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Tax Revision Studies, 1937: Volume II

Income, Capital Stock, and Excess-Profits Taxes

VOLUME II

TAX REVISION STUDIES, 1937

INCOME, CAPITAL STOCK

AND EXCESS-PROFITS TAXES

Table of Contents

Table of Contents

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

Summary and
Recommendations

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE AUG 31 1937

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 holdsno 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.

Introduction

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE AUG 31 1937

TO Mr. Magill

FROM Mr. Haas

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

A. Introduction

The American experience with the income tax dates from the Civil War period. Prior to that time the Government's revenue requirements were met mainly by customs duties, with occasional use of internal revenue taxes. The emergency of the Civil War led to the enactment of a Federal income tax which, however, did not produce the best results, probably because the nature of the tax is such as to require a substantial period of experimentation and adjustment. From 1861 to 1872, during the period of its existence, this first of Federal income taxes yielded approximately $376,000,000. No resort was again made to the income tax until 1894. This tax, however, was held unconstitutional by the United States Supreme Court in 1895 before any collections were actually made under it on the ground that being a direct tax it must be apportioned among the several States on the basis of population. The Supreme Court's decision precluded the possibility of a permanent Federal income tax until the ratification of the Sixteenth Amendment on February 25, 1913. This Amendment permitted Congress to levy and collect taxes on income without apportionment among the several States and without regard to their population. In the meantime in 1909, in lieu of an income tax, Congress enacted a tax on corporations which was sustained by the Supreme Court as an excise tax.

The first of the present series of Federal income tax laws was signed by President Wilson on October 3 of the year of ratification of the Sixteenth Amendment. During the intervening quarter century the income tax has acquired an increasingly important part in the Federal fiscal system. Its productivity increased from $35 millions or 10.2 percent of all internal revenue collections during the fiscal year 1913 to a war-time peak of almost $4 billions in 1920. For the fiscal year 1937 its yield amounted to $2,149 millions, representing 46.2 percent of all internal revenue collections. For the fiscal year 1938 it is estimated that the income tax will yield about $2,950 millions, which will be about 47.1 percent of all estimated internal revenue.

Table 1
Income taxes and total internal revenue receipts,
for the fiscal years 1925-1938
(On collection basis)

Fiscal year	Income taxes: Corporation	Income taxes: Individual	Income taxes: Total	Total internal revenue	Total income taxes as a percentage of total internal revenue (percent)
	(In millions of dollars)				
1925	916	846	1,762	2,584	68.2
1926	1,095	879	1,974	2,836	69.6
1927	1,308	912	2,220	2,866	77.5
1928	1,292	883	2,175	2,791	77.9
1929	1,236	1,095	2,331	2,939	79.3
1930	1,263	1,147	2,410	3,040	79.3
1931	1,026	834	1,860	2,428	76.6
1932	630	427	1,056	1,558	67.8
1933	394	353	747	1,620	46.1
1934	398	419	817	2,672	30.6
1935	572	527	1,099	3,299	33.3
1936	739	674	1,413	3,520	40.1
1937	1,057	1,092	2,149	4,653	46.2
1938 (Est.)	-	-	2,949	6,260	47.1

The rising importance of income taxation in the Federal fiscal structure is reflected in the rate history of the corporation and individual income taxes during the last quarter century.

In the Revenue Act of 1913 the normal tax rate was 1 percent, which three years later was increased to 2 percent. In 1917 the uniform normal tax rate was replaced by a 2 percent rate applicable to the first $2,000 and 4 percent on net incomes in excess of that amount. The multiple normal rate structure was retained until 1934 when the present 4 percent uniform rate was enacted. During the interim the normal rate schedule consisted of as many as three varying rates and ranged all the way from 1/2 percent on the first $2,000 applicable to the year 1929 to 12 percent on amounts in excess of $4,000 for 1918. The maximum individual surtax rates have increased from 6 percent under the Revenue Act of 1913 to the present level of 75 percent. The minimum surtax rates applied to the high level of incomes from $20,000 to $50,000 at the rate of 1 percent in 1913 and now apply to the relatively low incomes of

Objectives of
Revision

$4,000 to $6,000 at a minimum rate of 4 percent. Combining the surtax with the normal tax, the highest income tax rate now amounts to 79 percent as against 7 percent under the Revenue Act of 1913 and 77 percent under the 1918 law.

The changes in the individual normal and surtax rates, and in personal exemptions and credit for dependents during the period 1913-1936 are presented summarily in Table 2.

