DIARY

Book 81

Tax Revision Studies, 1937 - Volume I

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General Statement, Revenue Estimates, Summaries, and Recommendations

VOLUME I

TAX REVISION STUDIES, 1937

GENERAL STATEMENT, REVENUE ESTIMATES, SUMMARIES AND RECOMMENDATIONS

General
Statement

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE AUG 1937

TO Mr. Magill

FROM Mr. Haas

Subject: TAX REVISION STUDIES, 1937 - General Statement

1. Range of Studies and Recommendations

In a memorandum dated July 7, 1937, you requested that the Division of Research and Statistics undertake the preparation of a series of tax studies, as follows:

"1. An outline of the taxes which you believe should constitute the Federal tax system, together with the estimated yield therefrom during the fiscal year 1938-39. Needless to say, the total yield of the recommended taxes must be sufficient to meet the estimated expenditures.

"2. A detailed statement of the precise changes which you feel should be made in the present Federal tax system to accomplish (a) your general recommendations outlined in (1) above; and (b) any additional improvements in detail which the system requires.

"3. All necessary supporting data to enable us, and later Congress, to act intelligently upon your proposals. Included in such data should be statements of the history of the particular form of tax, its use or adoption in other jurisdictions, and the arguments for and against it, not only in respect to its productivity but also in respect to its effect upon the social and economic life of the country.

"As I understand it, your Division has already prepared a considerable number of detailed memoranda which will serve the purposes outlined above. Iwould like the entire body of material organized in binders in such a way as to make it available for ready reference and use."

In response to this request, the findings and recommendations of the Division are presented in the six manuscript volumes that comprise this report. Although every effort has been exerted to make these studies as thorough and as inclusive as possible, the fact that only a relatively short time was available for the completion of the entire project naturally proved a severe limitation. In many respects, therefore, particularly as respects details, our recommendations should be regarded as tentative rather than as definitive.

In our appraisals and recommendations we have attempted to avoid going beyond the limits of the existing constitutional framework and the present distribution of functions and powers between the Federal and State governments. Partly for this reason, but more importantly because of the complexity of the problem and the limited time available to us, our studies have not included any comprehensive and detailed analysis of the general problem of conflicting and overlapping taxation between Federal, State, and local governments; although our recommendations with respect to certain Federal taxes are designed in part to reduce the area of such conflict. Likewise, because the revenue aspects of customs duties are in many cases transcended in importance by other considerations of public policy, only incidental recommendations have been made in connection therewith. The like is true of various Federal taxes imposed for regulatory purposes primarily. Finally, we excluded an appraisal of the taxes levied under the Social Security and related Acts.

II. General Character and Objectives of Proposed Changes

Virtually all students of taxation would agree that the major requirements of a sound tax structure are, first, that it produce adequate revenues; second, that it be equitable; third, that the non-fiscal influences that must inevitably be exerted by each of its component parts be such as produce a minimum of undesirable economic and social consequences; and fourth, that administration of and compliance with the various elements of the tax structure be as simple as possible.

Unfortunately, these desirable characteristics are mutually incompatible in part; and, equally unfortunately, agreement respecting these objectives in the abstract by no means insures agreement respecting them in the concrete. Simplicity of administration and ease of compliance are ideals that notoriously conflict with the demands of equity in many cases. Likewise, equity often conflicts with productivity or with the desire to avoid unfavorable non-fiscal consequences. Every tax system inevitably represents a compromise among these several aims.

The general character of the changes proposed in this report may be summarized as follows:

(1) The annual volume of Federal revenues under the economic conditions, which we estimate will prevail in fiscal year 1939, is raised to approximately $9 billions, assuming that the new law has been effective so as to have had its full effect on revenues for an entire collection year. This estimate is exclusive of statutory increases in social security taxes now scheduled for future years, which will add, in addition, more than $1 billion annually by 1949. The level of approximately $9 billions of revenue as above described is predicated upon the adoption of the suggested tax provisions and rates of tax <u>in their entirety</u>. It is evident that any changes made in these provisions or rates either now or in the future will also change the estimated level of Federal revenues.

The fluctuations in Federal revenues at varying stages of the business cycle may be sharper than under the present law due to the greater reliance upon progressive direct taxes the yields from which are highly sensitive to changes in property values and in the national income. Changes in the law regarding these progressive direct taxes are slow to be reflected in Federal revenues due to the definite lag (a) between the time income is earned and the time of collections of taxes levied on these incomes, and (b) between the time of death of a decedent and the time when the estate tax is paid.

Thus if the proposed provisions of the Revenue Act of 1938 were enacted into law by June 30, 1938, the estate tax provisions following past custom would be made effective on the estates of decedents dying after the time of signing of the Act and the final payment of the estate tax would not be due and payable until one year after death. Hence, the only effect on fiscal year 1939 revenues of the proposed changes in the estate tax law would be the payment of estate taxes under the provisions of the new law by some estates before such payment is finally due.

The income tax provisions would probably be made retroactive to January 1, 1938 but the increase in Federal revenues due to these new provisions will appear for the first time in the collections accompanying the income tax returns which will be filed on March 15, 1939. Because of the privilege of making quarterly installment payments of these tax liabilities only two quarterly payments will be received in fiscal year 1939 under the provisions of the new law from those taxpayers who elect to use the quarterly installment payment method.

For the fiscal year 1939, with the recommended changes only partially effective, aggregate Federal revenues are estimated at $8,008 millions, or some $835 millions more than the estimate under the existing laws, but $985 millions less than the $8,993 millions which the new law is estimated to produce when fully effective under similar economic conditions. A basic tax structure capable of yielding revenues in these amounts under economic conditions substantially similar to those now prevailing would appear to meet any practicable current standard of adequacy as measured by the estimates of Federal expenditures including provisions for debt retirement.

(2) In the belief that direct taxes levied at progressive rates best satisfy the present-day concept of equity in taxation, and in the further belief that such taxes result in a minimum of undesirable economic and social effects, the bulk of the estimated revenue increases provided by the recommended changes would be derived from alterations in the tax treatment of individual incomes and estates and gifts.

The tables on Page 16 and Page 17 indicate not only the relative importance of the various proposed changes in the revenue law affecting the individual income and estate taxes but also the relative yield of the individual income tax and estate tax provisions of the proposed law compared with those contained in the Revenue Act of 1936. The most important increase in the revenue yield of the individual income and estate taxes is achieved by alterations in the rate schedules.

On the basis of the level of individual incomes estimated for the calendar year 1938, the full application of the recommended changes would increase the estimated yield of individual income taxes from $1,728 millions under the present law to $2,672 millions, or by 54.6 percent. A comparison of the estimated estate tax liabilities for returns estimated to be filed during fiscal year 1939, computed under the provisions of the Revenue Act of 1936 and under the full application of presently proposed provisions for a Revenue Act of 1938, show estate tax liabilities of $401.8 millions and $1,084.5, respectively. This represents a 169.9 percent increase in estate tax liabilities.

(3) The equitable character and the general economic effects of the Federal corporation taxes are improved by the elimination of the capital-stock, excess-profits, and normal corporation income taxes; by the substitution for these of a corporation privilege tax measured by net income as specially defined for this purpose; and by related and other alterations in the undistributed profits tax.

(4) The relative role of indirect taxes in the Federal revenue structure is diminished.

III. General Economic Background of Proposed Changes

1. Basic adequacy versus year-to-year balance: Under present-day conditions and in an economy as fluctuating as that of the United States, a year-to-year balance in Federal revenues and expenditures would constitute a superficial and unrealistic criterion of the adequacy of the Federal tax structure. The expenditures of the Federal Government have been rising to successively higher plateaus over a long period of years and they now constitute an important fraction of the whole national income -- about 12 percent. A tax structure designed to meet such a level of expenditures must, almost of necessity, yield highly variable annual revenues. This variability becomes greatly pronounced if, in accordance with present-day concepts of the demands of equity, considerable reliance is placed upon progressive direct taxes. The latter are peculiarly unstable in yield because they tap highly sensitive constituents of the national income, such as business profits and dividends.

The successively higher plateaus in the level of Federal expenditures have been accompanied in the past, as they doubtless will in the future, by temporary periods of abnormally high expenditures arising out of such special factors as wars and serious business depressions. The timing and needs of such temporary periods are impossible to forecast; and attempts to create temporary tax structures adequate to meet the year-by-year needs of such abnormal periods encounter grave practical difficulties and involve highly undesirable economic consequences, although counterbalancing necessities sometimes outweigh these evils. The marked lag in collections ordinarily experienced from new or increased direct taxes is well known; and the economic objections to frequent changes in other parts of the tax structure are discussed below. In general, a tax structure which, over a period of years, perhaps a decade or more, yields sufficient revenues to meet all the expenditures of the period, including the retirement of debt created to meet temporary deficiencies, would appear to satisfy any reasonable and realistic test of adequacy, if its framework be such as to permit flexible response to anticipated increases in requirements without drastic change.

2. Desirability of Stable Tax Structure: Attempts to seek a year-to-year balance in revenues and expenditures must of necessity involve exceedingly frequent changes in the tax structure. Frequent changes, however, unless confined largely to the rates of individual income taxes, give rise to great inequities and to highly undesirable economic consequences. The whole field of the shifting and final incidence of the various types of taxes is yet to be explored in detail by economists. It is impossible for legislators to be aware at all accurately in advance, in the present state of knowledge, of the final incidence of most excise taxes, customs duties, and even corporation taxes.

In the case of excise taxes and customs duties, every increase or decrease in rates or coverage introduces an extraneous disruptive influence upon the relative competitive positions of different commodities and of those dealing in them. The extent to which a given increase or decrease in rates will be borne by suppliers, middle-men, or ultimate consumers, will vary greatly according to the relative elasticities of demand and production for the various products and the associated service involved. A tax on processors of wheat, for example, may actually be borne by the farmer; a tax on salt, by the consumer; and a tax on proprietary medicines is likely to be divided between the producers and consumers.

In the case of corporation taxes, the rates and related provisions that have been in force for any length of time are likely to have been capitalized and discounted in the market prices of the corporate securities, or reflected, in some cases and to an unknown extent, in the prices of the products and services of the corporations. Taxes which are measured by corporation incomes constitutes deductions from the incomes available to holders of corporation common stocks, primarily, rather than the holders of corporate preferred stocks and bonds. The whole capitalized value of an increase in such taxes tends to be borne by those common stockholders who own the stocks at the time the increase is made; for the market prices of common stocks will tend to decline by the full capitalized value of such increases. Analogously, the whole capitalized value of decreases in corporate income taxes tends to constitute an unexpected bonus to the common stockholders who own the stocks at the time of such decrease.

