresponding portion of the capital investment in such shares should be recognized in determining invested capital.² Other inadmissibles, including bonds the interest upon which is not required to be included in computing net income,³ may be excluded as under the 1918 Act.

III (g). Possible Use of Appraised Value Alternative

The alternative use of standard profits or of a percentage of invested capital would greatly reduce the possible number of erratic instances in the operation of the statute. Isolated unfairness, however, might still result for the reason, among others, that the suggested proposal, like the old excess profits tax, would not take any

1. Internal Revenue Code, Sec. 25(b). See, however, following note.

2. Minor complications in connection with Supplement Q may be left for detailed consideration later.

3. See Revenue Act of 1918, Sec. 325; Reg. 45, Art. 815. Corporations engaged in buying and selling securities (dealers in securities) present a special problem here for further consideration.

consideration of appreciation of value,¹ except as appreciation in value is implicitly recognized by the allowance of an increase over 3% of invested capital if the standard or representative earnings permit. Therefore, a third possible alternative of measuring invested capital may be offered as a suggestion, consisting of the appraised value of the corporate assets at the beginning of the taxable year.

The alternative would, however, be impractical as a compulsory provision. Even if the data relevant to a current valuation were readily available, which is to be doubted, appraisal would necessitate fixing upon some general principles of valuation; and the use of this factor, to some extent justifiably and to a perhaps greater extent because of wide-spread taxpayer prejudice against valuation necessities, would be an unpopular provision if made compulsory. Moreover, the Government would have its problems; counter-proof in valuation cases is expensive and beyond the ordinary facilities of administration. Again, we would have the factor of delay in

1. *La Belle Iron Works v. United States*, 256 U.S. 377 (1921).

the collection of revenues. Taxpayers would claim high values and the inevitable process of horse-trading would have to be endured. It should also be noted that the use of appraised value is to some extent a duplication of the use of average earnings, for one of the principal methods of appraisal is to capitalize earnings.

For these reasons I would advise against the use of appraised value as an invested capital factor. If this alternative is used, its use should be optional to the taxpayer. This would certainly diminish criticism, since any taxpayer which then chose to use this method would be doing so in order to diminish tax liability. Moreover, if the alternative is adopted, appraised value should be operative only by way of refunds, and should not be permitted to be employed in computing original tax liability payable in the year of filing returns.

IV DETERMINATION OF STANDARD PROFITS

As set forth above, many of our largest business units were making substantial profits during the period from 1935 to 1938, inclusive, and to use average earnings as an exclusive test of tax liability would mean virtual exemption for many of our largest corporations. A similar situation was the very reason why Congress, in passing the 1917 Act, did not use the principle of pre-war profits as standard profits. A

ceiling limitation, based upon some percentage of invested capital, seems necessary to prevent a serious loss of revenue on account of the escape from the operation of the tax by the very corporations the tax should most fairly reach, and a cellar limitation is necessary to prevent an excessive burden being placed upon corporations making less than a fair return on their capital during the representative period.¹ As has been noted, it is proposed

1. Such a treatment would be very similar to the 1917 law in computing excess profits. That tax took the excess over a so-called normal amount consisting of a fixed sum (\$3,000 for domestic corporations or \$6,000 for partnerships, citizens or residents) together with an amount equal to the percentage of the invested capital represented by the average annual income during the pre-war period, provided that in no case should this percentage be less than 7% nor more than 9% of capital. The years 1911 to 1914 were used as the pre-war period. If the business was not in existence during those years, the deduction was fixed at 8% instead of 7% to 9%. If there was no income or a very low income during the pre-war period, the criterion was the percentage of capital earned by similar or representative business. (Sec. 209).

An alternative possible limitation would be that the normal rate of return might not exceed the amount necessary to pay 6% dividends on the paid-up capital stock of the corporation (or in the case of no-par stock to pay the rate of dividends paid in some representative year). Cf. Part III, Sec. 13 (7) of the English Excess Profits Tax. This alternative would be simpler, but less satisfactory, since it would unduly favor over-capitalized corporations.

that standard profits, which are exempted from the operation of the proposed excess profits tax by the mechanism of an excess profits tax credit, be computed on an alternate basis. They may consist of (a) 8% of the invested capital, or (b) the standard profits of the representative period up to 8% of the invested capital plus 50% thereof, or in other words, 12%. Stating this thought in positive form, there would be an excess profits tax credit consisting of the standard average profits, but this credit would not be less than 8%, or more than 12% of the invested capital for the taxable year. Thus, a corporation is always entitled to an exemption of profits up to 8% of its invested capital, and may be entitled to an exemption of a greater amount if the standard profits of the representative period exceed 8% of the invested capital. But the exemption is limited to 12% of invested capital.

The determination of standard profits involves the further problems indicated in succeeding paragraphs.

IV (a) The Choice of a Representative Period

The cardinal problem in the use of average earnings over a representative period as the basic measure of standard profits is to choose some fairly representative period. For this purpose the years 1935, 1936, 1937 and 1938 are perhaps the best available, since the use of earlier years would lead back to the pit of the depression. At least one of the above years would be a high income year for many industries, and more than one would be a high income year for some industries.

Criticism of this period as unrepresentative may be anticipated, particularly from corporations which found the period one of less earnings. This criticism is answered by the fact that a corporation is in all cases entitled to a minimum earnings exemption of 3% of its invested capital. There is the further possible expedient in this connection of allowing the taxpayer the use of some other fairly representative consecutive period upon a showing that the years 1935 to 1938, inclusive, were in its particular case not a fair period. This expedient has been used in connection with the Agricultural Adjustment Program and the Sugar Act.¹

Taxpayers which commenced operation too recently to have had existence during the full standard period could be given the option of taking the average of the last two years, or merely of the single year, prior to the enactment of the tax. Here the minimum return based upon the percentage of invested capital would afford an adequate protection against unfairness in most cases. The same protection would apply where the net result of operations during the whole standard period was a loss. Here, however, any part of the current profits applied to the extinction of losses suffered during the standard period might well be an allowable deduction for purposes of computing the excess profits tax.

1. The taxpayer might be given the option of using 3 out of 4 years in certain exceptional cases where one particular year was not representative.

IV (b) Adjustment of Standard Profits to
Invested Capital of Taxable Year

It would, of course, be an over-simplification to average the profits of the representative period and to ignore the average invested capital employed in producing such earnings. Such a procedure would be unfair to concerns which had increased their invested capital in the period, and would unduly favor concerns which had decreased their invested capital. It is, therefore, suggested that the average invested capital be taken into the equation by increasing or decreasing standard profits for the representative period in the proportion which the invested capital at the beginning of the taxable year bears to the average invested capital during the standard or representative period. Thus, if the invested capital at the beginning of the taxable year was double the average invested capital in the standard or representative period, the normal or standard profits of the taxable year to be free from the tax for the period would be double the standard profits of the representative period, but the standard profits to be used as an excess profits credit could not exceed 12% of the invested capital for the taxable year.

The formula involves the reasonable assumption that capital added during the standard or representative period would have earned ordinary profits at the same ratio as did the original capital. However, as to additional

capital investments after the enactment of the tax, a somewhat higher percentage might be used, due to the reasonable assumption that fair profits during a war period would be somewhat higher than fair profits during the standard or representative period.

IV (c) New Corporations Organized after the Representative or Standard Period

New corporations organized after the representative or standard period present a peculiar problem. In their case no standard profits are available to be taken into the equation, and it seems necessary to rely wholly upon the 3% invested capital formula. The only alternative is perhaps to increase this formula in such cases by an arbitrary percentage, say 25% (which is halfway between the straight invested capital formula and the highest standard profits available to other companies) making the percentage 10%. This arbitrary increase is justified by the consideration that most of these new corporations would be in a relatively unsafe economic position and should be favored from a tax standpoint as compared with older established corporations.

IV (d) The Effect of Fiscal Periods Differing from the Calendar Year

Another complication arises from the fact that many corporations keep their books on a basis of fiscal periods differing from the calendar year. In such cases the calendar

years of the standard period will not actually have been used as an accounting year by the taxpayer. There is some anomaly in treating corporations otherwise similar differently simply because of accidental differences in fiscal periods. Theoretically all profits should be subject to the same tax irrespective of past accounting period. It would be possible to accomplish this by providing for an apportionment of profits or losses to translate the profits of a fiscal year into the years used, either in computing the standard profits or in computing the excess profits tax. Such an apportionment, if used, would normally be on a time basis.¹ It might, however, involve complications and additional expense to taxpayers, and I am inclined to prefer the more practical expedient of resorting instead to those established fiscal years which most closely coincide with the calendar years specified in the statute.

1. Cf. Part III, Sec. 14 (1) of the British Act and Sec. 335 of the Revenue Act of 1918.

V. DETERMINATION OF PROFITS SUBJECT TO TAX

In determining what profits should be subject to the excess profits tax, net income for income tax purposes would be the natural and efficient starting point.¹ For example, investment income, as pointed out above, should be included.² The statute should perhaps expressly incorporate by reference methods of determining net income stated in the income tax regulations to cover instances in which methods are not expressly provided for in the income tax

1. There probably should be no special provision as in the 1918 Act with respect to Government contracts; the income from such contracts should be kept at the level of other profits. Of course, many such contracts are treated specially by the Vinson Act. An excess profits tax would in fact be illusory here, since the excess profits tax would itself be taken into account in arriving at the contract price. In other words, the manufacturer would strive to obtain a price which would leave him after paying the tax in about the same profit position as he would have achieved had the tax not been in existence. The Government would itself be creating with one hand the excess profits which it would be taxing with the other.

2. But compare British Excess Profits Tax, Seventh Schedule, Sec. 6; see also Canadian Excess Profits Tax, Sec. 4(1)(e), exempting from the Canadian tax any dividends received from domestic Canadian corporations.

statute itself. For example, the income tax regulations¹ have a special provision - not appearing in the statute itself - as to apportioning income from long-term contracts, permitting the income from such contracts (a) to be taxed when received or (b) apportioned over the life of the contract. Consolidated returns would be very desirable in the case of subsidiary or affiliated companies, since the duplication of tax upon the same earnings which otherwise ensues is especially burdensome when the rates of tax reach the brackets suggested in this proposal.² However, the use of consolidated returns for this purpose would not be desirable unless the income tax statute were also amended to permit the general use of such returns.³

Some variations from net income for income tax purposes would, however, be necessary to conform to the peculiar characteristics of an excess profits tax. Most of these modifications would take the form of additional deductions.

1. Reg. 101, Art. 42-4.

2. Decentralization of the Bureau of Internal Revenue emphasizes the necessity of consolidated returns.

3. They are now used only by railroad corporations; Internal Revenue Code, Sec. 141.

V. (a) Deduction of Income Tax

Clearly the ordinary income tax of the corporation should be a proper deduction. This was not done under the 1918 Act; that act conversely allowed the excess profits tax as a credit in arriving at the amount subject to income tax.¹

V. (b) Additional Losses

The act should also be liberal as to the deduction of losses. Deduction for amounts used to restore previous losses during the standard period might be desirable. The importance of such a relief provision is obvious; it would help in hard cases and silence complaints. Also, losses occurring in a year after the enactment of the excess profits tax should be carried forward as under Section 211 of the Revenue Act of 1936. The 1918 law, in Section 204, had a special relief provision somewhat along this line to take care of losses² ensuing from a termination of the war. That act provided that net losses for 1918 could be charged back to 1918 and forward to 1919, if the taxable year chanced to begin between certain dates. Such a relief provision should be repeated and extended in any present law.