The corporation income tax rates, aside from the excess-profits tax, were relatively low under the Revenue Acts 1913-1917 but since 1918 have been consistently 10 percent or in excess thereof. Changes in the corporation income tax rates for the period 1913-1936 are shown in Table 3.

B. Objectives of Income Tax Revision

The history of the Federal Income Tax since 1913 is the history of the extension of the ability to pay principle and progressiveness in taxation. Economic principles require not only that the direction of that trend be uninterrupted but also that it be enhanced. It is in part with that end in view that the revenue revisions here proposed have been conceived. The individual surtax rates have been consistently high, with the exception of the period from 1925 to 1931 when the maximum surtax rate was lowered to 20 percent. In general, however, the individual income tax has not as yet attained its proper place in the Federal revenue system. This is evident from the heavy reliance the Federal Government has found it necessary to place upon numerous miscellaneous excise taxes which are in conflict with the principle of ability to pay and which serve to counteract the influence of the individual income tax on the nature of the distribution of the Federal tax burden.

Reference to the accompanying table (Table 4) will reveal that the share of direct taxes in internal revenue and customs declined for 68 percent at the turn of the present decade to 33.9 percent in 1934. Since then the trend has been reversed but indirect taxes bid fair to play a significant part in the fiscal system for some time. To be sure, circumstances may preclude the possibility of eliminating all regressive taxes but the role of the Federal individual income tax in the Federal revenue system should be so preeminent that the progressive features of the tax structure as a whole might be maintained in all circumstances. Income tax revision must, therefore, be directed toward increasing the importance of the individual income tax in the Federal revenue structure to the level where it will be possible to relieve the low income classes from at least some of the regressive taxes, or in any event, to increase the individual income tax in the middle and upper brackets sufficiently to counteract the regressive taxes and thereby render the aggregate Federal revenue system progressive.

Table 2: Individual Income Tax

Personal Exemptions and Credit for Dependents, Normal Tax Rates, and Range of Surtax Rates, 1913 - 1936

Revenue Act	Income Year	Personal exemptions and credit for dependents			Normal tax rates				Surtax rates			
									Minimum rates		Maximum rates	
		Married	Single	Dependent	First $2,000	$2,000 - $4,000	$4,000 - $8,000	Over $8,000	Applying to net income block of	Rate	Applying to net income over	Rate
1913	Mar. 1, 1913 - Dec. 31, 1915	$4,000	$3,000	None	1%	1%	1%	1%	$20,000 - $50,000	1%	$ 500,000	6%
1916	1916	4,000	3,000	None	2	2	2	2	20,000 - 40,000	1	2,000,000	13
1917	1917	2,000	1,000	$200	2	4	4	4	5,000 - 7,500	1	2,000,000	63
1918	(1918	2,000	1,000	200	6	6	12	12	5,000 - 6,000	1	1,000,000	65
	(1919 - 1920	2,000	1,000	200	4	4	8	8	5,000 - 6,000	1	1,000,000	65
1921	(1921	2,500 1/	1,000	400	4	4	8	8	5,000 - 6,000	1	1,000,000	65
	(1922, 1923 2/	2,500 1/	1,000	400	4	4	8	8	6,000 - 10,000	1	200,000	50
1924	1924	2,500	1,000	400	2	2	4	6	10,000 - 14,000	1	500,000	40
1926 and 1928	(1925 - 1928	3,500	1,500	400	1 1/2	1 1/2	3	5	10,000 - 14,000	1	100,000	20
	(1929 3/	3,500	1,500	400	1/2	1/2	2	4	10,000 - 14,000	1	100,000	20
	(1930 - 1931	3,500	1,500	400	1 1/2	1 1/2	3	5	10,000 - 14,000	1	100,000	20
1932	1932, 1933	2,500	1,000	400	4	4	8	8	6,000 - 10,000	1	1,000,000	55
1934	1934	2,500	1,000	400	4	4	4	4	4,000 - 6,000	4	1,000,000	59
1935 and 1936	1935, 1936	2,500	1,000	400	4	4	4	4	4,000 - 6,000	4	5,000,000	75

1/ For net income in excess of $5,000, personal exemption was $2,000.
2/ Tax for 1923 reduced 25 percent by credit or refund under Section 1200(a) of the Revenue Act of 1924.
3/ Rates of normal tax reduced by Joint Resolution of Congress, No. 133, approved by President, December 16, 1929.