Considerations of the character advanced in the foregoing three paragraphs constitute the origin and meaning of the old adage that the best tax is an old tax: The long series of competitive economic adjustments have already been made in the case of an old tax; they must newly be made in the case of a new tax or an increase in rates or coverage.

3. Flexibility: The general economic considerations that argue in favor of a stable tax structure, though frequently ignored, are extremely important; for the Federal tax structure constitutes an exceedingly significant part of the whole competitive framework. And, as previously implied in our discussion of corporation taxes, stability is also desirable in the interest of equity. Nevertheless, an adequate tax structure must possess elements of flexibility.

Of all the constituents of the existing or proposed Federal tax structure, the one that lends itself best as an instrument of flexibility in Federal revenue yields is the individual income tax. Unlike internal excises, customs duties, and corporation taxes, the final incidence of an increase or decrease in rates of the individual income tax is known in advance. For practical purposes, the impact of such increases or decreases may be said to fall exclusively upon the taxpayers immediately affected.

Estate and gift taxes, though also direct and levied at progressive rates, by no means lend themselves as equitably for this purpose. An individual's estate is normally accumulated over a long period of years. It would appear to violate every consideration of equity if the rates to be paid by his heirs on the capital value of the whole estate should be determined by the revenue requirements of the year of death. It would be difficult to defend as a general policy that the tax treatment of equal estates left by two individuals should differ greatly because the death of one preceded that of the other by a few days, a few weeks, or a few months. Estate and gift tax rates should be stable.

The tendency exhibited during the depression years to introduce a great variety of new excise taxes, and to raise the rates on old ones, to make up for the diminished receipts from direct taxes is not a wholesome one. A few basic excise taxes may be defended as permanent and important sources of revenue from the lower income groups which cannot, for administrative reasons, be reached satisfactorily through income taxes. But, for reasons previously advanced, the economic effects of frequent and important changes in excises are wholly undesirable. Similar considerations argue against frequent changes in corporation taxes.

There are rare occasions, such as when the credit of the Federal Government is threatened, or when a pronounced inflationary rise in prices threatens to get out of hand, or when military needs dictate the diversion of a maximum proportion of the country's expenditures from ordinary consumption goods, when the ill-effects of changes in excise taxes are more than balanced by the competing requirements of public policy. Barring such extraordinary occasions, however, changes in excise taxes should be infrequent.

4. Stable Tax Structure Versus Stable Revenues: It is clear that there is a real conflict, in an economy as variable as that of the United States, between a stable tax structure and one that produces stable annual revenues; a conflict that becomes more pronounced when, in response to the demands of equity, a large role in the tax structure is given to direct taxes levied at progressive rates. In previously discussing this conflict, we have indicated that a tax structure which produces unstable annual revenues may nevertheless be amply adequate over an appropriate period of years, such as an economic cycle; and we have further indicated the great desirability, on both economic and equitable grounds, of a stable tax structure.

Certain further considerations of fundamental economic import suggest the positive desirability of substantial variations in annual revenues when these variations are produced by a basically adequate and stable tax structure which relies heavily upon progressive direct taxes.

In periods of business recession, such a tax structure will produce a marked decline in revenues at the very time when the financial requirements of the Government are likely to increase substantially. The result is a budgetary deficit, which is financed in the ordinary course by the sale of interest-bearing obligations to banks and other investors. The funds so borrowed will come either from the real savings of private and institutional investors or from an expansion of bank credit. In either case, the effects of the borrowing will be stimulating to the national economy.

In the opinion of an important body of present-day economists, a business depression is characterized by a lack of balance between saving and investment. During such a period the unpromising or threatening outlook causes individuals and institutions to withhold funds representing bona fide savings from current investment in concrete, durable goods; and this withholding creates a volume of unemployment of both labor and capital, corresponding to the excess of such savings over current investment. If such abortive savings are borrowed by the Federal Government and expended in the current employment of labor and capital, the effect is to increase the national income by virtually the whole of the sums so borrowed, or even more. In this way, during a period of abnormal unemployment, an unbalance of the Federal budget may be said to help to redress the unbalance of the entire economy.

If, instead of being financed by bona fide savings, the Federal deficit is financed by an expansion of bank credit, the stimulating effect is of the same character but is even more marked. Under our present banking structure, periods of subnormal business activity are characterized by ample or excess bank reserves, by a small demand for business borrowing on the part of acceptable borrowers, and by the unattractiveness for bank investment of many securities which are ordinarily acceptable. These factors make it possible and profitable for banks to add substantially to their purchases of Government securities by an expansion of deposit credit. Such an expansion, which may or may not completely offset the contraction occurring in bank credit to private parties during such a period, is wholly desirable. The purchasing power acquired by the Government through such borrowing is entirely new, and not, as in the case of tax money, acquired at the expense of others. Such borrowing has the same effect, in the first instance, as the borrowing of idle savings; but, in addition, it leaves behind it a quasi-permanent expansion in the circulating medium, which helps to counteract the deflationary forces operating in such periods.

If, in contrast to borrowing, the Federal Government attempts to meet its current expenditures by the imposition of new taxes, such degree of success as is obtained tends to be achieved at the expense of the entire economy. The most productive taxes during such periods are excise taxes which are largely paid by the lower income groups, and from funds which would be expended in any event. Hence, an increase in governmental revenues so obtained only adds to the deflationary forces already operating upon private business.

The subsequent repayment of the public debt from revenue surpluses which, under the type of tax structure here recommended, would occur during periods of prosperity, would likewise be beneficial to the whole economy. Periods of prosperity, particularly periods of abnormally great prosperity, are distinguished from those of depression in that investment in concrete durable goods tends to outrun the accumulation of real savings. The effect of the repayment of the public debt from the proceeds of taxation during periods of prosperity is to add to the current volume of savings available for investment; and therefore prevents or retards the rise in interest rates that so frequently initiates a business depression.

From a monetary standpoint, the same effects upon the economy as those arising from operations in interest-bearing debt might be achieved at substantially lower fiscal costs by the issuance and subsequent redemption of paper currency, or by obtaining non-interest-bearing loans from the Federal Reserve banks during periods of depression and repaying them in periods of prosperity. Such operations are undesirable primarily because they would constitute a shock to business confidence, a shock which is not involved in operations of a more orthodox character; and a shock that would be justified in part by the greater danger that such operations, once resorted to during periods of depression, would be less apt to be redressed, than interest-bearing debt transactions, by retirements during periods of prosperity.

5. Relation to National Savings: In addition to the use of abortive savings during depressions, just cited, there is another important respect in which the type of tax structure here recommended would influence the aggregate volume of saving and consumption. Practically all of the saving of the country, other than that performed by governmental units, is done by the middle and upper income classes, and a very large proportion of the total is done by the highest income classes. This fact, in conjunction with the very high rates proposed for the upper brackets of the income and estate taxes, is likely to lead to a significant reduction in the volume of private saving.

The older view of the classical economists was that savings were an unlimited blessing and that taxes which fall upon funds that would otherwise be saved are less desirable, other things being substantially equal, than those which fall upon funds that would otherwise be expended for current consumption. The newer view is that savings are a social blessing only to the extent that they can find actual current investment. In other words, the important thing is a proper balance between the annual volume of consumption, savings, and investment.

There is good reason to believe that the type of tax structure here recommended will help lead to such a better balance. The taxes levied under the contributory old-age retirement provisions of the Social Security Act fall principally upon segments of income which would otherwise be expended for current consumption, and divert them instead for a long period of years to the retirement of the privately held public debt. Such debt retirement, whether arising from this source or from the ordinary revenues of the Federal Government, will constitute a very significant volume of saving; the amounts so paid to holders of Government bonds will become available for private investment. A vast and involuntary increase in the savings to be made by members of the lower income groups under the Social Security Act might well have decidedly unfavorable and profound economic repercussions if this volume of income withdrawn from current consumption were not offset in considerable measure by a reduction, through taxes levied to defray ordinary Government operating expenditures, in those segments of the incomes of wealthy individuals which would otherwise be saved by them.

IV. Fiscal Background of Proposed Changes

1. Level of Revenue Requirements: During the last four fiscal years, the annual expenditures of the Federal Government, exclusive of expenditures for debt retirement, and exclusive of soldiers' bonus outlays aggregating $2,230 millions, were as follows:

1934 -	$ 6,745 millions
1935 -	6,802 millions
1936 -	6,803 millions
1937 -	7,445 millions

The budget estimates of expenditures for the fiscal year 1938, as revised in April 1937, aggregate $7,324 millions, exclusive of debt retirement.

The budget estimate for the fiscal year 1938 includes $1,820 millions for recovery and relief, and the amount of this item might well be expected to fall substantially during the next few years. On the other hand, the Federal Government is committed to growing outlays for grants to the States under the Social Security Act, notably for old-age assistance and for various social welfare purposes. Unlike scheduled increases in other social security expenditures, those just cited are not covered by any scheduled increases in tax revenues. These uncovered social security expenditures, which are estimated at $225 millions for the fiscal year 1938, are scheduled to rise to $565 millions annually by 1945.

Further, it is by no means certain that all the expenditures now included under the head "recovery and relief" will be eliminated in the near future. Part of these expenditures are now serving purposes that might otherwise be covered by normal appropriations, such as those for public roads, river and harbor improvements, naval construction, et cetera. Moreover, the estimated 1938 expenditures for recovery and relief already represent a reduction of $1,026 millions from those of 1937 and of $1,471 millions from those of 1936. It is not unreasonable to assume that perhaps one-half of the 1938 level of expenditures for recovery and relief may continue, possibly in altered form, for some time to come. Under these circumstances, the ordinary operating expenditures of the Federal Government, exclusive of the increases in requirements under the cited sections of the Social Security Act and other statutes, and exclusive of debt retirement, may be estimated at approximately $6.5 billions.

To this sum must be added provision for debt retirement. The statutory Sinking Fund alone, which is now deficient by approximately $619 millions, will call for annual appropriations ranging upward from $600 millions. It is doubtful, however, that the program of debt retirement during the next several years should be limited to the statutory Sinking Fund requirements. During the past seven fiscal years, the interest-bearing public debt has risen by nearly $20 billions. Debt retirement at a rate of $1 billion to $1.5 billions a year would be no more than prudent. This would raise the annual revenue requirements of the Federal Government to between $7.5 and $8 billions annually.

As described on Page 3, the proposed changes could not be fully reflected in collections during the first fiscal year after their enactment. Even if enacted by June 30, 1938, the program is estimated to yield only $8,008 millions for the fiscal year 1939, as against $8,998 millions when fully effective, assuming business conditions substantially similar to those now prevailing.

The $1 billion "excess" revenue receipts over indicated annual revenue needs of approximately $8 billions will allow for (a) contingent requirements and (b) certain adjustments in the recommended program which were not made initially, primarily because of revenue considerations.