1. 1918 Act, Sec. 238 (b). This method would be an acceptable substitute.

2. Sec. 204 (b).

V.(c) Inventories

Inventories present a special problem in connection with an excess profits tax, since one should be prepared for a large fall in values following the war. The increased value of inventories at the present time may thus eventually prove illusory. The Revenue Act of 1918¹ permitted rebates in case of inventory shrinkages under certain narrowly-defined restrictions, but did not go far toward a complete solution of this problem.

If inventory losses are allowed to offset the gains of a prior year, grounds for complaint are greatly reduced. Under the 1918 treatment the loss could not be claimed in the subsequent return itself, but had to be obtained by way of a refund claim, and the taxpayer's money was therefore withheld from the time of collection of the tax until the ultimate refund. But this is a relatively unimportant procedural item, and is probably necessary to preserve the orderly audit of returns. The allowance of an offset against the inventory gains of a prior year should be combined with a carry-over of the loss to subsequent years as under Section 211 of the

1. Sec. 214 (a)(12) and Sec. 224 (a)(14); Reg. 45, Art. 261-8.

1939 Act. As an alternative, corporations might be permitted to set up a reserve allowance of some percentage to guard against a possible fall in values.

The last-in - first-out inventory principle, allowed for a few industries by the 1939 Act and extended by the 1939 Act, might be enough to cover the case of goods actually taken out of inventory during the taxable year. In an inflationary period this provision generally has the effect of adding to the actual cost of goods sold during the year the higher-price goods purchased later, and thus would be a shock-absorber of a useful character, because it would relate high costs to high gross income with a tapering off of costs as the income tapers off in the deflation period. Such a provision, however, should be coupled with the net-loss provision mentioned above. It might not be enough alone, since its operation would be somewhat haphazard, depending on when goods were purchased and when prices happened to change. Standing alone, it might also have the undesirable effect of encouraging taxpayers to engage in a scramble of end-of-the year sales, thus intensifying any possible deflationary movement.

V.(d) Amortization

The 1918 Act contained an amortization provision, supplementary to the general provision for the deduction of the depreciation and obsolescence, which provided that:

- (a) in the case of buildings, machinery, and equipment or other facilities constructed, erected, installed, or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the War with Germany, and
- (b) in the case of vessels constructed or acquired on or after April 6, 1917, for the transportation of articles or men contributing to the prosecution of the War, ¹ there should be allowed a reasonable deduction for the amortization for such part of the cost of such facilities as had been borne by the taxpayer.²

This provision, founded in the idea that equity required a recognition of the substantial risk involved in war

1. This feature of amortization is obviously inapplicable to the present situation.

2. 1918 Act, Sec. 214(a)9, 224(a) 8. See Holmes, Federal Taxes, 1923 Edition, p. 352, for a discussion of this provision.

time construction, proved very difficult of administration.¹ Perhaps a substitute for the word "amortization" should be found. The amortization allowed under the 1918 Act was nothing more than extraordinary depreciation or obsolescence, and the essential problem is to relate that depreciation or obsolescence, chiefly the latter, to a short period of earning capacity. What really happens is that certain facilities lose their earning power as soon as the war has ended; all that an amortization provision means is that certain war facilities may be depreciated over the period of their extraordinarily short useful life with proper allowance for subsequent non-war usefulness, which is really salvage value.

It should be noted that amortization may be thought of in terms of a deduction for both income tax purposes and war tax purposes, or it may be regarded as a special deduction for war tax purposes. The old amortization provision was for both purposes.

If it is practicable, some more flexible amortization provision than was contained in the 1918 Act should be devised; its virtue would be that it would be adaptable to incentive taxation and an encouragement of capital investment in industries where expansion is thought desirable.

1. Report of Special Committee on Investigation of the Munitions Industry, No. 944, Part 2, 74th Cong., 1st Sess., p. 30 (1935).

V.(e) Dividends Paid Credit

One of the principal functions¹ of the tax under consideration is to tax excess profits in corporations because of our knowledge that such corporate profits will not be sufficiently distributed to permit them to be subjected, as they should be, to the individual surtaxes.² The suggestion may, therefore, be made of the advisability of permitting a limited dividend-paid credit of the kind now allowed for purposes of the domestic personal holding company provisions³ and for purposes of Section 102. Such a credit would tend to encourage the distribution of corporate earnings to stockholders, some of whom would be taxable at reasonably high brackets, and the remainder of whom would enjoy increased spending power. The extent to which this credit would be availed of would, of course, depend upon the rates adopted in the excess profits tax.

1. True, the tax would also have some non-revenue, regulatory, effects in connection with price control. See Report No. 344, Special Committee on Investigation of The Munitions Industry, pp. 8, 55, 74th Cong., 1st Sess. (1935).

2. The personal holding company provisions do not reach the majority of corporations, and Section 102, applicable to improper surplus accumulations by corporations generally, has been a conspicuous failure.

3. Internal Revenue Code, Sec. 405. Such a credit was also allowed for purposes of the discarded undistributed profits tax. Id., Sec. 27.

The credit might, perhaps, depending upon the amortization provision adopted, discourage new construction, but any such effect might be obviated by allowing a credit in respect to taxable stock dividends. The credit might also be allowed only as against the 50% surtax on income in excess of 10% of the invested capital. So limiting the credit would obviate the objection that the tax in effect required a corporation to distribute funds needed in the business. For no corporation which can earn and retain more than 10% of its invested capital in any one year can complain if a tax induces it to distribute the balance.

If any such provision is made a part of the law, it should allow a reasonable period (say 2½ months) after the close of the year for the declaration of dividends, and perhaps also a deficiency dividends paid credit. This would obviate such criticism of the type leveled with justice and effect against the undistributed profits tax. It would, of course, mean some revenue lag, since stockholders would report dividends paid after the close of the corporate fiscal year in a later taxable year. Permission might also be granted to obtain the credit through the mechanism of a consent dividends credit without actual distribution.

VI. ADMINISTRATIVE PROBLEMS

VI. (a) Assessment and Collection

The provisions as to assessment, collection, and refund should be the same as those existing in the ordinary income tax field, probably including the privilege of appealing to the Board of Tax Appeals or the courts even from the special assessments suggested below.

VI. (b) Possible Avoidance

Methods of attempting to avoid an excess profits tax would undoubtedly be as limitless as the infinite ingenuity of taxpayers and their advisors; they would vary all the way from the petty device of putting relatives of the officers on the payroll of small corporations at exorbitant salaries, or the postponement of profitable activities in the hope that the tax might disappear, to spending excess profits (otherwise subject to the tax) for excessive advertising and every other imaginable purpose which could conceivably be justified as a business expense. However, it is unlikely that any great amount of wasteful expenditures would result, or that avoidance would be effective enough to hamper administration very seriously.

1. One additional suggestion with respect to the administration of the tax would be a lengthening of the statute of limitations upon assessment and collection and possibly also upon refunds.

2. See Paul, The Background of the Revenue Act of 1937, 5 Univ. of Chicago L.R. 41, 44 (1937).

Salaries present no very grave problems where the tax is not made applicable to individuals or partnerships. Exorbitant salaries could be treated under the limitation as to reasonableness laid down in the income tax provisions without any further statutory provisions. Many of the devices common under the older acts were designed to postpone profits until the abolition of the tax;¹ if the statute were passed as a permanent part of the tax system, the efficacy of such methods would largely disappear. Moreover, avoidance and evasion are less likely to be rampant if the rates of tax are kept fairly moderate.

VI.(c) Special Assessment in Cases of Peculiar Hardship (Secs. 327 - 328 of the 1918 Act)

The Revenue Acts of 1918 and 1921 contained the famous Sections 327 and 328 which the framers of the 1918 Act wisely inserted in the statute to cover peculiar cases which would not fit into the general pattern of the act without undue hardship. These sections gave to the Commissioner of Internal Revenue a wide discretion to adjust profits tax on a special

1. See, e.g., Report of Special Committee on Investigation of Munitions Industry No. 944, Part 2, 74th Cong., 1st Sess., p. 24 (1935).

basis in cases in which invested capital could not be satisfactorily determined and in cases in which abnormal conditions affected the capital or income of the corporation. In such cases the Commissioner had the task of fixing the tax of the corporation affected by such conditions by reference to the taxes paid by representative corporations engaged in a like or similar business.¹

The administration of these provisions put a great burden upon the Commissioner. Many taxpayers in the course of the war paid tax without protest in accordance with the conventional standards of invested capital set up in the act. These same taxpayers later, with some abatement of patriotic fervor, made application for revision and reduction of the taxes they originally computed on the ground of alleged abnormal conditions affecting capital or income. If the Commissioner decided that such conditions existed, he was faced with the problem of assessing a fair tax. He was handicapped in this task by the fact that in the first few years after the war the taxes of "representative" corporations computed in the ordinary way had not yet been finally determined. Moreover, from time to time rumored scandals were rife in connection

1. For a consideration of these sections by the Supreme Court, see *Williamsport Wire Rope Co. v. United States*, 277 U.S. 551 (1928); *Blair v. Osterlein Machine Company*, 275 U.S. 220 (1927).

with the special assessment section which handled these cases, and there is no doubt that many corporations not entitled thereto received the benefit of the provisions.

However, there seems to be no escape from the necessity of some such relief provision, perhaps somewhat more circumscribed than that contained in the 1918 and 1941 Acts. The wisdom of too much inflexibility is dubious, and in the end the legislative branch will probably have to trust the administrative authorities once more.¹ It is literally impossible to frame a broad comprehensive statute such as the one under consideration without working undue hardship in many meritorious cases. No reasonable

1. It would theoretically be very desirable to exclude the possibility of a judicial review regarding such assessments. But our greater reluctance to permit administrative finality, as compared with the English practice, would make such an attempt very unpopular. Moreover, it is at least conceivable that some of our Supreme Court cases might be interpreted to impose a constitutional requirement of judicial review regarding income tax valuation questions. See *Ohio Valley Water Co. v. Ben Avon*, 253 U.S. 287; *Crowell v. Benson*, 285 U.S. 22; cf. *Anniston Manufacturing Co. v. Davis*, 301 U.S. 337 (1937).

person expects a statute of universal application to be perfect,¹ and occasional hardship must be disregarded.² But the door should be left open to prevent irreparable damage in extreme situations. Difficulties arise from the fact that in so many businesses the profits may fluctuate very widely from year to year. Also, the profits of 1940 may be merely the fruit of expensive activities long antedating that year. Therefore, as under the 1918 Act, some safety-valve must be provided for cases in which taxable income is seriously disproportionate to capital as well as cases in which invested capital is for some reason difficult to determine.

Handwritten signature: Randolph S. Paul

November 16, 1932.

¹ See, e.g., *Purity Extract & Tonic Co. v. Lynch*, 226 U.S. 201, 204 (1912); *Tyler v. United States*, 291 U.S. 497, 508 (1933); *Milliken v. United States*, 283 U.S. 15, 20 (1931).

² *Cardozo, The Paradoxes of Legal Science*, p. 62 (1927).