As for contingencies which may result in increased Federal revenue requirements, it should be pointed out that the computed rate of interest being paid upon the public debt July 31, 1937 is only 2.58 percent, an abnormally low rate as compared with any since the World War. It is altogether conceivable that a rise in market rates of interest might increase th annual interest charge upon the budget by $100 millions or more, as portions of the maturing debt are refunded. The portion of the public debt acquired for the Old Age Reserve Account will, by statute, bear interest at the rate of 3 percent. In addition, a number of the newer functions undertaken by the Federal Government during the past few years may require increasing financial outlays for some time to come.

If, after taking into consideration such contingencies, the revenue which it is estimated that the recommended program will yield when fully effective is still thought to be excessive, then either before the enactment of the program or in subsequent years, one or more of the following adjustments could be made: (a) Eliminate more of the excise taxes discussed in the memorandum on Excise Taxes and recommended for temporary or permanent retention primarily on the basis of revenue considerations; (b) lower the rates recommended for the new corporate privilege tax; (c) under the income tax, allow losses to be carried forward for some period longer than the recommended two years; (d) lower the normal individual income tax rate; (e) reduce the Federal tax upon the sale of gasoline and possibly, also, upon other excises; (f) allow capital losses to offset ordinary income to some extent; and (g) lower the personal exemptions to some level above the recommended $800 and $2,000 for single and married persons, respectively.

2. Stability of Tax Structure: The recommendations made herein are designed to provide a stable tax structure. The figures already cited indicate that the revenue yield in years of satisfactory economic conditions would be ample both to meet the expanded requirements of the Government and to provide substantial surpluses, above statutory Sinking Fund requirements, for debt reduction.

All the increases in revenues estimated to be provided by the recommendations made herein are from permanent taxes. Should conditions permit, however, reductions in revenues can be effected with minimum economic disruption and maximum equity, by reductions in the rates of the individual income tax. The tax treatment proposed for capital gains and losses is far less arbitrary than that now or previously in effect and permits of indefinite continuance. The changes recommended in corporation taxes, including the undistributed profits tax, the substitution of a privilege tax for the present corporation income, capital-stock, and excess-profits taxes, are such as may be continued indefinitely. The increased schedule of rates proposed for estate taxes and the coordination of the estate and gift taxes would provide a highly important and permanent source of additional Federal revenues.

3. <u>Equity and Administrative Simplicity:</u> The proposed changes would greatly increase the absolute and relative role of progressive direct taxes in the Federal revenue structure and would diminish the absolute and relative role of indirect taxes.

While no important improvement is recommended as respects either administration or compliance, save with respect to the sharing of estate tax revenues with the States, it is not believed that the other changes recommended herein would involve any material additional burden as respects administration or compliance.

4. <u>Detailed Estimates of Revenue Effects of Proposed Changes:</u> The following four tables portray the effects of the proposed changes upon the Federal revenues as compared with the estimated revenues under existing law:

Revenue
Estimates

Comparison by taxes proposed to be changed, of revenue estimates for fiscal year 1939 under present law and under August 1937 tax proposals of Division of Research and Statistics for Revenue Act of 1938 assumed to be enacted on June 30, 1938

(Dollar figures in millions)

General and special accounts (On basis of daily Treasury statement, unrevised)	(1) Under present law	(2) Assuming new law passed by June 30, 1938 1/	(3) Difference: (2) - (1)	(4) Percent increase or decrease (2) over (1)
Corporation taxes:				
Privilege tax	-	$ 708.9	$708.9	-
Normal tax (current)	$1,160.0	590.7	-569.3	-49.1
Undistributed profits tax (current)	85.0	82.8	- 2.2	- 2.6
Back taxes	158.9	158.9	-	-
Excess-profits tax	33.2	18.5	- 14.7	-44.3
Capital-stock tax	145.0	145.0	-	-
Total corporation taxes	$1,582.1	$1,704.8	$122.7	7.8
Individual income taxes:				
Current taxes 2/	$1,622.0	$2,185.7	$563.7	34.8
Back taxes	101.1	101.1	-	-
Total individual taxes	$1,723.1	$2,286.8	$563.7	32.7
Other suggested changes in the law:				
Estate tax 2/	$ 401.8	$ 521.0	$119.2	29.7
Gift tax 2/	26.8	5.0	-21.8	-81.3
Stock transfers	36.0	91.3	55.3	153.6
Toilet preparations, etc.	20.5	14.7	- 5.8	-28.3
Radio sets, phonograph records, etc.	7.9	10.1	2.2	27.8
Sporting goods, cameras, and lenses	8.7	8.4	- .3	- 3.4
Total	$ 501.7	$ 650.5	$148.8	29.7
All other revenues and receipts (unchanged)	$3,365.8	$3,365.8	-	-
Total receipts, general and special accounts	$7,172.7	$8,007.9	$835.2	11.6

1/ It is assumed that the new corporation and individual taxes become effective for taxable years beginning after December 31, 1937; that all other new taxes become effective after June 30, 1938; and that the capital stock tax liability for the fiscal year ending June 30, 1938 will be collected in full.

2/ The estimated receipts under the new individual income tax, estate tax, and gift tax proposals make no allowance for the possible breaking up of estates by gift during the period which must elapse between the announcement of the new revenue proposals and their enactment into law.

Comparison, by taxes proposed to be changed, of revenue estimates for fiscal year 1939 under present law and for a hypothetical fiscal year 1939 (which assumes that collections reflect a full year's operation of the proposed act) under the August 1937 tax proposals of the Division of Research and Statistics for a Revenue Act of 1938

(Dollar figures in millions)

General and special accounts (On basis of daily Treasury statement, unrevised)	(1) Under present law	(2) Assuming full year's effect of new law 1/	(3) Difference (3) - (1)	(4) Percent increase or decrease (3) over (1)
Corporation taxes:				
Privilege tax	-	$1,398.0	$1,398.0	-
Normal tax (current)	$1,160.0	-	-1,160.0	-100.0
Undistributed profits tax (current)	85.0	73.4	- 11.6	- 13.6
Back taxes	158.9	158.9	-	-
Excess profits tax	33.2	-	- 33.2	-100.0
Capital-stock tax	145.0	-	- 145.0	-100.0
Total corporation taxes	$1,582.1	$1,630.3	$ 48.2	3.0
Individual income taxes:				
Current taxes 2/	$1,622.0	$2,672.0	$1,050.0	64.7
Back taxes	101.1	101.1	-	-
Total individual taxes	$1,723.1	$2,773.1	$1,050.0	60.9
Other suggested changes in the law:				
Estate tax 2/	$ 401.8	$1,084.5	$ 682.7	169.9
Gift tax 2/	26.8	5.0	- 21.8	-81.3
Stock transfers	36.0	102.4	66.4	184.4
Toilet preparations, etc.	20.5	13.5	- 7.0	-34.1
Radio sets, phonograph records, etc.	7.9	10.5	2.6	32.9
Sporting goods, cameras, and lenses	8.7	8.3	- .4	- 4.6
Total	$ 501.7	$1,224.2	$ 722.5	144.0
All other revenues and receipts (unchanged)	$3,365.8	$3,365.8	-	-
Total receipts, general and special accounts	$7,172.7	$8,993.4	$1,820.7	25.4

1/ Assuming that the new law had been effective so as to have had its full effect on revenues for an entire collection year. The estimated receipts under the new corporation and individual tax proposals are based upon calendar year 1938 levels of income. All other items of this column are based upon the same levels of income as are the corresponding data of column (1).

2/ The estimated receipts under the new individual income tax, estate tax, and gift tax proposals make no allowance for the possible breaking up of estates by gift during the period which must elapse between the announcement of the new revenue proposals and their enactment into law.

Comparison of estimated individual income tax liabilities based on calendar year 1938 incomes under the provisions of the Revenue Act of 1936 and those of the August 1937 tax proposals of the Division of Research and Statistics for a Revenue Act of 1938

	(Millions of dollars)
Estimated liabilities Revenue Act of 1938	$2,672.0
Estimated liabilities Revenue Act of 1936	1,727.8
Increased liabilities due to Revenue Act of 1938	$ 944.2
Percentage increase in tax liability	54.6%

The following tabulation shows the estimated increase (+) or decrease (-) in these total individual income tax liabilities made by each proposed revision, assuming that the specified revision in each case is the last revision made in the law (i.e., if adjustments have been made for all other revisions.) In other words the amounts shown are the amounts of revenue which will be lost (+) or gained (-) if all proposed provisions are adopted except the one indicated. 1/

	(Millions of dollars)
New surtax rates	$ + 575.0
Separate returns taxed at joint return rates	+ 297.0
New method of taxing capital gains and losses	+ 138.6
Reduction in personal exemptions	+ 98.5
Increase in earned income credit	- 31.6
Limitation of deductions for contributions	+ 14.9
Carry-over of net deficits	- 5.6
Foreign income of nonresident citizens	+ 5.0
Increase in maximum age of dependents - to "under 20 years of age"	- 3.0
Reporting of loss of worthless stock as a regular capital loss	+ 1.0

1/ If two or more of the suggested proposals are not enacted into law the amount by which the revenue estimates must be reduced is not the sum of the amounts shown opposite each of the specified provisions. It will be less than that amount and will require a new estimate due to the interdependence of the estimates.

Comparison of estimated estate tax liabilities for returns estimated to be filed during fiscal year 1939 computed under the provisions of the Revenue Act of 1936 and under the August 1937 proposals of the Division of Research and Statistics for a Revenue Act of 1938

	(Millions of dollars)
Estimated estate tax Revenue Act of 1936	$ 401.8
Estimated estate tax Revenue Act of 1938	1,084.5
Increased liabilities due to Revenue Act of 1938	$ 682.7
Percentage increase in tax liability	169.9%

The following tabulation shows the estimated increase in these total estate tax liabilities made by each proposed revision, assuming that the specified revision in each case is the last revision made in the law (i.e., if adjustments have been made for all other revisions.) In other words the amounts shown are the amounts of revenue which will be lost if all proposed provisions are enacted into law except the one indicated. 1/

	(Millions of dollars)
Revision of tax rate	$425.1
Revision of specific exemption	175.0
Tax on capital gains	125.0
Revision in deduction of charitable bequests	50.2
Revision in deduction of insurance	33.5
Revision in deduction of property taxed within 5 years	14.1

1/ If two or more proposals are not enacted into law the amount by which the revenue estimates must be reduced is not the sum of the amounts shown opposite each of the specified provisions. It will be less than that amount and will require a new estimate due to the interdependence of the estimates.

Summaries and
Recommendations

TAX REVISION STUDIES, 1937

SUMMARIES OF FINDINGS AND RECOMMENDATIONS

In the following section there are presented collectively, for purposes of convenient reference, the summaries of the findings and recommendations respecting each of the taxes examined. These summaries, copies of which are included also at the beginning of the separate volumes of the Tax Revision Studies, outline briefly the criteria which governed the examination of the tax structure. They indicate also the major considerations affecting the recommendations and state the specific recommendations themselves.

The detailed treatment of the various taxes will be found in the several volumes, as follows:

Volume II - Income, Capital Stock, and Excess-Profits Taxes.

Volume III - Capital Gains Tax.

Volume IV - Undistributed Profits Tax.

Volume V - Estate and Gift Taxes.

Volume VI - Excise Taxes.

Income, Capital Stock and Excess Profits

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE

TO Mr. Magill

FROM Mr. Haas

Subject: TAX REVISION STUDIES, 1937: INCOME, CAPITAL STOCK, AND EXCESS-PROFITS TAXES

SUMMARY OF FINDINGS AND RECOMMENDATIONS

In the accompanying memorandum consideration, viewed primarily from an economic standpoint, has been given to certain features of the Federal income, capital stock, and excess-profits taxes. The proposals contained herein are predicated upon three objectives: (1) The placing of increasing reliance upon the progressive taxes, (2) the coordination of the individual and the corporate income taxes, and (3) the elimination of existing structural inequities. The more significant of the conclusions are as follows:

1. With a view to increasing the relative importance of the individual income tax in the Federal revenue structure and with a view to facilitating the elimination of less desirable regressive taxes, it is recommended that the level of the surtax rate schedule be increased. Specifically, it is proposed that the present rate schedule be replaced by a new rate schedule ranging from 3 percent on surtax net income of $3,000 to $6,000 to 75 percent on surtax net income of $5,000,000 and over. In addition to affording the individual income tax a larger role in the revenue structure, the proposed rate revisions will enable a more scientific distribution of the aggregate Federal tax burden and will impose a justifiable addition to the tax burden of the middle size incomes.

2. It is recommended that the present personal exemption of $1,000 for single persons and $2,500 for married persons, be reduced, respectively, to $800 and $2,000. This will broaden the individual income tax base, making it applicable to a substantially larger number of taxpayers and will, in addition, increase the burden upon individuals subject to surtax rates. Although a lowering of personal exemptions will increase Federal revenue, the recommendation is primarily prompted by the desirability of obtaining substitute revenue from the low income classes in a more equitable manner than is possible through the miscellaneous excise taxes. It is recognized that the eventual elimination of even the least desirable indirect taxes cannot be realized so long as the personal exemptions are maintained at a relatively high level.

3. Inasmuch as the lowering of personal exemptions to the levels of $800 and $2,000 might unduly burden the recipients of small incomes, it is recommended that the earned income credit be raised from 10 percent to 15 percent and that the limitation of the earned income credit to 10 percent of net income be eliminated.

4. The two existing corporate privilege taxes, the corporate normal income tax and the capital stock tax, are believed to be relatively high as well as defective. The corporate normal income tax allows corporations with a substantial volume of business to escape the privilege tax in years of unprofitable operation. The capital stock tax overcomes this difficulty as far as concerns the taxing of corporate privilege because it applies annually to both profitable and unprofitable business corporations. It, however, is deficient in its arbitrary determination of taxable base (adjusted declared value). In combination, the two taxes are inadequate for the taxation of corporate privilege because corporations with net income pay both taxes each year whereas corporations with no net income pay only the arbitrary capital stock tax. It is, therefore, recommended that the corporate normal income tax and the capital stock tax be repealed.

5. The present capital stock and excess-profits taxes were linked for the purpose of furnishing a base for a capital stock tax as a corporate privilege tax and for establishing a base for an excess-profits tax. Neither of these objectives were achieved. On three occasions (Revenue Acts of 1934, 1935, and 1936) the corporate taxpayer has been enabled to determine that tax base which, considering the profitableness of its business, the fluctuations in such profits from year to year, and the prospects for repeal of these taxes, would result in the least aggregate amount of tax liability. Taxes which leave the taxpayer options of this character are undesirable. Furthermore, the present interrelationship of the capital stock and excess-profits taxes holds no promise of resolving the vexing problems associated with the establishment of an excess-profits tax base. It is, therefore, recommended that the repeal of the capital stock tax be accompanied by the repeal of the excess-profits tax. This, it is noted, will in no way jeopardize the opportunity of establishing a satisfactory excess-profits tax base for future use.

6. It is recommended that the present corporation normal income tax, capital stock tax and excess-profits tax be replaced by a new corporation privilege tax. The present corporation normal income tax favors corporations whose capitalization is made up of stocks and bonds, as against those with stocks only. Furthermore, the base for the existing corporation normal income tax favors corporations that rent business properties as against those that own them. Since a corporation privilege tax should properly tax corporations in accordance with the scope of their operations and in accordance with the

return on the entire amount of capital operating in the business, but without regard to the character of the capital structure, it is recommended that for purposes of the new corporate privilege tax interest, rents, and royalties be disallowed as deductions and that the income of corporations include tax-exempt interest as well as inter-corporate dividends, rents and royalties.

7. The incomes of husbands and wives are not taxed as a unit under the present law. Husbands and wives may, at their option, file separate or joint returns. The husband and the wife may each report such income as is viewed to be theirs under State property laws. In community property States the usual division is one-half of the community income to each spouse; the practice followed in other States is less uniform. This results in interstate variations of Federal income tax burden. In addition, the use of separate returns enables wealthy husbands and wives to avoid high surtax rates, which would otherwise be applicable. If the incomes of husbands and wives be viewed as a unit, then to overcome the inequities resulting from the existing practice, it is recommended that when husbands and wives file separate returns, the tax liability should be determined on the basis of their aggregate income, prorated to each in accordance with the amounts of their separate incomes.

8. The present income tax base is determined primarily on an annual basis. Over a period of years and under existing progressive corporation and individual rates, this imposes a higher tax upon taxpayers receiving variable sources of income than upon those receiving stable sources of income, even though the aggregate amount of income received over the period is identical. This inequity might be rectified by averaging the income tax base for several years. Such a procedure, however, would produce much hardship during depression years when the average tax base exceeds the taxpayer's current income, out of which taxes for the most part must be paid. To accomplish some degree of averaging, it is recommended that the taxpayer's annual net losses be adjusted for non-statutory income items and carried forward for a two-year period.

To avoid impairment of revenue during depression years, it is recommended in the separate memorandum on Capital Gains and Losses that for purposes of determining the carry-forward of capital losses, the most variable of the income items, capital gains and losses, be segregated, except with respect to the undistributed profits tax. Such segregation would tend to prevent capital losses from making inroads upon the taxes determined on ordinary sources of income.

9. The allowance of discovery value and percentage depletion is believed to discriminate in favor of oil and mining interests. These bases for depletion enable the taxpayers to recoup more than 100 percent of their investment in mining and oil properties. To limit the

amount of depletion allowable to the capital invested, it is recommended that cost or March 1, 1913 value be the only allowable bases for the determination of depletion.

10. The surtax on gains from the sale of oil and gas properties prospected by individuals is limited to 30 percent of the sale price. A similar limitation had been in effect under the several revenue acts through 1932 but was eliminated under the Revenue Act of 1934, only to be restored in 1936. It is recommended that this limitation be repealed. This favored treatment of the oil and gas interests rests on the theory that the application of the full surtax rates to gains from such sales tends to discourage prospecting by individuals and discriminates against them by comparison with corporations. The first of these arguments can be discarded by reference to the fact that the Federal Government is finding it necessary to restrict production; the second carries little conviction since it applies equally well with respect to other capital gains.

11. The present personal holding company tax is deficient, for its overly precise definition of the personal holding company produces difficult administrative problems. This difficulty can be surmounted if holding companies receiving 80 percent of their income from specified sources of the type now included in the definition of personal holding company income (Revenue Act of 1937) are taxed on the entire amount of their undistributed profits, according to the concentration of control. Accordingly it is recommended that the rate schedule be graduated downward from 70 percent in those cases where control is concentrated in one to five individuals, to 10 percent in those cases where control is vested in the hands of more than fifty individuals.

12. The deductions on account of charitable contributions now allowable to estates and trusts seem to be excessive. The absence of limitation upon the deduction in the case of estates and trusts enables individuals to establish trusts for the sole purpose of administering charities, thereby avoiding the 15 percent limitation upon such deduction applicable to individuals. It is, therefore, recommended that the deduction for charitable contributions in the determination of the net income of estates and trusts be limited to 15 percent.

13. Partnership net income is at present determined after the allowance of a deduction for charitable contributions up to the amount of 15 percent of partnership income. The partners, as individuals, are allowed a deduction for charitable contributions up to 15 percent of their net income, including their pro rata shares of partnership net income. Thus, individual members of partnerships are permitted two potential deductions for charitable contributions. It is, therefore, recommended that in computing the 15 percent limitation for individual members of partnerships, such individuals include their

pro rata share of the partnership contributions, and further, that instead of including their pro rata share of partnership income after the deduction for charitable contributions, their pro rata share be included before such deductions.

14. Taxpayers are now permitted to treat certain donations as business expenses under Section 23(a). By shifting the donations from allowable deductions under Sections 23(o) and (q) to expenses (23(a)), individual taxpayers and partnerships can free themselves of the 15 percent and corporations of the 5 percent limitation upon deductions for charitable contributions. To prevent such shifts it is recommended that the computation of the limitations for charitable donations be based on the total amount of donations, whether included under expenses or under deductions.

15. Section 120 of the present law provides that if an individual donates amounts which together with certain taxes exceed 90 percent of his net income for each of ten years, then there is no limitation upon the deduction for charitable contributions made in subsequent years. In practice this provision applies to few, if any, taxpayers. In addition it would not operate equitably with respect to individuals with substantially similar but technically dissimilar records of large donations. It is, therefore, recommended that the section be repealed.

16. Employees' pension trusts, whether revocable or irrevocable, are now exempt from the income tax. Taxpayers are allowed certain deductions from the income tax base to support the employees' trust funds. In the case of revocable trusts, taxpayers are now enabled to shift income into such trust funds for the purpose of reducing current income tax liability and to recoup the amounts so shifted by subsequently cancelling the terms of the trusts. Similarly, bankruptcy may intervene to make funds shifted to employees' trusts available to the general creditors rather than to employees. To prevent possibilities of tax avoidance through employees' pension trusts, it is recommended that only irrevocable trusts be exempt from the income tax and only those of such trusts which, in the terms of the trust, provide for at least 75 percent of the employees of five year standing with salaries under $5,000 and provide further a plan for the distribution of the trust funds to employees in the event of liquidation.