Exhibit A

Computation Based Upon
5% Normal Return

<u>Brackets</u>	<u>Amount of</u> <u>Net Income</u> <u>Each Bracket</u>	<u>Statutory</u> <u>Normal</u> <u>Return</u>	<u>Balance</u> <u>Subject</u> <u>to Tax</u>	<u>Rate</u> <u>of</u> <u>Tax</u>	<u>Amount</u> <u>of</u> <u>Tax</u>
Not over 15% of invested capital	1,500,000	800,000	700,000	10%	70,000.
Over 15% but not over 18% of invested capital	300,000		300,000	25%	75,000
Over 18% of invested capital	660,000		660,000	50%	<u>330,000</u>
Total Excess Profits Tax					<u>\$475,000</u>

MEMORANDUM OF TRANSMITTAL
OF A AND A-1

TO: Honorable Henry Morgenthau
Secretary of the Treasury

FROM: The White House .

I transmit to you herewith a copy of a memorandum marked A prepared by Mr. Randolph E. Paul, whom I have consulted with respect to possibilities of securing additional revenue by the elimination of various discriminations contained in the statutes covering the taxation of income, estates and gifts as now enacted. I would like to have from you an estimate of the revenues which would reasonably be derived from Mr. Paul's suggestions. For your convenience I enclose a memorandum of specific questions keyed to Mr. Paul's memorandum, marked A-1.

I realize that some of these questions will be difficult to answer in categorical terms. Where the question deals with suggestions of a tentative nature, I will be obliged if you will make your answers as definite as may be possible under the circumstances.

MEMORANDUM A

MEMORANDUM OF POSSIBLE CHANGES IN THE TAX LAW WHICH WOULD INCREASE REVENUE BY THE ELIMINATION OF DISCRIMINATIONS

INCOME TAX

1. Personal Exemptions
2. Stock Dividends
3. Trust Income
4. Unreasonable Accumulations of Surplus
5. Charitable Gifts in form of Property
6. Non-Business Casualty Losses
7. Interest on Non-Business Loans
8. Deduction of Interest Paid or Accrued
9. Non-Business Bad Debts
10. Non-Business Taxes
11. Basis Where Optional Valuation Privilege Is Chosen
12. Taxation of Husband and Wife
13. Taxation of Interest from State Obligations
14. Taxation of Capital Gains
15. Corporate Distributions of March 1, 1913 Profits
16. Life Insurance Proceeds Paid in Installments
17. Double Loss Deductions
18. Property Transmitted at Death
19. Domestic Building and Loan Associations
20. Mutual Casualty and Fire Insurance Companies
21. Employers' Contributions to Pension Trusts
22. Discovery Value and Percentage Depletion
23. Development Expense
24. Taxation of Non-Resident Alien Individuals and Foreign Corporations

ESTATE TAX

25. Estate Tax Exemptions
26. Taxation of Life Insurance
27. Property Passing under Powers of Appointment
28. Reverter Interests
29. Gifts in Contemplation of Death
30. Elimination of Estate Tax Against Insurance Proceeds by Reason of Uncollectible Claims

GIFT TAX

31. Gift Tax Exemptions

MEMORANDUM OF POSSIBLE CHANGES IN THE TAX
LAW WHICH WOULD INCREASE REVENUE BY THE
ELIMINATION OF DISCRIMINATIONS

INCOME TAX

1. Existing Law as to Personal Exemptions (Sec. 25 (b)) The Internal Revenue Code now allows personal exemption of \$1,000 to a single person and to a married person not living with husband or wife, and a personal exemption of \$2500 to the head of a family or a married person living with husband or wife. A credit is also allowed for dependents amounting to \$400 for each person dependent upon the taxpayer.

Discussion This provision involves serious discrimination in favor of high bracket taxpayers. To a married person with a net income of less than \$4,000 it means a tax saving of 4% (the normal tax rate) of \$2500, or \$100. To a married person with a net income in excess of \$100,000 and not in excess of \$150,000 the provision means a tax saving of 62% of \$2500, or \$1550, which is more than 15 times the saving to the first low bracket person mentioned. To a married person with a net income in excess of \$5,000,000 the same exemption means a tax saving of 79% of \$2500 or \$1975, which is almost 80% of the personal exemption.

Recommendation Section 25 (b) should be amended so that the credit now allowed therein for both normal tax and

surtax purposes is made a credit against tax under which equal benefit is given by the exemption to taxpayers in the low brackets and taxpayers in the high brackets. An alternative remedy might be to limit the credit presently in the statute by making it a credit for normal tax purposes only.

2. Existing Law as to Stock Dividends (Sec. 115 (f))

The statute since 1936 has contained an illuminating provision that a "distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution." This provision was drawn in the light of such cases as Eisner v. Macomber,¹ Koshland v. Helvering,² and Helvering v. Gowran.³ In practice it means that stock dividends of the type involved in Eisner v. Macomber (common upon common with no other class of stock outstanding) are still exempted from tax. Most other dividends, such as (1) preferred upon common and (2) common upon preferred, are regarded as taxable.

Discussion As was prophesied by Mr. Justice Brandeis in his dissenting opinion in Eisner v. Macomber, the existing

1. 252 U.S. 189 (1920).

2. 298 U.S. 441 (1936).

3. 302 U.S. 238 (1937).

statutory provision, as administratively interpreted, constitutes a serious revenue leak. There are approximately 350 issuers of stock listed on the New York Stock Exchange, the total issues of these issuers being approximately 1230. Excluding common stock issues of railroad companies, there are approximately 390 issues of common stock on the New York Stock Exchange of 390 companies in which the capital is represented by common stock, or which have a small senior equity security ranking prior to the common stock. The capitalization of these companies, including 33 preferred stock issues, no one of which is of a \$1,000,000 nominal value, consolidate into approximately 625,000,000 common shares having a nominal value in excess of \$16,000,000,000. These figures constitute a prima facie showing of the companies merely on the New York Stock Exchange which are now in a position to issue tax-free stock dividends. Further investigation would no doubt show that many, if not the majority, of these corporations have an earned surplus upon the basis of which stock dividends may be distributed.

Recommendation It is highly desirable to subject all stock dividends to tax by an amendment either to the statute or to existing regulations. Such an amendment either of the statute or of the regulations would avoid difficulties as to retroactive application which would arise from a judicial

decision decreeing all stock dividends to be taxable under the existing regulations. If there be any doubt as to the possibility of securing a statutory amendment, some attempt should be made through the courts to secure a reversal of Eisner v. Macomber. In spite of the Supreme Court's decision of November 6, 1939, in the Wilshire Oil case, the issue¹ of a regulation prospectively incorporating a new rule may be advisable.

3. Existing Law as to Trust Income (Secs. 166, 167)

A number of years ago Sections 166 and 167 were placed in our revenue act for the purpose of taxing the grantors of tax-avoidance trusts which did not accomplish any transfer away from the grantor of unfettered control over the corpus or income of the trust. These sections, according to Mr. Justice Roberts, were designed to prevent "facile evasion of the law."² The constitutionality of Section 167 was upheld in Burnet v. Wells.³

Discussion The purpose of these sections has been very largely frustrated by court and Board decisions. The sections, as interpreted by the courts,⁴ permit the accomplish-

1. Helvering v. Reynolds Tobacco Co., 306 U.S. 110 (1939).

2. Reinecke v. Smith, 289 U.S. 172, 178 (1933).

3. 289 U.S. 670 (1933). See Corliss v. Bowers, 281 U.S. 376 (1930).

4. See e.g., Clifford v. Helvering, 105 F (2d) 586 (CCA 8th, 1939); Corning v. Comm., 104 F (2d) 329 (CCA 6th, 1939); John E. Rovensky, 37 BTA 702.

ment of the tax-avoidance purpose of the grantor in the case of the income of short-term trusts.¹ Thus, even though the grantor-trustee has reserved broad powers of sale and investment, the grantor has been held not taxable upon the income of a trust for the benefit of his wife where the trust was to terminate at the end of five years, or upon the death of the beneficiary or the grantor during that period, and the remainder (in excess of the undistributed income or the proceeds of the investment thereof) was to go to the grantor.² If it is certain that the power to revest will come into being at a fixed point of time, Section 166 will be applicable, but if the same substantial result is accomplished by providing that the trust automatically ceases to exist at the end of a fixed period, without any affirmative act on the part of the grantor in exercise of a power,³ then the grantor is not taxable under Section 166. This

1. Of course, the trust problem is much broader than here indicated. The splitting of income by irrevocable multiple trusts accomplishes tax avoidance on a large scale. But the only remedy in this case of irrevocable trusts seems to be a system of taxation on a family unit basis. Cf. *Hooper v. Wisconsin*, 284 U.S. 206 (1931), which probably would be overruled by the Supreme Court as now constituted.

2. *Clifford v. Helvering*, supra.

3. See *Meredith Wood*, 37 BTA 1065, aff'd per curiam 104 F (2d) 1013 (CCA 2nd, 1939); *Christopher L. Ward*, 40 BTA 225.

means that the grantor in high brackets on account of other income is able to transfer high-bracket income to a trust which starts in the low brackets.

Recommendation Sections 166 and 167 should be entirely revamped to prevent this type of tax avoidance. The amendment necessary may be briefly described as an elimination of the emphasis now placed in the statute upon the word "vested", combined with an addition covering short-term trusts which are¹ to revert automatically.

4. Existing Law as to Unreasonable Accumulations of Surplus (Sec. 102) Section 102 of the Internal Revenue Code provides a special penalty tax upon corporations formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders (or the shareholders of any other corporation) through the medium of permitting the accumulation of earnings or profits. Although the constitutionality of this statutory provision was recently sustained by the Supreme Court in Helvering v. National Grocery Company,² the section has been a conspicuous failure.³ Up to a few weeks ago the reports show only about 33 cases directly involving Section 102, most of which were decided after 1930. The score in these cases is nominally 18 to 15 in favor of the government, but the score is really against the government when it is

1. Clifford v. Helvering, 105 F (2d) 586 (CCA 8th, 1939); Meredith Wood, 37 BTA 1065, aff'd per curiam 104 F (2d) 1013 (CCA 2nd, 1939).

2. 304 U.S. 282 (1938).

3. See Statement of Mr. Vinson, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess., p. 173 (1937).

remembered that in 13 of the government victories against 9 of its defeats, the taxpayer was one which would now be classed as a personal service corporation.

Discussion What may be now done with impunity under the existing statute is illustrated by the famous Cecil De Mille case.¹ Mr. Cecil De Mille successfully advanced as a reason for the large surplus accumulation in his corporation the argument that his corporation was building up its surplus to a point where it could some day achieve independent picture production.² Mr. Bud Fisher successfully maintained that his corporation was building up a surplus so as to have capital sufficient to effect the distribution of independent comic strips in the contingent event that a syndicate through which distribution was effected should refuse to renew outstanding contracts. This sort of argument is like the argument made by the White Knight who carried a bee hive around with him because some day he might want to keep bees.

Recommendation Section 102 should be strengthened by adding to the section a clause similar to subdivision (b) now therein providing that certain facts "shall be prima facie evidence of a purpose to avoid surtax upon shareholders." Among such facts constituting prima facie evidence may be suggested the following:

1. 31 BTA 1161, aff'd 90 F (2d) 12 (CCA 9th, 1937), cert. den. 302 U.S. 713 (1937).

2. Fisher & Fisher, Inc., 32 BTA 211, aff'd per curiam 84 F (2d) 996 (CCA 2nd, 1936).

- (a) The fact that less than a stated percentage of income is distributed;
- (b) The fact that ~~more than a given percentage of in-~~come consists of dividends;
- (c) The fact that the corporation is to a stated degree¹ closely held;
- (d) The fact of any major change in distributive policy resulting in a lower percentage of distribution;
- (e) The existence of substantial loans to stockholders;
- (f) The existence of substantial non-interest bearing loans by stockholders; and
- (g) The fact that the non-distribution of profits actually had the effect of a substantial tax saving.

Another amendment which would strengthen Section 102 at one of its weakest points would be the insertion before the word "business" in subdivision (c) of the word "existing", making the "fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the (existing) business" determinative of the purpose to avoid sur-

1. The addition of this factor as creating a rebuttable presumption would be quite different from the so-called "third basket" provision as proposed in the House of Representatives in 1938. (See House Bill, Revenue Act of 1938, Secs. 451 et seq.; Ways and Means Committee Report No. 1360, 75th Cong., 1st Sess., p. 53 (1938)). That proposal imposed a new tax which was totally separate from that imposed by Section 102, and which was inescapable if the stockholding requirements were met. The present suggestion would simply transfer some of the determining factors from the proposed Section 451 into Section 102 itself as an additional ground for raising a rebuttable presumption of intent to avoid tax.

tax upon shareholders unless there is a clear preponderance of evidence to the contrary. This would mean that the term "reasonable needs" of the business would be related to the business in which the corporation is currently engaged and would place a greater burden upon the corporation to justify accumulations allegedly designed to permit the corporation to enter some new business activity. This sort of amendment would prevent tax avoidance of the De Mille type.

It may be that the statute of limitations should be lengthened for Section 102 cases, as has been done with respect to foreign personal holding company cases,¹ corporate distributions in liquidation,² and where there is a 25% omission from gross income.³

An alternative remedy might be to adopt in some part the English counterpart of Section 102.⁴ This English statute applies only to closely held corporations, and in effect ignores the separate entity of such corporations. It taxes retained income to the stockholders, a remedy which may be too drastic.

-
1. ✓ Internal Revenue Code, Sec. 275 (d).
 2. ✓ Internal Revenue Code, Sec. 275 (e).
 3. ✓ Internal Revenue Code, Sec. 275 (c).
 4. Finance Act of 1922, Sec. 21, First Schedule as Amended by Act of 1927.

Perhaps also the rates of tax imposed by this section should be increased. In relation to our present surtax brackets the existing rates - 25% upon the undistributed Section 102 net income not in excess of \$100,000, and 35% upon such income in excess of \$100,000 - render it advisable for some corporations to pay the tax rather than distribute.

5. Existing Law as to Charitable Gifts in Form of Property (Sec. 23 (c)) The Internal Revenue Code now provides for a deduction on account of religious, charitable scientific, literary, educational and other contributions.

Discussion This provision works satisfactorily with respect to cash distributions, but it is wholly indefensible as to contributions in the form of property. As the law now stands, a taxpayer secures a deduction to the extent of the value of the property transferred at the date of the gift.¹ For example, a taxpayer has purchased securities in 1932 for \$1,000 cash, and their value in 1939 is \$5,000. This taxpayer would have a taxable profit of \$4,000 if he sold the securities and made a gift of \$5,000 cash; however, if the taxpayer is well advised, he will donate the securities themselves without any sale thereof; the donee institution may then make the sale as it pleases without any tax liability.²

1. Reg. 101, Art. 23 (c)-1.

2. Paul, Selected Studies in Federal Taxation, Second Series, p. 173, note 75 (1938).

Recommendation Gifts not in money form to religious, charitable, scientific, literary and educational institutions should be allowed as a deduction only in the amount of the adjusted cost basis of the property to the donor or its value at the date of gift, whichever is lower. A middle alternative would be to allow no more than would be allowed if the donor sold the property and contributed the cash proceeds less the capital gains tax.

6. Existing Law as to Non-Business Casualty Losses (Sec. 23 (e)(3)) The Internal Revenue Code now provides for the deduction of losses on property not connected with the trade or business if the loss arises from fire, storm, shipwreck, or other casualty, or from theft.

Discussion This provision results in substantial deductions and difficulty of administration, particularly in connection with losses of the type sustained on account of the recent hurricane which devastated the eastern seaboard. It is particularly availed of by taxpayers who have large estates; smaller taxpayers cannot afford the appraisal fees involved in proving losses.¹

Recommendation The provision allowing non-business casualty losses should be eliminated or restricted, like the charitable deduction, to a fixed percentage of the taxpayer's net income as computed without the benefit of this particular

1. *Obici v. Helvering*, 305 U.S. 468 (1939).

deduction. Another appropriate limitation might be to treat such losses as capital losses, thus limiting the tax effect thereof.

7. Existing Law as to Interest on Non-Business Loans (Sec. 23 (b)) The Internal Revenue Code now allows the deduction of interest on non-business borrowings (see item 8 below).

Discussion While it may be that a deduction should be allowed on business borrowings, although we have here the discrimination mentioned in item 8 below, the principal justification for allowing a deduction of interest on personal borrowings is a desire to promote small home ownership and building. The deduction in its broader aspects is more or less arbitrary, and often results in debatable questions as to whether loans were contracted for any real purpose or a mere tax-avoidance purpose.¹

Recommendation Section 23 (b) should be amended by limiting the allowance for the deduction of interest on non-business borrowings to a fixed maximum amount of, say, \$500, a sufficient amount to cover interest on mortgages upon a personal home of limited value, and on small personal borrowings to pay doctor and hospital bills or to hold title to small investments.

1. Paul and Mertens, Law of Federal Income Taxation, Sec. 24.06 (1934).

8. Existing Law as to Deduction of Interest Paid or Accrued (Sec. 23 (b)) Section 23 (b) of the Internal Revenue Code now allows a deduction for all interest paid or accrued within the taxable year on indebtedness (except indebtedness incurred or continued to purchase certain tax-exempt securities). On the other hand, no deduction is allowed for purposes of the ordinary corporate income tax for dividends paid. From the stockholders' standpoint dividends and interest are treated alike; the provision formerly in the law allowing a credit for normal tax on account of dividends received has been eliminated.

Discussion The above provision is designed to encourage corporate financing by borrowing, rather than by capital contributions.¹ In the last few years a large number of corporations have "recapitalized" without tax under Section 112 (g) by retiring preferred stock and issuing bonds in the place thereof. For instance, if a corporation has outstanding a preferred stock issue of \$10,000,000, upon which it pays dividends at the rate of 6%, or \$600,000, it is at a disadvantage as compared with a corporation which owes

1. See Final Report of the Committee of the National Tax Association on Federal Taxation of Corporations, p. 36: "Certainly the present federal income tax on corporations, which permits the deduction of interest on money borrowed but makes no allowance for imputed interest on proprietor's capital, sets up a marked discrimination against financing by means of stock issues and in favor of financing by bonds."

\$10,000,000 to bondholders and pays out the same annual interest of \$600,000. The disadvantage consists of 18% of \$600,000 annually, or \$102,000 in years beginning with 1940.

Recommendation Section 23 (b) should be amended to eliminate this discrimination. The entire elimination of this deduction would probably be too drastic a remedy, although it would be incentive taxation of an extreme character and would definitely encourage equity financing. A less drastic mechanism would be at least to disallow the deduction in all cases in which a tax-avoidance purpose colored the incurring of the indebtedness. This may be covered, so far as recapitalizations are concerned, by the doctrine of Gregory v. Helvering,¹ although this is by no means certain.² At the very least a regulation should be framed to cover such situations.

1. 293 U.S. 465 (1935).

2. The Higgins v. Smith case, now pending in the Supreme Court, may help to settle this question.

9. Existing Law as to Non-Business Bad Debts

(Sec. 23 (k)) The Internal Revenue Code now allows a deduction for debts ascertained to be worthless and charged off within the taxable year. This provision differs from the provision relating to losses in that generally speaking losses (apart from casualty losses discussed in item 6 above) must be incurred in trade or business, or in transactions entered into for profit. Deductions are allowable to individuals for non-business bad debts, including debts between relatives.

Discussion Few provisions of the statute have been productive of so much litigation as the bad debt provision.¹ A great many so-called debts are originally in fact gifts because there is no intention to repay when the so-called indebtedness is incurred; from the creditor's side² there is no expectation of repayment.

* Recommendation Section 23 (k) should be amended by limiting the allowance for the deduction of non-business bad debts to a fixed small amount, say \$1,000 in the case of each debtor.

1. See Paul, Studies in Federal Taxation, p. 235 (1937).

2. Paul and Mertens, Law of Federal Income Taxation, Sec. 23.15 (1934).

10. Existing Law as to Non-Business Taxes

(Sec. 23 (d)) The Internal Revenue Code allows as a deduction taxes paid or accrued within the taxable year except income, profits, estate, inheritance, legacy and succession taxes and taxes assessed against local benefits. State income taxes, sales taxes, local property taxes, and custom duties are not within the exception. This deduction is allowed without reference to whether the taxes in question are on business property or dealings.

Discussion This allowance involves a manifest discrimination between taxpayers who own their own homes and taxpayers who rent their homes. Taxpayers who own their homes are enabled through this provision and the provision for the deduction of interest on non-business borrowings (item 7 above) to deduct almost the equivalent of rent, an expenditure which is regarded as a non-deductible personal expense in the case of taxpayers who rent their homes.

Recommendation Section 23 (d) should be amended by limiting the allowance for the deduction of taxes on non-business property or dealings to taxes on small homes not exceeding, say, \$10,000 in cost or value. Possibly some exception should be made in the case of state income taxes.

11. Existing Law as to Basis Where Optional Valuation Privilege is Chosen (Sec. 302 (j) of 1926 Act as Amended)
The 1935 law added to the estate tax provision Section 302 (j)

permitting the executors of a decedent to elect the date a year after the death of the decedent for valuing the decedent's assets. The remedial purpose was to avoid a heavy estate tax where assets have shrunk greatly in value during the period of administration.¹ No corresponding provision has ever been made, however, with respect to the cost basis to be used by the distributees in computing gain or loss upon the sale of the assets. The cost basis of such assets is still the value at the date of acquisition, viz., the date of the decedent's death.

Discussion Since executors never use the optional valuation unless there has been a shrinkage of value, taxpayers obviously get the benefit of a differential which was never subjected to an estate tax. For example, a decedent may leave assets having a value of \$1,000,000 at the date of his death, and drastic market fluctuations may have reduced the value of these assets a year after the date of death to \$100,000. In such a case the executors may exercise the option accorded to them by Section 302 (j), and the basis to the distributees for purposes of depreciation and purposes of computing gain on sale is, nevertheless, \$1,000,000, although only \$100,000 has been subjected to an estate tax.

Recommendation The simplest solution is to insert a new subdivision in Section 113 stating that where the optional

1. See H.R. Rep. No. 1681, 74th Cong., 1st Sess., p. 9 (1935); H.R. Rep. No. 1835, 74th Cong., 1st Sess., p. 9 (1935).

valuation privilege is exercised, the basis of such property shall be the value as used in the estate tax return.

12. Existing Law as to Taxation of Husband and Wife
(Sec. 51 (b)) Husband and wife living together have an option, as the law now stands, of filing separate returns or a single joint return including their aggregate income.