17. At present the sale of a depreciated stock results in the realization of a capital loss, but if the depreciation is extreme so that the stock becomes worthless, the taxpayer is allowed a deduction against ordinary income to the extent of the basis for the worthless stock. This distinction between moderate and extreme depreciation in stock values is believed to be invalid for income tax purposes. It is, therefore, recommended that when stock becomes worthless, or approximately worthless, when it depreciates to, say, 3 percent of its basis, the taxpayer be allowed to include the loss among other capital losses reported for the year; and in case the worthless or near-worthless stock subsequently appreciates in value and is sold, the basis for such stock is to be the market value used in determining the capital loss.

18. Nonresident American citizens are allowed to exclude their foreign earned income from the gross income reported for Federal income tax purposes on the ground that the taxes imposed by foreign countries burden nonresident Americans to a point where any additional taxes on their earnings abroad would be unreasonable. This view is not consistent with the general framework of the Federal income tax and the system of credits allowable on account of foreign taxes paid. The basis for Federal income tax liability is citizenship, not residence. It is, therefore, recommended that so long as citizenship constitutes the basis for the tax, all citizens of the United States, whether resident or nonresident, be taxed on income from sources within and without the United States, and further, that international double taxation be avoided by allowing nonresidents the same privileges as are now granted residents, e.g., afford tax credits on account of foreign income, war profits, and excess-profits taxes against the tax determined on the citizen's aggregate income. The consideration that most foreign taxes are not of the creditable type, is not germaine because resident citizens are also burdened with nondeductible taxes.

19. Building and loan associations are exempt from the Federal income tax. The exemption appears to be predicated on the assumption that these associations are nonprofit organizations and operate on a mutual basis. Actually, building and loan associations accept deposits at interest rates differing from those on capital contributed by different classes of shareholders. They may thus be said to be in competition with the banks. It is, therefore, recommended that building and loan associations be subjected to the Federal income tax, unless they can demonstrate that their operations conform to the standards of mutuality, upon which tax exemption is predicated. This recommendation will serve to make taxable all building and loan associations which accept deposits and guarantee a fixed rate of return, as well as those which pay a rate of return on founders', organization, or other special types of shares different from that paid on ordinary members' shares. In other words, a building and loan association's tax exemption is made conditional upon a test of mutuality: the payment of a uniform rate to all contributors of capital.

20. In order to relieve a liquidated subsidiary from the full impact of the undistributed profits tax on the adjusted net income accounted to date of liquidation, the Revenue Act of 1936 provided for the allowance of earnings and profits accumulated since 1913 for purposes of determining the dividends paid credit, despite the fact that distributions in liquidation are not dividends and so not taxable as income to the recipients. This provision conflicts with the general policy expressed elsewhere in the law, that distributions not taxable to the recipients are not available for purposes of determining the dividends paid credit. The regulations respecting distributions in liquidation appear to lack adequate legal foundation. It is, therefore, recommended that Section 27(f) be repealed and that the law be clarified by making the substance of Section 27(f) an exception to Section 27(h). This would enable the Bureau to substantially follow the present procedure with closer conformity to the explicit provisions in the law.

Capital Gains

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE 1937

TO Mr. Magill

FROM Mr. Haas

Subject: TAX REVISION STUDIES, 1937 - TAX TREATMENT OF CAPITAL GAINS AND LOSSES

SUMMARY

1. The subjection of income derived from capital gains to the progressive income taxes is justifiable on economic, equitable and practical grounds. From the standpoint of taxation, the kind of income that is relevant and significant is the income that measures taxpaying ability. Capital gains constitute real taxpaying ability no less than equivalent income derived from other sources.

2. The tax treatment of capital gains and losses in Great Britain, France and Germany provides no satisfactory model on which to build a system for the United States. In each country, the differentiation of taxable from non-taxable gains is by a process so arbitrary as to create severe inequities between taxpayers of substantially identical circumstances but with unimportant differences in the form of income received. Moreover, there is a strong inducement to taxpayers to convert taxable income into non-taxable gains, thus making tax considerations an extremely important influence on investment activities and policies.

3. The tax treatment of capital gains and losses of individuals in the United States has ranged from the complete inclusion of capital gains and losses in the tax base in the years 1918-1921, to the present treatment which includes in taxable income certain percentages of capital gains and losses (subject to limitation) which vary with the years assets have been held. From 1922 to 1933, the taxpayer was allowed, at his option, to segregate from his ordinary income the gains from assets held more than two years, and subject them to a 12½ percent flat rate. Losses from assets held more than two years could likewise be segregated, except for 1922 and 1923, and allowed a tax credit of 12½ percent subject to certain limitations. Gains and losses from assets held two years or less were included in ordinary income.

4. The existing tax treatment of individuals is inequitable as respects both gains and losses. It is not intolerable as respects

capital gains, however, and in this respect is greatly superior to the treatment that it displaced. The limitation on capital losses, however, is so unjust as to be indefensible.

Capital gains are now given decidedly preferential tax treatment as compared with other sources of individual income. Wealthy individuals, especially, are offered an extremely strong tax inducement to make their new investments in such manner as will permit their returns therefrom to take the form of capital gains.

The chief effect of the present system on the securities markets arises through the influence on timing. At the option of the taxpayer, income taxes on capital gains may be postponed by delaying the formal realization of gains, reduced by deferring formal realization until one or more of the four "step-down" intervals provided in the law has elapsed, and completely avoided by foregoing formal realization, leaving such realization to be accomplished by the taxpayer's heirs.

5. Although the influence of tax considerations is real, their effects upon the movements and volume of activity of the securities markets are far less substantial than is often contended. The bulk of capital assets is relatively insensitive to the character of our capital gains taxation. This is true of the part held quasi-permanently for purposes of control and income. It is also true of the part employed in the short-term operations of traders and speculators, operations which normally account for a large fraction of the total trading in listed securities. For intermediate-term speculators and investors, tax considerations necessarily operate among a welter of other factors which usually provide stronger incentives to action.

The available statistical evidence, though by no means conclusive, does not support the contention that the tax treatment of capital gains since 1922 has been of more than modest influence upon the level and activity of the securities markets. The underlying business situation and the related speculative temper of the times are primarily responsible for stock market booms and collapses.

6. The capital gains and losses of corporations have not created tax problems in any way similar to those of individuals. Special treatment was not needed as long as there was a relatively low flat corporation income tax; and the enactment of graduated rates beginning in 1936 created no practical problem, because the range of graduation is relatively narrow.

Imposition of the surtax on undistributed profits has raised a new problem for corporations with respect to the tax treatment of capital gains and losses. If the capital gains of good years must be paid out currently to avoid surtax liability, but no carry-forward of the capital losses of bad years is allowed, the tendency over a period of years will be to shrink the value of capital assets. The most practicable method of minimizing or eliminating this tendency appears to be that of allowing net capital losses in full as a deduction in computing adjusted net income, with a carry-forward for two years of any excess losses.

7. It is recommended that capital gains and losses of individuals be subjected to tax treatment on the basis of what may be called the average accrual method. According to this method the amounts of gain and loss realized are averaged separately over the number of years the assets were held, and taxed at rates determined on such average amounts when added to ordinary income. The increment of tax resulting on the average gain and tax credit on the average loss are multiplied by the average number of years respectively the assets were held, and the combined products represent the tax on capital gains. The objective of the plan is to recognize more adequately the fact that the realized gains and losses frequently accrue over several years.

In more detail the procedure under this method is as follows:

a. Capital gains are segregated from capital losses. The average investment period for gains and the average annual gain during this period are determined; and the average investment period for losses and the average annual loss during this period are determined.

b. The average annual gain and the average annual loss are combined to determine a net average gain or loss applicable to the shorter of the two investment periods. The tax or tax credit on the resulting figure is computed with reference to the surtax net income, and this tax or tax credit is multiplied by the number of years in the shorter average investment period to determine the tax or tax credit on capital gains and losses during this period.

c. The tax or tax credit on the average annual gain or the average annual loss, whichever accrued for the longer average investment period, is computed with reference to the surtax net income, and multiplied by the number of years by which the longer average investment period exceeds the shorter, to determine the tax or tax credit applicable to those years.

d. The taxes or tax credits thus obtained are combined, the result representing the total tax or tax credits on capital gains and losses. Any unused tax credit is carried forward for two years, to be allowed only as an offset against tax liability on capital gains realized in those years.

e. In computing the tax, no allowance is given for any portions of the personal exemption, credit for dependents, or minimum earned income credit not utilized in computing the ordinary income tax. If there is no surtax net income, the tax or tax credit is computed, assuming surtax net income to be zero rather than a negative quantity.

If legally feasible, contributions to charitable and similar institutions should be regarded as occasioning the realization of capital gains and losses by their donor; and such capital gains and losses should be included with other capital gains and losses for tax purposes. If this is not feasible, it is recommended, for purpose of determining the deduction for charitable contributions, that the value of such contributions in kind be fixed at the adjusted basis (Section 113) or market, whichever is lower.

If legally feasible, transfers by inter vivos gifts should be regarded as occasioning the realization of capital gains and losses by the donor. If this proposal is not deemed feasible, it is suggested that a supplementary gift tax be levied, measured by the capital gains and losses incorporated in such transfers. In the event that this should also be unacceptable, it is recommended that, for the purpose of determining both capital gains and losses, the basis for property acquired by gift be made either the base in the hands of the donor or market value at time of transfer, whichever is lower.

It is recommended that the capital gains and losses of corporations be included in ordinary income in full, except that for purposes of determining the normal-tax net income, capital losses be allowed only to the extent of capital gains. Any excess of capital losses not allowed in the current year in determining normal-tax net income is carried forward for two years to be credited against the capital gains of those years. In determining adjusted net income capital losses are allowed in full against income from any sources. Any excess of capital losses not so utilized is carried forward for two years for use as a deduction in determining adjusted net income of those years.

8. Next to the recommended average accrual plan, the most superior alternative would be a continuation of the present five-step system with an improved scale of percentages designed to approximate more closely the resulting taxes to taxes applicable to other sources of income; and with a liberalization of the present loss limitations.

All of the other alternative tax treatments of the capital gains and losses of individuals possess weaknesses which make their adoption unwise.

The undistributed profits tax will tend to diminish one important source of capital gains, but will leave a number of other sources unaffected. Hence it does not obviate the justification for the tax on capital gains.

Undistributed
Profits

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE AUG 31 1937

TO Mr. Magill

FROM Mr. Haas

Subject: TAX REVISION STUDIES, 1937 - UNDISTRIBUTED PROFITS TAX

SUMMARY

The primary purpose of the undistributed profits tax is to make effective the rates of the individual income tax. To accomplish this, the tax should be sufficient over the major portion of its range to induce the distribution of corporate earnings to the equitable owners thereof, and over the remaining portion of its range should at least compensate the Treasury in part for the individual income taxes lost by the non-distribution of corporate earnings. While the theoretical need for a tax of this character has existed ever since the rates of the individual income tax diverged substantially on the upside from those of the corporation normal tax, this need became acute for the first time in a decade with the high rates of the individual income tax imposed by the Revenue Act of 1932 and subsequent Acts. These rates--at present amounting to as high as 79 percent on segments of income in excess of $5,000,000 and 62 percent, or higher, upon all segments of income in excess of $100,000--could not be made really effective as long as corporate profits could be retained and reinvested without the payment of the individual income tax. The undistributed profits tax, as at present upon the statute books, takes a long step toward making such rates effective. We believe that its efficacy in this direction can be further increased and that certain elements of harshness can be greatly diminished by the changes suggested in this memorandum. A careful canvass of the situation, on the other hand, has failed to reveal any practicable alternative device by which this could be accomplished.

Aside from its primary objective of reducing the inequity and increasing the revenue productivity of the income tax system, the undistributed profits tax has certain social and economic effects. The most important of these are (1) that the tax tends, on balance, to reduce somewhat the proportion of the national income which is saved and to increase somewhat the proportion which is currently consumed, and (2) that it tends to "democratize" the process of capital formation by returning to stockholders the function of deciding whether or not they are willing to reinvest in a particular corporate enterprise their pro rata share of its annual earnings. These effects are inseparable from the tax as such, except

to the extent that corporate earnings may be distributed through the declaration of taxable dividends in the form of securities of the corporation itself, or are reinvested by the stockholders through the exercise of coercive rights. While we advocate the undistributed profits tax primarily as a revenue and equitable measure, we believe that these incidental and largely inseparable social and economic effects are, in themselves, desirable and tend to reenforce rather than detract from its revenue and equitable objectives.

In order to make the tax more equitable in its application, to remove certain hardships, and to increase its effectiveness in certain respects, the following changes are suggested:

(1) Coordination with the Privilege Tax. It is recommended that adjusted net income should consist of privilege-tax net income -- that is, net income before the deduction of interest, rents and royalties -- less the privilege tax paid, and that undistributed net income should consist of adjusted net income less dividends, interest, rents and royalties.

(2) Rate Schedule. The following rate schedule is recommended:

Percent of adjusted net income undistributed	Tax (Percent)
0 - 5	3
5 - 15	15
15 - 50	40
50 - 100	60

The rate in the initial bracket has been lowered as compared with the present law, principally in order to make allowance for the margin of error of estimate in net income, while the rates in the last two brackets have been made sufficiently high to induce distribution of earnings in the vast majority of cases, including even those of closely held corporations. The narrowing of the first bracket is necessary to prevent a substantial loss in revenue in view of the change in the base for adjusted net income. It will have an effective width substantially greater than that of the present initial 10 percent bracket for corporations with large amounts of prior charges. These corporations cause little revenue loss, and are the most needful of and the most clamorous in demanding relief in any event, while some relief for them seems especially timely in view of the transitional burden to which they will be subjected by the new privilege tax.

(3) Small Corporations. It is not believed that the contention frequently made that the undistributed profits tax places small corporations at a disadvantage has merit, but the contrary is rather believed to be true. Nevertheless, in line with our consistent policy of granting preferential treatment to small corporations in any event, it is recommended that the specific credit provided in Section 14(c) of the Act be continued at $5,000, that the rate of tax thereon be lowered from 7 percent to 3 percent to conform with the lower rate suggested for the first bracket of the regular tax, and that it be extended in its application to corporations with adjusted net incomes of up to $100,000 (rather than $50,000) in view of the proposed change in the base of adjusted net income. It is further recommended, however, that whatever income remains undistributed beyond the amount included in the specific credit be taxed at the rates applicable if the specific credit had not been granted.

(4) Allowance of Net Capital Losses. It is recommended that an unlimited offset of capital losses be permitted, for the purpose of the undistributed profits tax only, against other income.

(5) Net Loss Carry-Over. It is recommended that a two-year carry-over should be allowed for all losses (including capital losses as merged with other losses by the preceding recommendation) for the purpose of the undistributed profits tax only.

> It is believed that recommendations 4 and 5 taken in conjunction will meet the legitimate complaint that it is often necessary for a corporation incurring substantial capital losses, or engaged in a fluctuating business, to pay an undistributed profits tax, in order to retain its capital intact; whereas, in the contemplation of the law, such a tax should be paid only when it is desired to increase the capital employed in a business by the reinvestment of earnings free from the individual income tax.

(6) Optional Settlement of Subsequently Found Deficiencies. It is recommended that if audit of a corporation return reveals that net income from a previous year should have been reported at a higher figure than that appearing upon the face of the return, and no question of bad faith is involved, the taxpayer should have the option of paying the undistributed profits tax liability thereby created,

with interest, or of paying a special tax of 5 percent of the undistributed profits newly determined by the Commissioner, and adding the remainder of such newly determined profits to adjusted net income in the current year. It is felt that this recommendation will restore to the taxpaying corporation, as far as it is possible to do so, its original option either of paying the undistributed profits tax, in whole or in part, or of distributing its earnings, in whole or in part.

(7) Special Tax on Earnings Exempted from the Undistributed Profits Tax by Reason of Contracts Prohibiting the Payment of Dividends, etc. It is recommended that a tax of 10 percent be levied upon earnings exempted from the undistributed profits tax under Section 26(c) of the Act, because of contracts prohibiting the payment of dividends, etc., and that such tax be levied in lieu of the lowest brackets of the undistributed profits tax in which the amounts so exempted would otherwise have fallen. This tax will take cognizance of the fact that income which remains undistributed as a result of prior contractual obligations both increases the equity of the stockholders and results in revenue loss to the Government in the same measure as though it had remained undistributed as the result of a currently made decision of the Board of Directors of the corporation.

Estate
and Gift

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE AUG 31 1937

TO Mr. Magill

FROM Mr. Haas

Subject: TAX REVISION STUDIES, 1937 - ESTATE AND GIFT TAXES

SUMMARY OF FINDINGS AND RECOMMENDATIONS

Part I: Structural Revision of the Federal Estate Tax

The accompanying memorandum examines in some detail those features of the Federal estate tax which may be deemed worthy of revision in the interest of maximum equity and greater productivity. The more significant of the conclusions are as follows:

1. The specific exemption of $40,000 may well be reduced to $20,000. While no particular case can be developed for precisely that figure as opposed to one slightly higher or lower, evidence is abundant that the present figure is too high. A reduction of the specific exemption to $20,000 would make the estate tax more effective on smaller estates and thus increase revenue. It would, in addition, bring Federal exemption into better conformity with the exemptions provided by State laws, thus eliminating one potent field of interstate variation, yet leaving it at a level above that generally recognized as adequate to provide a tax-free subsistence fund to the decedent's dependents.

2. The suggestion that the specific exemption provided by the estate tax recognize the number of beneficiaries and their relationship to the decedent, is not considered desirable for immediate adoption. That either an inheritance tax or an estate tax which recognizes the number of beneficiaries and their relationship to the decedent would make for greater equity, can be readily conceded. However, the accompanying administrative difficulties are believed to outweigh the net addition to equity which could thus be obtained.

3. With respect to the three types of specific exemptions (constant, conditional, and vanishing) now in use in various countries, the vanishing type of exemption is singled out as the one most desirable. The constant exemption ignores the very argument to which it presumably owes its existence, namely, the discrimination in favor of the relatively small estates by granting the privilege of bequeathing a tax-free fund for the maintenance of the decedent's dependents. On the contrary, it bestows a tax advantage which grows larger rather than smaller with the increase in the size of the estate. The conditional exemption, on the other hand, is too arbitrary for it fails to provide a gradual transition from non-taxability to taxability. The vanishing exemption is considered most desirable. It recognizes the necessity of granting tax-free bequests for the support of dependents in the case of small estates, and does not, like the constant exemption, perpetuate the same advantage in the case of large estates, and hence does not impair the productivity of the tax.

4. In connection with the manner of taking exemptions, it is observed that if the vanishing exemption is adopted, the necessity for specifying that the exemption be taken from the lowest bracket will be eliminated. In the event, however, that the constant exemption is retained, it will be desirable either to specify that the exemption be deducted from the lowest bracket or to replace the present exemption - expressed as a deduction from the otherwise taxable base - by an exemption expressed in terms of a constant tax credit. While it is recognized that an exemption in terms of tax credit is psychologically undesirable because it seems smaller to the taxpayer than a corresponding exemption deductible from a tax base, considerations in the interests of equity and productivity are judged to be more significant. The elimination of the tax advantage inuring to large as opposed to small estates from a constant exemption deductible from the top bracket and the consequent destructive effects upon estate tax revenues, are vital considerations.

5. An examination of the treatment of insurance leads to the conclusion that the present exclusion from the taxable base of $40,000 of insurance payable to named beneficiaries should be eliminated. While the practice of providing a liquid fund for one's family is socially desirable, no valid reason can be presented why that form of asset should be singled out for especially favored treatment. Such exclusion of insurance from the taxable base serves to double the size of the specific exemption and thus affords a greater tax advantage to the larger as opposed to the smaller estates, and in addition, of course, results in an impairment of the productivity of the tax.

6. The proposal that insurance for the payment of estate taxes be rendered tax free is not recommended. The contention that estate taxes may subject an estate to forced liquidation is recognized; the Government's obligation to prevent such liquidation, however, is not conceded. The facts that the exclusion of such insurance would defeat progression, impair revenues and deprive the Government of one of its relatively few opportunities to employ the principle of ability to pay as a criterion of taxation, are sufficient justification for including all insurance in the taxable estate.

7. The present treatment of property previously taxed (excluding such property from taxation when the two successive deaths occur within five years) strives for the elimination of multiple taxation, one of the existing inequities in the estate tax. However, the present provision limiting the period of grace to precisely five years is conducive to inequity and should be replaced by a graduated scale ranging from a complete exemption of property previously taxed in cases where the two deaths occurred within one year to exemptions of 20 percent in those cases where the interval between the two deaths is more than four but not more than five years.

8. With respect to the present policy of granting full exemption to charitable bequests, stress is laid upon the inequity resulting from the fact that the tax reduction inuring to estates of different size from a given bequest is widely different, ranging from zero to as much as two-thirds of the entire bequest. While the entire elimination of this form of exemption is deemed undesirable, it is proposed that the present full exemption of charitable bequests be eliminated and in its place a tax credit substituted, such tax credit to bear that ratio to the total tax liability which 50 percent of the charitable bequest bears to the net estate. This procedure would not unduly discourage charitable bequests and would, in a moderate manner, equalize the tax benefits accruing from the exemption to estates of various size, increasing at the same time tax revenue.