Discussion This permission to husband and wife to file separate returns results in unfair discrimination between persons whose income is derived principally from property and persons whose income is derived principally from personal services. Property owners frequently convey part of their property to their spouses, thus reducing income tax, whereas individuals deriving income from personal services are not able to secure a corresponding reduction in income tax, since an assignment of income from personal services is not recognized for income tax purposes.¹ On the other hand, in the community property states income even from services is divided equally between husband and wife, which gives the citizens of these states a special substantial advantage over the income of citizens from the other 40 states. This situation may become aggravated by the fact that there is a tendency in some states to establish an optional community property system. It is understood that Oklahoma has recently passed such a statute. Furthermore, many

1. Corliss v. Bowers, 281 U.S. 376 (1930); Lucas v. Earl, 281 U.S. 111 (1930).

family unit incomes must escape tax under existing law because the income of neither husband nor wife on a separate basis is sufficient to require the filing of an information return by the payor of the income. If the payor of income were required to file an information return on all yearly payments of over \$1,000, whether the recipient be single or married, this method of escaping taxes would be curtailed.

Recommendation One thing which could be done in this situation is to require husband and wife living together to file a joint return. If this recommendation is adopted, a difficult differentiation should probably be made, in the interests of the modern independent status of women, between husbands and wives who are on an independent earnings or property basis and husbands and wives who transfer property to each other for the purpose of saving tax, the requirement being limited to the latter type of case. If the recommendation is not adopted, the present permission, as distinguished from requirement, of husband and wife to file a joint return might be eliminated from the statute. Such a return is never filed under existing circumstances unless it is to the advantage of the spouses. Still another method might be to tax the income of husband and wife on a combined basis. Or the method employed in the British statute might be adopted, - namely the assess-

ment of the entire income of both spouses against the husband at a rate determined by the combined total.¹ Still another method, which would come substantially to the same result, is to assess husband and wife separately at surtax rates based upon the combined income.

13. Existing Law as to Taxation of Interest from Governmental Obligations (Sec. 22 (b)(4)) At the present time the Internal Revenue Code excludes from gross income (1) interest upon the obligations of a state, territory or any political subdivision thereof, or the District of Columbia, (2) interest upon the obligations of a corporation organized under act of Congress if it is an instrumentality of the United States (to the extent provided in the acts authorizing the issue of such obligations), and (3) interest upon obligations of the United States or its possessions (to the extent provided in the acts authorizing the issue of such obligations).

Discussion Extended discussion of this exemption is unnecessary. It results in a serious loss of revenue.

Recommendation Interest upon all bonds, state and Federal, issued after the date of introduction into Congress of a new act should be taxed directly and com-

1. See Paul, Five Years with Douglas v. Willcuts, 53 Harv. L. Rev. 1 (1939); Paul and Havens, Husband and Wife under the Income Tax, 5 Eklyn L. Rev. 241 (1936).

pletely. This would of course mean that Congress would have to refrain from authorizing any issue of tax-exempt bonds by the Federal government or affiliated organizations, such as the Federal Farm Loan Banks. Interest on future issues of state bonds should be taxed directly and completely.

It would not be fair to tax the income from past issues of state and municipal bonds even though it might be constitutional to do so. In so far as Federal bonds have been issued on a tax-exempt basis, the impairment of contract clause would probably prevent their taxation.

Although it is not suggested that income on past issues of state and municipal bonds or of tax-exempt Federal bonds should be taxed, Senator Glass's proposal, that the surtax on income from non-tax-exempt sources should take into account the existence of tax-exempt income, should be adopted; that is, a taxpayer with an income of \$200,000, one-half of which comes from existing tax-exempt securities, ought to pay surtaxes on the non-exempt half at the rates applicable to incomes between \$100,000 and \$200,000. That would not be taxing income from tax-exempt securities. If the court wished to sustain the tax, it could do so by reasoning that this would simply be denying the taxpayer the right to escape his proper surtax on his non-tax-exempt income.

14. Existing Law as to Taxation of Capital Gains

(Sec. 117) The Internal Revenue Code now lays a tax on capital gains, which in the case of long-term capital gains

cannot exceed 15% of the gain on the sale of assets held two years, and 20% of the gain on the sale of assets held from 18 months to two years. Short-term capital gains, which arise upon the sale of assets held less than 18 months, are subjected to the ordinary surtaxes.

Discussion This tax is extremely lenient, particularly as it will operate in an inflationary period. It involves a serious discrimination against persons who derive their income from personal services.¹ The oft-repeated criticism that the taxation of capital gains impedes the mobility of capital, and discourages capital from venturing, is exaggerated.

Recommendation The capital gain rate should be increased, or, in lieu of a flat increase, tax should be imposed on capital gains by reference to the other non-capital gain income of the taxpayer. If the taxpayer is in a bracket between \$200,000 and \$300,000, he can afford to, and should, pay a higher capital gains rate than a taxpayer in the bracket just above the point at which it pays to elect to be taxed at the flat rates contained in the existing statute. An additional thought would be to give some favored treatment on account of the reinvestment of the proceeds of capital gains in equity risks in new enterprises.

1. Internal Revenue Code, Sec. 117. An individual with an earned income of \$100,000 (disregarding credits for earned income and dependents, but allowing a \$1,000 exemption) would be taxed \$33,354, whereas an individual realizing \$100,000 from long-term capital gains would be taxed only \$9,334.

15. Existing Law as to Corporate Distributions

of March 1, 1913 Profits (Sec. 115 (b)) Every corporate distribution of earnings and profits accumulated, or increase in value accrued before March 1, 1913, is exempt from income tax. Such a distribution cannot be made so long as a corporation has earnings or profits accumulated since February 28, 1913, because there is a conclusive presumption in the statute that every distribution is made out of most recently accumulated earnings or profits. But the pre-March 1, 1913 profits, or increase in value of property, may be distributed free from tax if all more recently accumulated earnings or profits have been distributed.

Discussion There is no constitutional reason why earnings or profits accumulated, or increase in value of property accrued before March 1, 1913, should not be taxed.¹ Corporations have been given a reasonable opportunity (20 years) to distribute pre-March 1, 1913 earnings and increase in value of property without any tax.

Recommendation You may wish to revive the attempt once made to amend Section 115 (b) so as to eliminate the exemption therein given to corporate distributions of earnings or profits accumulated, or increase in value of property, accrued, before March 1, 1913.²

1. *Lynch v. Hornby*, 247 U.S. 339 (1918); *Lynch v. Turrish*, 247 U.S. 221 (1918).

2. Such an amendment at least once passed the Senate, but did not survive in the final bill enacted.

16. Existing Law as to Life Insurance Proceeds Paid in Installments (Sec. 22 (b)(1)) The Internal Revenue Code provides for an exemption for income tax purposes of amounts received under a life insurance contract paid by reason of the death of the insured. In Section 22 (b)(1) there follows a parenthetical clause to the effect that if life insurance proceeds are held by the insurer under an agreement to pay interest thereon the interest payment shall be included in gross income.

Discussion This provision does not work satisfactorily. A few years ago the General Counsel ruled¹ that this provision exempted only the principal sum or capital value of the life insurance policy as of the date of the insured's death, and that all amounts which are added to such principal sum when it is paid in installments by reason of the running of time should be taxable. The Board has recently held that this interpretation was incorrect, and that the Congressional intent was to exempt amounts received by the beneficiary of a policy paid by reason of the death of the insured in installments or in annuities and not merely amounts paid upon the death of the insured or payable at that time. Putting this thought in another way, the exemption is construed not to apply merely to the commuted value of the face of the policy, but rather to the face amount of the policy whenever

1. G.C.M. 13,796, CB XIII-2, p. 41.

its proceeds are paid. Only income from the retained face amount of the policy, usually taking the form of excess interest dividends, is taxable, because such excess interest dividends are not received solely by reason of death of the insured, but are paid by reason of the withholding of the future installments of the principal amount and are profitable investments by the company.

Recommendation Section 22 (b)(1) should be amended in such a way as plainly to incorporate the principles announced in G.C.M. 13,796.

17. Existing Law as to Double Loss Deductions
(Secs. 23 (e), (f), 24 (b), 112 (b)(5), 113 (a)(8)) It is possible under the law as it stands for an individual who owns securities which have substantially decreased in value to transfer these securities to a new corporation without the recognition of loss under Section 112 (b)(5). The corporation under Section 113 (a)(8) takes over the high cost basis of the individual transferor. It may then sell the securities and obtain the benefit of the loss. If there is a mere expectation and not an agreement to liquidate the corporation at the time of the transfer of the securities to it, a second or

✓
1. See Sidney W. Winslow, Jr., 39 BTA 373, cf. United States v. Heilbroner, 100 F (2d) 379 (CCA 2nd, 1938); Edith M. Kinnear, 20 BTA 718.

double loss deduction may be secured upon the liquidation¹ of the corporation.

Discussion Although double deductions are frowned upon by the Supreme Court,² this seems to be a wholly indefensible loophole. While several members of the Board dissented in the W. & K. Holding case and the case may be reversed on appeal, there is a substantial possibility that it reflects a correct interpretation of the present statute.

Recommendation The statute should be amended to prevent this double loss deduction.

18. Existing Law as to Basis of Property Transmitted by Death (Sec. 113 (a)(5) Under the Internal Revenue Code taxable gain and deductible loss on the sale or exchange of property transmitted at death (acquired by bequest, devise or inheritance or by decedent's estate from the decedent) is the fair market value of the property at the time of acquisition (death).

Discussion For example, if B acquires property transmitted at death by A, and the property cost A \$100,000 in his life time and is worth \$500,000 at the date of death, B when he sells the property is entitled to use \$500,000 as his basis. This means that \$400,000 of appreciation in value

1. See W. & K. Holding Corp., 38 BTA 830, 839.

2. McLaughlin v. Pacific Lumber Co., 293 U.S. 351 (1934); Ilfield Co. v. Hernandez, 292 U.S. 62 (1934).

has never been, and will never be, subject to income tax. Tremendous loss of revenue must be involved in this rule, and it must have a freezing market effect by discouraging sales by persons late in life.

Recommendation Section 113 (a)(5) of the Internal Revenue Code should be amended to provide that the basis for gain or loss on the disposition of, or for purposes of depreciation or depletion upon, property transmitted at death is the adjusted cost basis in the hands of the decedent, rather than value at the date of death.¹ While this would raise the basis where property has depreciated in value between original acquisition by the decedent and the date of death, it is perfectly fair to allow such a potential loss to be carried over from the decedent; moreover, this aspect of the change should not so greatly affect the revenue, since losses are frequently consummated during life to save taxes, whereas many gains for the same reason go deliberately unrealized. In connection with this recommendation it should be noted that it is fairer than the basis in the case of gifts inter vivos established by Section 113 (a)(2) which establishes as a gain basis of cost to the donor, but limits the donee to a loss basis of cost to the donor, or value at the time of gift, whichever is lower.

Another alternative remedy for this situation would be to count death as a closed transaction, somewhat in the manner established by Section 42 with respect to accrued income. This

1. It is realized that this change may involve problems of distribution among legatees, the high donor cost basis property being of greater value to a legatee, but problems of this sort are hardly insuperable.

remedy, however, would be largely self-defeating under the present scheme of estate tax deductions in that the additional tax imposed upon the decedent during the last taxable year of his life time would be increased and this¹ would automatically increase the estate tax deductions.

19. Existing Law as to Domestic Building and Loan Associations (Sec. 101 (4)) The Internal Revenue Code under certain conditions now allows a special exemption from income tax to domestic building and loan associations, substantially all business of which is confined to making loans to members.