9. It is suggested that the present bracketed rate structure be replaced by one on a totality basis. The contentions that the Federal Government has never employed a totality rate schedule and that the bracket rate structure permits a smoother degree of progression are significant, to be sure. They are secondary, however, in light of the considerations that a totality rate structure allows for an increase in the effective rate of taxation without any apparent increase in the statutory rate schedule and reflects the weight of the tax burden more correctly. Top bracket rates, which under the bracket system

appear confiscatory may, when considered in relation to the tax burden on the total estate, be moderate and can be expressed as such in a totality rate schedule. It is considered good public policy to recognize the general public's lack of understanding of bracket rates through the use of totality rates with adequate equalizing provisions at the break-over points.

10. With reference to the level of estate tax rates, it is suggested that the 1935 rate schedule be replaced with a new rate schedule on the totality basis ranging from 1 percent on net estates above a $20,000 vanishing exemption to 75 percent on net estates of $100,000,000 and over. It is readily defended on the ground that an upward revision of the rate structure, with a view to enhancing the effectiveness of the tax on small and medium size estates, is imperative in the interests of productivity and essential in the interests of equity. The rate structure proposed would produce a substantial increase in revenue with a minimum of administrative difficulty and public opposition. It would add a justifiable addition to the tax burden falling upon middle size estates without interfering with the desire of the individual to provide his heirs with the necessities of subsistence.

11. It has been urged that the tax burden imposed on transfers of property at death recognize the prior wealth of the beneficiary. Although such procedure would be theoretically desirable in the interest of equity, the innovation involves a refinement of a finer order than that commensurate with other features of the present tax system and threatens to involve legal and administrative difficulties, some arising in connection with the determination of prior wealth and others from the necessity of taking due cognizance of the ultimate beneficiaries. It is concluded that present efforts at revision could more profitably be directed in other channels.

12. It is suggested that the practice of affording the executor of an estate an option between valuation for tax purposes as of date of death or one year hence be eliminated. Since the estate tax is a tax on transfer of property at death, no logical justification grounded in economic reasoning can be found for the recognition of property values as of any subsequent date. While in periods of rapidly declining values it may be deemed expedient to temporarily alleviate injustice by shifting the date of valuation one year hence, the practice on the whole is undesirable. At all events, now that the downward trend of security values has reversed itself, the plea of expediency has lost its force and the option can produce only administrative difficulty.

13. With respect to community property, it is urged that the Federal Government take a definite position. It is recognized that in the interest of greater productivity it may be desirable to sterilize the community property principle, in which case a utilization of the "right of management and control" concept may prove fruitful.

14. At present when property which has enhanced in value is transferred by inheritance, the capital gains escape income taxation. The constitutional concept of income precludes the taxing of such capital gains under the income tax. To eliminate this inequity, it is proposed to impose a compensatory tax in the form of an additional estate tax on capital gains that have accrued to real estate, stocks and bonds, in the following manner: A tentative tax is to be computed at the regular estate tax rates on the entire amount of the gross estate without the allowance of any deductions whatsoever. Against this tentative tax there is to be permitted a tax credit, computed at the regular estate tax rates on an amount which will be the sum of the adjusted bases for real estate, stocks, and bonds, and the current market of all other gross estate assets. The difference between the tentative tax and the tax credit thus determined will be the capital gains transfer tax or the "initial estate tax" liability which is to be allowed as a deduction for the purpose of computing the basic estate tax.

15. In view of the corollary relationship of the estate and the gift tax it follows that the adoption of any of the above proposals with respect to the estate tax should be accompanied by parallel revisions of the gift tax.

Part II: Coordination of the Federal Estate and the Federal Gift Tax

In this section there is examined the lack of coordination between the existing Federal estate and the Federal gift tax and there is outlined the procedure whereby the two taxes can properly be integrated. The more significant of the conclusions are as follows:

1. The gift and the estate taxes are complementary constituents of the tax system. As such, they should be properly coordinated. Coordination, however, does not require that the tax burdens imposed upon two complementary tax bases be identical. All that it requires is that the differential in the tax burdens imposed upon either of the two complementary tax bases express the preferential treatment the Government desires to accord the one as compared with the other and that the extent of that preferential treatment available to different individuals bear a rational relationship to the amount of their property transfers.

2. The Federal estate and gift taxes are in pressing need of coordination because: (a) The gift tax has greatly reduced the effectiveness of the estate tax by affording substantial opportunity for reducing tax liability incident to property transfers; (b) the opportunity for reducing tax liability in this manner is not uniformly available to all individuals but accelerates more than in proportion to their transferable wealth; (c) the reduction in the tax liability incident to property transfers available through inter vivos

gifts is greater than that required by public policy; and (d) the distribution of estates through inter vivos gifts encouraged by the preferential treatment accorded it for tax purposes and the consequent reduction of property transfers subject to the estate tax has reduced the amount of inheritance and estate tax revenue available to the States.

3. Partly as a result of the lack of coordination between the estate tax and the gift tax, transfer taxes occupy a relatively minor role in the American revenue structure, notwithstanding the fact that they comprise one of the two main constituents of the tax structure capable of the application of the ability to pay principle.

4. The advantages accruing from the use of inter vivos gifts are no doubt greater than those contemplated by Congress. The legislature did desire to encourage the distribution of estates during the lifetime of their owners, but not to the extent and in the disproportionate manner actually provided by the present law.

5. A coordination of the estate and the gift tax can be achieved by viewing inter vivos gifts as installments of property transfers and viewing the taxes on such gifts as payments on account of transfer taxes. The two taxes are mutually interdependent. They derive from identical origins and fall upon interchangeable transactions and, therefore, barring legal consideration to the contrary, should be combined.

6. Such coordination can be achieved by the following administratively relatively simple device: (a) Retain the 25 percent differential inherent in the existing gift tax and the estate tax rate structure; (b) change the existing net gift tax base to a gross base, comparable to that used in the taxation of estates; (c) consider the taxes paid on inter vivos gifts as installment payments on account of final estate taxes; (d) include in the taxable base at the time of death not only the residual estate remaining after gifts, but also the value of property previously reported for gift tax purposes; (e) compute a tentative estate tax liability upon all of the property disposed of by the decedent both during his lifetime and at his death; (f) credit against this tentative tax liability (1) gift taxes paid and (2) such a premium upon such gift taxes as suffices to express the tax advantage it is desired to afford inter vivos gifts.

7. The device herein proposed for the coordination of the Federal estate and the gift tax may possibly be subject to the following objections: (a) That it is impractical for it implies a stationary estate tax and gift tax rate structure and that in the event of future rate changes, tax liability would have to be recalculated retroactively to the first gift; and (b) that the accumulation of gifts for ultimate inclusion in the residual estate for gift tax purposes may be unlawful because title to the property distributed through inter vivos gifts is not held by the decedent at the time of his death. The first of these criticisms is considered to have little force; the appraisal of the second must await judicial review.

8. The proposed coordinating device has numerous advantages: (a) It would present no additional administrative problems for a record of inter vivos gifts is already being maintained currently for gift tax purposes; (b) it will increase revenue from the estate and the gift tax by increasing the effective transfer tax rate, without an alteration of the existing rate structure; (c) the Federal Government will be enabled to accord precisely that encouragement to inter vivos gifts which is required by public policy, and which at the same time will be uniformly available to all individuals, and not vary more than in proportion to their wealth; (d) the proposed treatment of property transfers will be a logical corollary of the cumulative tax base and cumulative tax credit concept already employed in connection with gift taxes; (e) it will make the bases of the estate tax and gift tax identical; (f) it will eliminate the double use of exemptions and the double use of lower brackets in connection with property transfer taxes; (g) it will provide the machinery for eliminating the inequitable effect of gift taxes upon the estate and inheritance tax revenues of State governments without any reduction of Federal revenues; (h) it will forestall the present movement toward independent State gift taxes and thus will stifle a new and potent conflict which is arising between the Federal Government and the States.

9. The present practice of exempting $5,000 gifts made in any one year to any number of individuals is considered excessive. Its replacement by a maximum donor's annual exemption of $5,000, irrespective of the number of donees, is recommended.

Part III: Coordination of Federal and State Taxes on Property Transfers

In this section there is examined the lack of coordination between the existing Federal and State taxes on property transfers and there is outlined a procedure whereby the transfer taxes of these two jurisdictions can be properly coordinated. The more significant of the conclusions are as follows:

1. The taxation of identical tax bases by two separate and sovereign jurisdictions requires coordinate action. The absence of coordination is certain to produce undesirable economic and social consequences. That coordination is lacking in the field of property transfer taxation and has of necessity produced undesirable consequences requires no demonstration.

2. While the problem of eliminating conflicting Federal and State taxation is of more vital significance to the States than to the Federal Government, the latter cannot continue ignoring the problem, partly because the States themselves are unable to solve it but primarily because the Federal Government itself is earnestly interested in sound fiscal practice by all governmental units.

3. The adoption of the crediting device in 1924 and its expansion in 1926 signified a willingness on the part of the Federal Government to share its transfer tax revenue with the States, first in the ratio of 3 to 1 and later in the ratio of 1 to 4. Immediately following 1924 and 1926 the States attempted to conform their transfer tax systems to this Federally dictated pattern by imposing tax burdens approximately equal to 80 percent of the 1926 Federal estate tax rate schedule; the Federal Government, however, gradually annihilated the effectiveness of its own program by reducing the relative quantitative importance of the State tax credit.

4. The 1932, 1934 and 1935 Federal Revenue revisions served to dwarf the role of the States in the transfer tax field. In their efforts to counteract Federal action, the States resorted to the enactment of additional death taxes and the imposition of gift taxes, thereby adding to Federal-State conflict.

5. The failure of the Federal Government to attempt an elimination of the conflict before now is probably due to the fact that the extent of existing conflict is generally underestimated and the remedial effects of the crediting device are exaggerated.

6. The extent to which the crediting provision has failed to eliminate interstate variation in property transfer taxation is remarkable. Not only does the need for dual administration and dual taxpayers' compliance remain but in many respects there is probably as wide a diversity in State death duties as prior to the adoption of the crediting provision of 1924. Information obtained through a questionnaire submitted by the Division of Research and Statistics of the Treasury Department to the death tax administrators of the several States and an analysis of the several death tax laws reveals that variations with respect to (a) the type of taxes employed, (b) definition of gross estate, (c) valuation practice, (d) definition of net estate, (e) treatment of insurance, (f) size of specific exemption, (g) manner of taking the exemption, (h) rate structures, and (i) the tax burden imposed, collectively produce a heterogeneous State-by-State property transfer tax pattern.