Discussion This broad provision gives exemption to building and loan associations the activities of which are not related to financing home ownership, but go to the length of owning and operating office buildings; also to associations which make loans to building contractors, as distinguished from persons who are purchasing or erecting their homes for personal use; and also to building and loan associations owned by small groups, which derive substantial income from their ownership of the association. It does not destroy exemption that associations accept what are substantially savings deposits, and thus compete with banks.

Recommendation Although the line of demarcation is hard to draw, Section 101 (4) of the statute should be re-drawn in such a way as to limit the exemption given to

1. See Reg. 80, Art. 37.

building and loan associations of a genuine cooperative character, the activities of which are primarily related to financing home ownership.

20. Existing Law as to Mutual Casualty and Fire Insurance Companies (Secs. 101 (11), 207 (c)(3) Section 101 (11) of the Internal Revenue Code exempts farmers' or other mutual hail, cyclone, casualty or fire insurance companies or associations (including interinsurers and reciprocal underwriters) the income of which is used or held for the purpose of paying losses or expenses. Section 207 (c)(3) gives a special allowance to mutual insurance companies (including interinsurers and reciprocal underwriters but not including mutual life and marine companies) requiring their members to make premium deposits to provide for losses and expenses consisting of the amount of premium deposits returned to their policy holders and the amount of premium deposits retained for the payment of expenses, losses and reinsurance reserves.

The effect of these provisions, as interpreted by the Bureau rulings, practice and regulations, ¹ is that

1. See Reg. 101, Art. 101 (11)-1; Reg. 101, Art. 207-6. See also Comm. v. National Grange Mutual Liability Co., 80 F(2d) 316 (CCA 1st, 1935); McLaughlin v. Philadelphia Contributionship for Insurance of Houses from Loss by Fire, 73 F(2d) 582 (CCA 3rd, 1934) cert den. 294 U.S. 718 (1935); Commercial Health & Accident Co. v. Pickering, 281 Fed. 539 (1922); Baltimore Equitable Society v. United States, 3 Fed. Supp. 427 (Ct. Cls., 1933) cert. den. 290 U.S. 562 (1933); Mutual Assurance Society of Virginia, 24 BTA 1102, acquiesced in CB XIII-1, p.11; L.O. 1050, CB 3, p. 279; S.O. 156, CB III-1, p. 284; A.R.R. 7939, CB III-1, p. 294.

practically all mutual insurance companies other than life are exempted from income tax; those which fail to secure exemption under Section 101 (11) escape tax in large part by reason of Section 207 (c)(3). It is believed that virtually no substantial tax is collected from such mutual companies, although a substantial tax is collected from stock insurance companies of the same type.

Recommendation Section 101(11) and Section 207 (c)(3) should be modified so that exemption is limited to companies of a purely local character, the phrase eliminated by Section 1013 (b) of the Revenue Act of 1924. Further protection should be introduced into the statute to prevent undue deductions under Section 207 (c)(3). One method would be to use the provisions of existing law applicable to the taxation of stock insurance companies other than life. Other possible methods should be canvassed.

21. Existing Law as to Employers' Contributions to Pension Trusts (Secs. 23 (a), (b), 165) The Internal Revenue Code allows a deduction on account of amounts transferred to pension trusts. Although amounts transferred to stock bonus, pension or profit-sharing plan trusts are deductible by the employer, the amounts transferred to the trusts are not taxable to the employee until they are paid out of the trust after retirement or otherwise, according to the pension plan. The trust itself is not taxable with respect to income earned

upon the investment of the funds transferred to it.

Discussion These statutory provisions were undoubtedly intended to encourage pension and retirement plans which would give a measure of old age security to employees.¹ They have been employed, however, to a large extent for the purpose not of benefiting junior low-paid employees, but rather for the purpose of laying aside for future lower-bracket taxation after retirement, large blocks of the salaries payable to senior key men in the employer companies.

Recommendation Sections 23 (b), (p) and 165 of the statute should be amended so as to limit the deduction for payments made by employers to pension trusts to some fixed amount (say \$5,000) for any one employee.

22. Existing Law as to Discovery Value and Percentage Depletion (Sec. 114 (b)) Section 114 (b) of the Internal Revenue Code allows special depletion in the case of mines (other than metal, coal or sulphur mines) discovered by the taxpayer. The basis is the value of the property at the date of discovery, or within 30 days thereafter; the depletion allowance is limited to 50% of the net income of the taxpayer from the property. In the case of oil and gas wells, the allowance is 27½% of the gross income from the property (excluding rents and royalties), but the allowance may not

1. The purpose of these statutory provisions is stated in part in Conference Report No. 486, 67th Cong., 1st Sess., p. 29, Nov. 19, 1921; Finance Committee Report No. 960, 70th Cong., 1st Sess., p. 29, May 1, 1928. See also Oscar A. Gistad, 32 BTA 670.

exceed 50% of the net income of the taxpayer from the property. In the case of coal mines, the percentage of gross income is 5%; in the case of metal mines it is 15%; in the case of sulphur mines it is 23%. These last three allowances are limited to 50% of the net income. It should be noted that these percentage allowances go on indefinitely and not merely until a definite capital sum is exhausted.

Discussion The special depletion deductions originated in discovery value deductions included in the Revenue Act of 1918 which was during the World War.¹ They were designed to encourage metal resource development, particularly oil wild catting. In 1926, because of valuation difficulties, percentage allowances were substituted in the cases mentioned for discovery value allowances. The original discovery value allowances were "favored industry" deductions, and involved the factor of incentive taxation. In 1937 the President and the Secretary of the Treasury re-²commended the elimination of these provisions, but the recommendation was not adopted.

Recommendation You will no doubt wish to urge once more the elimination of these special depletion allowances.

1. Paul and Mertens, Law of Federal Income Taxation, Sec. 21.53 (1934).

2. Letter of President Roosevelt, June 1, 1937, quoted in 1 Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess., p. 1 (1937); Secretary Morgenthau, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess., p. 11 (1937).

Of course, depletion on the basis of cost or value at March 1, 1913, should be retained in the statute.

23. Existing Law as to Development Expense¹

Under the regulations now outstanding the taxpayer is given the option to charge to capital or expense intangible drilling and development costs, including expenditures for wages, fuel, repairs, hauling supplies, etc., incident to the drilling of wells and the preparation of wells for the production of oil or gas.

Discussion Expenditures of the type mentioned result in a capital asset, which in the case of productive properties continues to produce income throughout the life of the property. The so-called option is only an option in an artificial sense,² since taxpayers generally take the cash and let the credit go by availing themselves of the privilege of deducting immediately the full cost of capital assets, rather than postponing the deduction to years when it may be recovered through the door of depreciation of a capitalized item. The Treasury made a move about a year ago in the direction of eliminating this so-called election, and compelling capitalization, but abandoned the idea after industrial hearings.

1. Reg. 101, Art. 23 (m)-16.

2. See Government Brief in Wilshire case, p. 9.

Recommendation This option has been granted by the regulations for a long period of years, and may have become embedded in the statute. Its elimination for the future will not require a statutory provision.¹

It is worth consideration whether a further provision should not be enacted limiting depletion and depreciation deductions to amounts reported to stockholders in annual reports. Conversely, listing applications to the Security & Exchange Commission might be required to show depletion and depreciation taken for income tax purposes.

24. Existing Laws as to Taxation of Non-Resident Alien Individuals and Foreign Corporations (Secs. 211-219; Secs. 231-238) Under the Internal Revenue Code neither non-resident individuals nor foreign corporations are now taxable with respect to capital gains; and foreign corporations are given the benefit of a flat rate of 15% on their taxable income, and 10% in the case of dividends (which may be reduced to 5% in the case of a corporation organized under the laws of a contiguous country - Canada and Mexico - if so provided by treaty with such country).

Discussion No sufficient reason appears why non-resident aliens should have this distinct advantage over

1. Helvering v. Wilshire Oil Co., U.S. (1939);
cf. Helvering v. R. J. Reynolds Co., 306 U.S. 110 (1939).

citizens and residents of the United States, nor why foreign corporations over domestic corporations should have any advantage with respect to rates of tax or types of taxable income. If anything, discriminations should operate in the opposite direction.

Recommendation Sections 211 to 219 and 231 to 238 of the Internal Revenue Code should be amended to tax non-resident aliens and foreign corporations upon income from sources within the United States in such a way that there is no discrimination in their favor. There appears no reason why non-resident aliens and foreign corporations should not be taxed upon capital gains consummated within the United States even though they have no office or place of business within this country.

1
ESTATE TAX

25. Existing Law as to Estate Tax Exemptions (1931 Act, Sec. 401 (c), 1926 Act, Sec. 301 (g)) The Internal Revenue Code now grants a general estate tax exemption of \$40,000, and a special exemption of \$40,000 of insurance upon policies taken out by decedent upon his own life and payable to beneficiaries other than the estate of the insured.

Discussion While a general estate tax exemption should be allowed in the case of reasonably small estates, and while a \$40,000 special insurance estate tax exemption should perhaps be allowed also in the case of small estates, these two exemptions as they now operate confer an undue benefit upon estates in high brackets. The \$40,000 general exemption means \$400 to an estate of between \$40,000 and \$50,000. In the case of a net estate in excess of \$4,000,000 but not in excess of \$4,500,000, the exemption means \$20,000 in tax. In the case of an estate in excess of \$50,000,000 the exemption means \$28,000 in tax. The same figures may be applied to the insurance exemption. It is well known in insurance circles that many persons with high brackets estates take out insurance policies of \$40,000 not because they are interested in insurance,

1 Section number references under the estate tax are to the several revenue acts and not to the new Internal Revenue Code with which latter section numbers most persons are not yet familiar.

2 Possibly an even greater exemption should be allowed in the case of small estates.

but merely to secure a \$40,000 exemption.

Recommendation As in the case of the personal exemption and credit for dependents in connection with the income tax, these \$40,000 exemptions should be modified so that they are of equal benefit to large and small estates; or perhaps they should be eliminated altogether in the case of net estates in excess of a given substantial figure. One mechanism for accomplishing this change would be to insert normal and surtax structure in the estate tax allowing the \$40,000 exemption for normal estate tax purposes. The special insurance exemption should perhaps be eliminated in the case of all estates and an increase of the general exemption allowed to small estates.

26. Existing Law as to Taxation of Life Insurance

(1926 Act, Sec. 302 (g)) Apart from the contemplation of death provision the proceeds of life insurance payable to beneficiaries other than the estate of the insured are taxable only if the insured is vested at the date of death with incidents of ownership in the policy. Incidents of ownership are now defined as including:

- (1) The right of the insured or his estate to the economic benefits of the policy;
- (2) The power to change the beneficiary;
- (3) The right to surrender or cancel the policy;
- (4) The right to cancel the policy;
- (5) The right to revoke an assignment;
- (6) The right to pledge the policy for a loan; and
- (7) The right to obtain from the insurer a loan against the surrender value of the policy.

1. Reg. 80, Art. 25, as amended by T.D. 4729, CB 1927-1, p. 284.

If the insured irrevocably assigns the above incidents of ownership to another person (usually his wife), there is no estate tax upon the proceeds of the insurance, unless the transfer is held to be in contemplation of death. The more modern form of avoidance in this field of the law is the issuance of cross policies, one on the life of the husband taken out and owned by the wife, and the other on the life of the wife taken out and owned by the husband. This method avoids the necessity of any assignment or irrevocable transfer of the incidents of ownership.

Discussion Large amounts of insurance proceeds altogether escape tax under existing law. Insurance is sold to large customers upon the basis of a tax-avoidance selling appeal.¹ It is believed that intra-company schools are maintained by the insurance companies in which salesmen are instructed how to discuss possible tax savings with prospective insurance buyers.

Insurance proceeds, in so far as they exceed cash surrender value, are at the date of the death of the insured enjoyable for the first time by the beneficiary. The death of the insured creates an additional untaxed value and frees it for the first time to the beneficiary's use. Such a genuine enlargement of the beneficiary's rights has been enough, without any shift of economic benefits from the estate, to

1. See Wright and Lowe, Selling Life Insurance through a Tax Approach.

support the taxation (1) of interests held by joint tenants and tenants by the entirety; ¹ (2) of property as to which the decedent has retained for life the possession or enjoyment of the income if transferred after the 1931 Joint Resolution amending Section 302 (c); ² and (3) of property as to which the decedent has retained nothing more than a veto right to prevent a revocation of the trust by the beneficiaries alone. ³ Where it is necessary to prevent tax avoidance devised by ingenious minds, there may be no denial of due process in measuring the tax upon the transfer of insurance by reference to what passes at death.

Recommendation We may be precluded from amending outstanding regulations retroactively. ⁴ Regulations 80, Article 25, as amended, should be further amended at least for the future. If necessary, the statute should be amended so as to make inescapably clear the intention of Congress to subject to tax the proceeds of all life insurance policies taken out by

1. Tyler v. United States, 281 U.S. 497 (1930).

2. Helvering v. Bullard, 303 U.S. 337 (1938).

3. Helvering v. City Bank Farmers Trust Co., 296 U.S. 85 (1935).

4. Helvering v. Reynolds Tobacco Co., 306 U.S. 110 (1939); cf. very recent opinion in the Wilshire Oil case.

the decedent on his own life to the extent that he has paid premiums thereon, or where he possessed at the time of death some incident of ownership over the policies. In the situation involving cross-policies, commonly taken out and paid for by spouses with their separate funds, there is lacking any substitute for testamentary disposition, and Congress might well canvass the comparative merits of revamping the present income-tax exemption of insurance proceeds, or of imposing a special excise tax, wholly dissociated from the estate tax title, upon the receipt by the beneficiary of life insurance proceeds in excess of the aggregate premiums paid by him. However, any amendment taxing the proceeds of policies, regardless of incidents of ownership or regardless of the source of premium payments, should be only prospective in application, to avoid obvious unfairness against persons who have already procured policies in reliance upon the Treasury's outstanding interpretation of the statute. It might be possible to apply the amended statute to policies taken out before its passage, but to exempt from ultimate estate tax the cash surrender value of policies theretofore taken out, existing as of the passage of the amendment, or to exempt an amount bearing the same ratio to the total proceeds as the time between the issuance of the policy and the passage of the amendment bears to the total period until the date of death. This amendment involves the

elimination from the statute of the completely unsatisfactory language "policies taken out by the decedent upon his own life."

27. Existing Law as to Property Passing Under Powers of Appointment (1926 Act, Sec. 203 (f)) The estate tax statute now provides that there shall be included in the gross estate property passing under a general power of appointment exercised by the decedent (1) by will, or (2) by deed exercised in contemplation of or intended to take effect in possession or enjoyment at or after death, or (3) by deed under which the decedent has retained for his life, or any period not ascertainable without reference to his death, or for any period which does not in fact end before his death (A) the possession or enjoyment of, or the right to the income from, the property, or (B) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Discussion The use of the word "passing" makes it possible to escape all estate tax at the election of the person for whom the power is exercised, if that person would have taken the same property in default of appointment. For instance, if a power is given to A, and in default of his

1. See Paul, Life Insurance and the Federal Estate Tax, 52 Harv. L. Rev. 1037 (1939); Bailey v. United States, very recently decided by the Court of Claims.

exercise of the power by will the property is to pass to A's issue, or if no issue to A's heirs-at-law, A's heirs may still elect to take under the will of the donor of the power, rather than under the appointment itself, even though A has expressly exercised the power in their favor.¹

The Board of Tax Appeals recently decided James Webster, Exec.² under authority of the Grinnell case. This case illustrates a simple estate tax avoidance expedient. The rule stated is that if the beneficiary-appointee receives no more because of the exercise of the power by the donee than he already had under the donor's will in default of the exercise, Section 302 (f) will not apply.³ This rule is highly prejudicial to the revenue because it will apply to numerous family testamentary dispositions.

So long as the statute covers only general powers, there are ample means of avoiding tax deriving from technical distinction between general and special powers. The outstanding regulations say that a power is general if the donee may appoint to himself, his estate or his creditors.⁴ A

1. Helvering v. Grinnell, 294 U.S. 153 (1935).

2. 36 BTA 273.

3. Lewis Spencer Morris, Exec., 39 BTA 570 followed the same rule.

4. Reg. 80, Art. 24.

special power may be used which in no way will affect the desired purpose of the donee. Examples of such special powers are:

- (1) A power to appoint among natural persons and charitable corporations in which the donee is deprived of the right to appoint business corporations.¹
- (2) A power exercisable with the consent of a trustee.²
- (3) Under Maryland law a power which on its face is general becomes a special power because no appointment can be made to creditors. In that state virtually no power of appointment can be reached by Section 302 (f) as the section now stands.³

Recommendation

- (1) The word "passing" should be eliminated from the statute so as to preclude escape from tax when a general appointment gives the beneficiary-appointee the same or less than he would have received in default of the exercise.
- (2) The words "alone or in conjunction with any person" should be associated in the statute with the word "exercisable."
- (3) The statute should include within its scope special powers, as well as general powers, with a provision for the exception of some special powers to cover cases in which an appoint-

1. Waldemar R. Helmholtz, Exec., 28 BTA 165.

2. Charles J. Hepburn, Exec., 37 BTA 459.

3. Leser v. Burnet, 46 F (2d) 756 (CCA 4th, 1931).

ment under a special power after a single life tenancy can be exercised only among the children of the donor or donee, and where the property in default of appointment is to be distributed among that class. This would not postpone the tax "unduly," but would prevent such situations as exist in Delaware, where an estate can escape tax forever by giving a son a life estate and a special power to appoint any of the son's children; each generation can then repeat this process.

(4) There should be provision for a tax on powers, whether they are exercised or not, except in the case of the exception mentioned in (3).¹

If special powers were taxed regardless of the limitation suggested, testators would immediately turn to the alternative of setting up life estates with vested remainders. Therefore, if no such limitation were placed upon the taxation of property passing under a special power, Congress should canvass the possibilities of imposing a succession or inheritance² (rather than an estate) tax whenever a remainderman under a will succeeds to property upon the death

1. This whole subject is ably discussed in Griswold, Powers of Appointment And The Federal Estate Tax, 52 Harv. L. Rev. 929 (1939).

2. See letter of the President to Congress quoted in Ways and Means Committee Report No. 1661, 75th Cong., 1st Sess., p. 1 (1935).

of the preceding life tenant. This would not be an extreme hardship, since life tenants are frequently given a power of invading the trust corpus, which gives them virtually the same economic control over the remainder as is possessed by the donee of a power of appointment. The rates of taxation upon the remaindermen in such cases should be considerably lower than those under the present estate tax law; and the remainder should probably be exempted from the tax if the life tenant dies within a period of five years after the death of the original decedent. Any statutory amendment along this line would have to cover the still further alternative of buying an annuity for the wife (as distinguished from making her a life tenant) and leaving the balance outright to the children, perhaps with enjoyment postponed until a certain age.

28. Existing Law as to Reverter Interests (Sec. 302 (c) as Amended by the 1932 Act, Sec. 803(a)) In Helvering v. St. Louis Union Trust Co.¹ the Supreme Court decided by a vote of 5 to 4 that there is no tax upon the estate of the grantor of a trust where the only reservation in the trust instrument is

1. 296 U.S. 39 (1935).

a possibility of reverter (as to income) if the beneficiary (the grantor's daughter) should predecease the grantor. This decision resulted in a revision of the estate tax regulations¹ and the insertion of the following language:

"On the other hand, if, as a result of the transfer, there remained in the decedent at the time of his death no title or interest in the transferred property, then no part of the property is to be included in the gross estate merely by reason of a provision in the instrument of transfer to the effect that the property was to revert to the decedent upon the predecease of some other person or persons or the happening of some other event."

Discussion The existing statute, as so interpreted, makes a highly artificial distinction. For instance, if the decedent provides that the benefit of the property should pass to A for life with a reservation of the fee to the grantor, but with a remainder in fee to A contingent upon A's survival of the grantor, then the property is includible in the grantor's estate. On the other hand if a technically vested fee title to the property is given to A, but with a further provision that the property should revert to the grantor if A predeceases him,

1. Reg. 80, Art. 17 (1937 Ed.)

no estate tax is imposed, although the net effect of the disposition is exactly the same as in the preceding case.

Recommendation There are, of course, all sorts of variations of reverter interests, but certainly as to many of them the dissenting opinion¹ of Mr. Justice Stone, concurred in by 3 of his associates, reflects the rule that should be incorporated into the statute. In net effect the rule is that the estate tax should be imposed in all cases in which the decedent in making disposition of his property retains any valuable interest in the property by which he postpones final disposition of the property until his death. The Supreme Court may, however, relieve this difficulty in several pending cases in which an overruling of the St. Louis doctrine is being requested by the government.

29. Existing Law as to Gifts in Contemplation of Death (Sec. 302 (c) of 1916 Act) The estate tax statute provides that there shall be included in the gross estate gifts and transfers in trust made in contemplation of death.

¹ Helvering v. St. Louis Union Trust Co., 298 U.S. 39 (1935).

Discussion The statute, by making taxability depend on the motive or purpose accompanying the gift, incorporates a subjective test.¹ Whether there is contemplation of death is a question of fact which the courts tend to answer with extreme liberality in favor of decedent estates. In United States v. Wells,² the frankly admitted motive of the decedent in making the gift was to reduce income taxes. The only motive connected with life which prevented the gift from being subjected to an estate tax was itself a tax-reduction motive. In many cases gifts made by persons well over 60 years of age are held not to be in contemplation of death; in one case a gift by a person over 90 years of age was held not in contemplation of death.³

Recommendation Some provision should be made to show Congressional intent to tax all gifts and transfers in trust which serve as substitutes for testamentary disposition. The 1926 Act inserted a two-year conclusive presumption which was held unconstitutional by a 6 to 2 decision in Heiner v. Donnan.⁴

1. Paul, Selected Studies in Federal Taxation, Second Series, p. 285 (1938).

2. 283 U.S. 102 (1931).

3. Rochester H. Rogers, 21 BTA 1124.

4. 285 U.S. 312 (1932).

While the present Supreme Court might sanction such a provision, it would be extremely unfair in the case of gifts by relatively young persons. A general provision might perhaps be enacted establishing conclusive presumption to cover cases in which the gift is made after the decedent reaches 60 years of age, with the present rebuttable presumption covering cases in which someone under the age of 60 makes a gift and dies thereafter within a two-year period.