7. As a result of these variations (a) the ratio of credits claimed for taxes paid to States against Federal estate tax liability to State inheritance and estate tax collections ranges from 0 to 92 percent; (b) the differential estate taxes passed by the various States in order to take advantage of the available Federal credit are limited in effectiveness because the taxes imposed by the States are in many cases in excess of the maximum Federal credit; and (c) the significance of the death taxes in the revenue structures of the various States ranges from 0 in one State to more than a fifth in another. In other words, interstate variations permeate all aspects of State death taxes leading to the unmistakable conclusion that the crediting provision in itself is not adequate for the elimination of interstate competition and Federal-State conflict in death taxation.

8. The proposals which have been advanced for the elimination of conflict in Federal-State taxation of property transfers fall into three general categories: (a) Separation of revenue sources, (b) modification of the crediting device and (c) Federal-State integration.

9. The relative merits of these proposals must be appraised in light of the following objectives: (a) That any change in Federal-State relations does not unduly reduce Federal revenues, (b) that it increases substantially or at least moderately State revenues, (c) that it not be coercive upon the States, (d) that it be of a type which can go into effect gradually and not be conditional upon the enactment of specific kind of legislation in all of the States, (e) that it disturb as little as possible the death tax legislation now on the books of the States, inspired in part by the Federal Government's crediting device, and (f) that it minimize as far as possible the need for dual administration and dual tax compliance.

10. In the light of the above enumerated criteria, none of the three general categories of proposals hitherto advanced for the elimination of Federal-State conflict in death taxation is acceptable.

11. Existing Federal-State conflict in the field of death taxation can be eliminated by combination of two previously proposed methods. Specifically, it is recommended that the Federal Government provide the States with an option as follows: Those States which continue to levy their own death taxes may continue to take advantage of the 80 percent credit allowed against Federal estate taxes under the 1926 Act. Those States, on the other hand, which will abolish their own death taxes will receive in lieu of this State tax credit a fixed proportion of Federal estate and gift tax collections in their respective States.

12. This option arrangement has numerous advantages: (a) It provides a gradual transition from the existing situation and can, therefore, go into operation immediately and need not be postponed until such a time as appropriate legislative action has been taken by all of the States; (b) the arrangement is in no sense coercive upon the States but will obviously be attractive to them; (c) it will eliminate the necessity for separate State administration and dual estate tax compliance; (d) it will not necessitate new State legislation either in the estate or gift taxation, but rather, will produce the gradual repeal of existing legislation; (e) it will contribute to the solution of the problem of State jurisdiction with respect to death taxation; (f) it will provide for a gradual simplification of the Federal estate tax structure itself by gradually eliminating the use of the 1926 rate schedule; and finally, (g) it will enhance general acceptability of the structural revisions of the estate and gift taxes themselves by providing for the gradual elimination of State taxes upon the same tax bases.

13. From point of view of the Federal Government, the disadvantage of the proposal lies in the fact that it will serve to transfer some revenue to the States which otherwise could be retained for Federal purposes. This, however, is no real disadvantage because the proposed structural revisions of the estate and gift tax will more than provide sufficient revenue to bridge the difference between the amounts which would have to be diverted to the States and the amount of the credits now allowed for taxes paid to States.

14. The proposed device will be acceptable to the States because it will obviate the necessity for dual administration and dual taxpayers' compliance at the same time that it eliminates interstate competition and increases State transfer tax revenues.

15. Finally, too much emphasis cannot be placed upon the necessity of making a start in the direction of Federal-State tax coordination. Death taxes offer a good starting point, particularly because of their wide use as sources of State revenue but primarily because they present an opportunity for adding substantially to State revenues without corresponding loss of Federal revenue. The resulting good will is certain to contribute immeasurably to the solution of Federal-State conflict in other fields of taxation.

Excise
Taxes

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE AUG 31 1937

TO Mr. Magill

FROM Mr. Haas

Subject: TAX REVISION STUDIES, 1937 - EXCISE TAXES

Summary of Findings and Recommendations

The accompanying memorandum examines in some detail the place of excise taxes (other than those imposed on liquor, tobacco and oleomargarine) in the immediate and more distant Federal tax structure. The more significant of the conclusions are as follows:

(1) Excise taxes have been enacted during practically every critical period in Federal fiscal history and their utilization during the last depression involves no innovation.

(2) During the past five years excise taxes have played a significant but declining role in the Federal Government's tax revenues and, with the increased yield of direct taxes, their relative importance is certain to decline further.

(3) Generally speaking, excise taxes other than those imposed for regulatory purposes are less desirable than progressive direct taxes and, so far as possible, should be replaced by a system of direct taxes. Other considerations, however, point to the desirability of retaining some measure of indirect taxation in the permanent tax structure.

(4) The retention of excise taxes is necessitated by the fact that the broadening of direct taxes to reach the smallest of income groups is not feasible or economically justifiable. Excise taxes, therefore, may justly be assigned a permanent place in the tax structure, viewed as supplements to the income tax and designed in part to bolster depression revenues but more particularly to supplant direct taxes on the lower income groups.

(5) The case for the permanent inclusion of excise taxes in the tax structure is further strengthened by considerations of revenue stability. During periods of depression individuals in the higher income groups frequently have a minimum or no taxable income and are thus freed of income tax liability, producing wide fluctuations in income tax collections, rendering the stabilizing qualities of indirect taxes indispensable.

(6) Present and anticipated near-future revenue requirements preclude the immediate wholesale elimination of excise taxes. Governmental functions initiated or expanded by the Federal Government during the recent depression, bid fair to remain permanent and burdensome features of the budget for some time, thus raising revenue requirements above pre-depression levels and necessitating some recourse to excise taxation.

(7) While excise taxes cannot be dispensed with, it must be conceded that the present system of excise taxation is deficient in that it contains a number of individual taxes which are inequitable in their incidence, complex in administration, and conflicting with other governmental imposts, without being substantial revenue producers. The system also contains other taxes, regulatory in character, which have outlived their usefulness. In consequence, the existing tax structure could be markedly improved by the elimination of the least desirable excises.

(8) The required revision of the existing excise tax structure should be governed by consideration of (a) productivity, (b) incidence, (c) equity, (d) ease of administration, (e) effect upon economic enterprise, and (f) effect upon State and local taxation, in the light of present and probable future revenue needs.

(9) On the basis of these considerations, repeal of certain of the excise taxes, ranked in three successive groups, is recommended as follows:

Excise taxes recommended for repeal

Item	Tax	Fiscal year 1936 Collections	Number of taxpayers
	Group I		
	(1) Regulatory taxes no longer required		
1	(a) Brewer's wort	$ 1,008,273.85	40
2	(b) Gasoline produced or refined from natural gas	38,751.80	406
3	(c) Sale of crude petroleum	563,766.88	694
4	(d) Refining of crude petroleum	561,235.89	400
	(2) Taxes on commodities in common use		
5	(a) Toilet preparations (the 5 percent tax)	4,823,967.94	6,100
6	(b) Cameras	577,925.70	50
7	(c) Chewing gum	807,279.40	40
8	(d) Furs	3,321,057.14	2,100
9	(e) Radio parts	5,075,270.82	300
10	(f) Automobile accessories	7,110,188.33	2,600
	(3) Import taxes (more properly to be treated under the tariff laws)		
11	(a) Imports of certain oils, etc.	1,500,000.00*	1/
12	(b) Imports of copper, coal, and lumber	5,684,000.00*	1/
13	(c) Imports of crude petroleum, etc.	7,281,000.00*	1/
	Total	38,352,717.75	12,730
	Group II (Recommended for repeal subsequent to Group I)		
14	(a) Processing of certain oils	27,691,080.79	340
15	(b) Mechanical refrigerators	7,939,063.75	100
16	(c) Matches	7,106,359.21	50
17	(d) Sporting goods	5,531,122.72	1,200
18	(e) Auto trucks, etc.	7,000,000.00*	950 2/
19	(f) Firearms, shells and cartridges	2,494,574.54	100
20	(g) Safe deposit boxes	1,997,409.57	10,600
	Total	59,759,610.58	13,340
	Group III (Recommended for repeal subsequent to Groups I and II)		
21	(a) Electrical energy	33,575,179.25	2,400
22	(b) Telephone, telegraph, cable and radio messages, etc.	21,098,347.65	460
23	(c) Lubricating oils	27,102,831.57	455
	Total	81,776,358.47	3,315
	Grand total	$179,888,686.80	29,385

* Approximated.
1/ Not available.
2/ Includes manufacturers of other automobile chassis, etc.

(10) The existing tax structure could be further improved both in productivity and equity by amending statutory provisions covering certain of the excise taxes, as follows:

(a) Tax on stock sales or transfers--to replace the present tax by changing the base and imposing a 1/4 of 1 percent tax determined on the value of the transaction.

(b) The 10 percent tax on toilet preparations--to include those who prepare or package toilet preparations in the form in which they are to be sold to the consumer for consumption or use.

(c) Tax on ticket brokers--to limit present 10 percent rate to excess charges not exceeding 75 cents, and to increase such rate to 25 percent on excess charges over 75 cents.

(d) Tax on admissions and dues--to extend the liability for the tax to anyone responsible for the collection of the tax but fails to do so, whether wilfully or otherwise.

(e) Tax on admissions to night clubs--to increase rate to a flat 2 percent of total admission charges.

(f) Tax on sporting goods--pending its repeal, to define more clearly articles liable to the tax.

(g) Tax on radio parts--pending its repeal, to be revised so as to apply only to completed radio sets, with provision for allowance of tax-free sales of parts.

(11) The regulatory taxes (other than those listed in Group 1 on the preceding page - "Regulatory taxes no longer required"), the documentary stamp taxes, the admissions taxes and the taxes on dues and initiation fees should be retained in the permanent tax structure.

(12) In the event of pressing revenue needs, the scope of excise taxation could conceivably be extended to numerous commodities and services not now taxed. However, the taxable items which have greatest revenue producing potentialities consist of commodities and services which are everyday necessities to the masses of the population. Taxes imposed upon them would fall most heavily on segments of the population possessing the least economic ability. Notwithstanding the herein contained recommendation for decreasing reliance upon excise taxation, sight

should not be lost of the possibilities of continuing to derive the same amount of excise revenue in a more desirable manner than is accomplished by utilization of some of the excise taxes now in effect. For this reason, if the loss of revenue inherent in the repeal of those excises enumerated in Group I should have to be recouped through other indirect taxes, the list of excise taxes could be extended to include tractors and trailers, radio stations, and wagers on horse and dog races.

(13) No detailed consideration is given in this memorandum to the revision of the liquor, tobacco, and oleomargarine excises. The retention of the taxes on liquor and tobacco are indicated because of their well established and significant position in the Federal tax structure. The tax on oleomargarine is of a regulatory nature and is predicated on non-fiscal considerations of a character which for the present were not evaluated.