30 Existing Law as to Elimination of Estate Tax Against Insurance Proceeds by Reason of Uncollectible Claims (Sec. 302 (a)) Under the Internal Revenue Code claims against the estate which are allowed in the jurisdiction in which the estate is being administered, are deductible in determining the net estate, even though the claims are not enforceable against some particular assets of the estate.

Discussion In many states the proceeds of life insurance payable to named beneficiaries are not subject to claims against the estate. Taxes are escaped altogether if the claims against the estate exceed not only the net estate, but also the statutory gross estate, including life

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insurance proceeds. In one case an estate evaluated at over \$2,000,000 more than half of which consisted of the proceeds of life insurance, had valid claims against it amounting to some \$6,000,000, none of which constituted a charge against the proceeds of the policies. Since the uncollectible claims exceeded the gross estate, there was no estate tax liability.

Recommendation Section 203 (a) of the Internal Revenue Code should be amended to provide that claims against an estate are allowable deductions only if collectible in the particular jurisdiction.

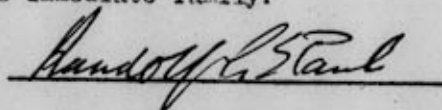
1. *Comm. v. Ames*, 88 F(2d) 330 (CCA 7th, 1937). See also *Helvering v. Northwestern National Bank and Trust Co.*, 89 F(2d) 553 (CCA 8th, 1937); *Comm. v. Lyne*, 90 F(2d) 745 (CCA 1st, 1937); *Helvering v. O'Donnell*, 94 F(2d) 852 (CCA 2nd, 1938); *Comm. v. Strauss*, 77 F(2d) 401 (CCA 7th, 1935), on rehearing aff'd 81 F(2d) 1315 (CCA 7th, 1936); *Comm. v. Hallock*, 108 F(2d) 1 (CCA 6th, 1939); *Wainwright v. Kyle*, 22 F. Supp. 175 (E.D. Pa., 1937); *Edna F. Hays et al., Ex'rs*, 34 BTA 308. See the dissenting opinion of Member Harron in *Thomas DeC. Ruth, et al., Ex'rs*, 26 BTA 191 which was however aff'd by the Circuit Court of Appeals (appeal dismissed, CCA 8th, 1936).

¹
GIFT TAX

31. Existing Law as to Gift Tax Exemptions (Secs. 505 (a), 504 (b) of the 1932 Act, as amended) The existing gift tax allows a cumulative exemption of \$40,000, and a non-cumulative annual exemption of \$4,000 per donee. This last exemption is not applicable to transfers in trust.

Discussion This \$4,000 exemption is much abused. Many taxpayers spread large amounts of valuable gifts among several persons and accomplish substantial transfers of property without any gift tax. Furthermore, a donor who sufficiently anticipates the future may over a span of years give away a considerable amount of property free from tax. The principal purpose of the exemption is merely to allow a reasonable latitude for inter-family gifts.

Recommendation Section 504 (b) of the Revenue Act of 1932 should be further amended so as to restrict exempted gifts at least to members of the donor's immediate family.



November 13, 1939

1. Section number references under the gift tax are to the several revenue acts and not to the new Internal Revenue Code with which latter section numbers most persons are not yet familiar.

MEMORANDUM A-1

QUESTIONS AS TO THE EFFECT ON THE REVENUE
OF THE POINTS MADE IN MEMORANDUM A

Referring to Mr. Paul's accompanying memorandum marked "A", question arises as to how much additional tax will be derived from the suggestions made as follows:

1. The making of some appropriate provision to the end that the personal exemption and credit for dependents will be changed from its present form to a credit against tax, under which equal benefit would be given to taxpayers in the low brackets and taxpayers in the high brackets. This might be accomplished by an amendment to the statute limiting the present personal exemption and credit for dependents to a credit for normal tax purposes only.

2. The taxation of all stock dividends not presently subjected to income tax and particularly common stock dividends upon common stock, there being no other class of stock outstanding at the time of the declaration of the dividend.

3. The taxation of short-term and other trusts of a character exempted from tax to the grantor in such cases as the Meredith Wood case,¹ in which title to the trust property is transferred for a limited term to the trust, and the trust becomes a taxpayer in a lower bracket than would be the

1. 37 BTA 1065, aff'd per curiam 104 F (2d) 1013 (CCA 2nd, 1939), cert. granted, Oct. 9, 1939.

grantor if he were charged with the income of the trust.

4 (a). The strengthening of Section 102 by a provision that the facts recited in Memorandum A, page 8, shall be regarded as constituting prima facie evidence of a purpose to avoid surtax upon shareholders.

(b). The strengthening of Section 102 by a provision that the word "existing" be inserted before the word "business" in subdivision (c) of Section 102 to prevent avoidance of the De Mille type described on pages 8 to 9 of Memorandum A.

(c). The lengthening of the statute of limitations as suggested in the same memorandum with respect to Section 102 cases.

5 (a). A provision to the effect that deductible religious, charitable, scientific, literary and educational and other contributions of the type deductible under Section 23 (c) be limited, when paid in the form of property, to the cost basis of the property to the donor or its value at the date of gift, whichever is lower.

(b). An alternative provision allowing no greater deduction than would be allowed if the donor sold the property and contributed the proceeds less the capital gains tax.

6 (a). An elimination of the deduction now contained in Section 23 (e)(3) applicable to losses arising from

fire, storm, shipwreck or other casualty, or from theft.

(b). Treatment of such deduction as a capital loss instead of an ordinary loss.

7. A limitation of the allowance for the deduction of interest on non-business individual borrowings to a fixed amount of \$500.

8 (a). An elimination of the deduction provided in Section 23 (b) of the Internal Revenue Code for interest paid or accrued on funded corporate indebtedness.

(b). A restriction of the reorganization provision so that it will not apply to recapitalizations having as their principal purpose the tax avoidance motive of substituting borrowed capital for an equity contribution by stockholders.

9. An elimination of the provision contained in Section 23 (k) for the deduction of non-business bad debts except bad debts when not exceeding \$1,000 in the case of each debtor.

10. A limitation upon the allowance of deductible taxes as provided in Section 23 (d) in respect to property held for the taxpayer's own use to taxes on small homes not exceeding \$10,000 in cost to the deducting owner, or value in the taxable year of deduction.

11. A provision to the effect that where the optional valuation privilege granted by Section 302 (j) of the estate tax statute is used, the basis for the property valued pursuant to this election shall be the same for purposes of capital gains or losses as the value used in the estate tax return.

12 (a). A provision denying to husband and wife living together the privilege of filing joint returns.

(b). A provision generally adopting the British method of taxation of husband and wife as outlined in Memorandum A, assessing the joint income at surtax rates based upon the combined income of both husband and wife.

13 (a). An amendment of existing law along the lines suggested in item 13 of Memorandum A with particular respect to taxing the interest on all state or Federal bonds issued after the passage of a new Congressional amendment.

(b). An amendment of the existing law, as proposed by Senator Glass 20 years ago, which would measure the surtaxes applicable to non-tax-exempt income in relation to taxpayer's total income, including tax-exempt income.

14 (a). A flat increase in capital gain rates of 50% of the existing rates with a provision that capital gains shall not be recognized to the extent that the gains are reinvested within 12 months in risk-bearing equities in new enterprises.

(b). An amendment of capital gains provisions so as to make capital gains taxable at the highest rate (not exceeding 50%, however) applicable to taxpayer's income, exclusive of capital gains, with a provision for a credit against the tax to the extent that the gains are reinvested within 12 months in risk bearing equities in new enterprises.

15. A provision revoking the exemption now granted by Section 115 (b) of the Internal Revenue Code to corporate distributions of earnings or profits or increase in value of property accrued prior to March 1, 1913.

16. A provision in the statute incorporating the general principles of G.C.M. 13,796, CB XIII-2, p. 41, discussed under item 16 of Memorandum A.

17. A provision discountenancing the doctrine of the W. & K. Holding case, 32 BTA 830.

18 (a). A provision that the basis for gain or loss and depreciation and depletion shall be, in the case of property transmitted at death, the adjusted cost basis in the hands of the decedent, rather than the value at the date of death.

(b). A provision along the lines of Section 42 of the Internal Revenue Code generally to the effect that death shall constitute a closed transaction with respect to

property transmitted by the decedent at death.

19. A provision limiting the exemption now accorded to domestic building and loan associations along the general lines indicated at page 28 of Memorandum A.

20. A provision limiting the exemption and deductions granted to mutual casualty and fire insurance companies along the lines indicated at page 29 of Memorandum A.

21. A provision limiting the deduction for payments made by employers to pension trusts to a fixed amount per annum of \$5,000 for any one employee.

22. A provision eliminating the "bonus" deduction on account of discovery value and percentage depletion now allowed to mine owners and oil and gas well owners, to the general end that such taxpayers shall be limited to cost depletion, or depletion on the basis of value at March 1, 1913.

23. A modification of the existing regulations granting the option as to the expense deduction or capitalization of intangible drilling and development costs as outlined at page 33 of Memorandum A.

24 (a). The elimination of the exemption from capital gains tax on sales consummated within the United States

now granted to non-resident aliens and foreign corporations having no office or place of business within the United States.

(b). A general provision placing foreign nonresident corporations upon a basis of taxation similar to that employed with respect to domestic corporations.

25 (a). A modification of the \$40,000 general estate tax exemption (and also the \$100,000 estate tax exemption granted by the 1926 Act) so that an equal benefit is derived from the exemption by both large and small estates.

(b). An elimination of the \$40,000 general estate tax exemption (and the \$100,000 estate exemption) in the case of estates exceeding \$1,000,000 in net value excluding the exemption.

(c). A redevelopment of the estate tax structure so that the effect of the \$40,000 general estate tax exemption (and the \$100,000 exemption granted by the 1926 Act) is limited to a normal estate tax not exceeding 20%.

(d). A provision similar to that mentioned in (a), (b) and (c) above with respect to the insurance proceeds exemption of \$40,000 on policies payable to named beneficiaries.

26(a). A prospective provision generally to the effect that the proceeds of life insurance shall be subjected

to estate tax to the extent that the decedent has paid premiums on the insurance or in their full amount where he possesses at the date of his death some incident of ownership over the policies.

(b). A provision as to cross-insurance policies along the lines suggested in Memorandum A, page 39, subjecting the proceeds of such policies to income tax at the regular rates, or to a special excise tax at a flat rate of 10%.

(c). A comparative statement showing the effect of this amendment generally as compared with an amendment modified on the basis of cash surrender value or ratio on the time basis, as described on page 39 of Memorandum A.

27 (a). A provision limiting the tax exempting effect now applicable in the case of special powers of appointment as indicated on page 43 of Memorandum A with an exception that special powers made thereunder can be exercised free from estate tax only among the children of the donor or donee and where the property in default of appointment is to be distributed among that class.

(b). A provision imposing a succession or inheritance tax on the value of remainders under a will, to be imposed at the death of the life tenant at rates equal to the existing estate tax rates.

28. A provision subjecting reverter interests to estate tax taxation where the decedent retains any valuable interest in his property by which he postpones final disposition thereof until his death, such as the interest involved in the St. Louis case mentioned on page 43.

29. A provision that gifts by persons over 60 years of age shall be subject to an irrebuttable presumption that they were made in contemplation of death.

30. A provision precluding the estate tax deductibility of uncollectible claims.

31. A provision limiting the \$4,000 gift tax exemption to gifts to members of the donor's immediate family.