Table 3: Corporation income tax, undistributed pr..ts tax and excess-profits tax rates, 1909-1936

Revenue Act	Income year	Income tax rates (percent)	Excess-profits tax: Minimum rates: Applying to net income	Minimum rates: Rate (percent)	Maximum rates: Applying to net income	Maximum rates: Rate (percent)
1909 (excise tax)	1909-2/28/1913	1	-	-	-	-
1913	3/1/1913-12/31/1915	1	-	-	-	-
1916	1916	2	-	-	-	-
1917	1917	1 - 4 1/	Equal to 15 percent of invested capital less credit	20	In excess of 33 percent of invested capital	60
1918	1918	12	Equal to 20 percent of invested capital less credit	30	In excess of 20 percent of invested capital	65
	1919, 1920	10	"	20	"	40
1921	1921	10	"	20	"	40
1921 and 1924	1922-1924	12½	-	-	-	-
1926	1925	13	-	-	-	-
	1926, 1927	13½	-	-	-	-
1928	1928	12	-	-	-	-
	1929	11 2/	-	-	-	-
	1930, 1931	12	-	-	-	-
1932	1932, 1933	13¾ 3/	-	-	-	-
N.I.R.A., 1933	1933	13¾ 3/	-	-	In excess of 12½ percent of adjusted declared value of capital stock	5
1934	1934	13¾ 3/	-	-	"	5
1934 and 1935	1935	13¾ 3/	In excess of 10 percent but not in excess of 15 percent of adjusted declared value of capital stock	6	In excess of 15 percent of adjusted declared value of capital stock	12
1936	1936	(1) Normal tax, 8-15 percent of normal tax net income (2) SURTAX ON UNDISTRIBUTED PROFITS, 7-27 percent	"	6	"	12

1/ One percent rate applied to dividends out of earnings from Mar. 1, 1913, to Dec. 31, 1915; a rate of 2 percent applied to net income in excess of the sum of (1) excess-profits tax for the current year, and (2) dividends received out of earnings from Mar. 1, 1913, to Dec. 31, 1915; the 4 percent rate applied to net income in excess of the sum of (1) excess-profits tax for the current year, and (2) dividends received out of earnings from Mar. 1, 1913 to Dec. 31, 1917.

2/ Rate reduced by joint resolution of Congress No. 133, approved by the President Dec. 16, 1929.

3/ The rate of tax on consolidated returns for 1932 and 1933 is 14½ percent; for 1934 and 1935 15¾ percent on consolidated returns for electric and steam railroads. In the Revenue Act of 1936 no distinction is made between the rates applicable to corporations privileged to file consolidated returns and other corporations. The 1936 Act extended the privilege to file consolidated returns to street, suburban or interurban electric railways.

Table 4: Direct and indirect tax collections for the fiscal years 1926, 1930-1937

(Collection basis, except customs which are on daily statement basis)
(In millions of dollars)

	1926	1930	1931	1932	1933	1934	1935	1936	1937
Direct taxes:									
Income	1,974	2,410	1,860	1,057	747	817	1,099	1,413	2,149
Excess profits	-	-	-	-	-	3	7	15	25
Capital stock	97	-	-	-	-	80	92	95	137
Estate	116	65	48	47	30	104	140	219	282
Gift	3	-	-	-	5	9	72	160	24
Total	2,191	2,475	1,908	1,104	781	1,013	1,4[illegible]	1,901	2,617
Indirect taxes:									
Liquor, including non-intoxicating liquors	26	12	10	9	43	259	411	505	594
Other internal revenue including AAA taxes	619	553	510	445	796	1,400	1,479	1,114	1,442
Customs	579	587	378	328	251	313	343	387	486
Total	1,225	1,152	898	781	1,089	1,973	2,233	2,006	2,522
Grand total internal revenue and customs	3,415	3,627	2,807	1,885	1,871	2,986	3,643	3,907	5,139
	Percentages of internal revenue and customs								
Direct taxes	64.1	68.2	68.0	58.5	41.7	33.9	38.7	48.7	50.9
Liquor, including non-intoxicating liquors	.8	.3	.3	.5	2.3	8.7	11.3	12.9	11.6
Other indirect taxes	35.1	31.5	31.7	41.0	56.0	57.4	50.0	38.4	37.5
	Percentages of internal revenue and customs excluding liquor								
Direct taxes	64.6	68.5	68.2	58.8	42.7	37.1	43.6	55.9	57.6
Indirect taxes excluding liquor	35.4	31.5	31.8	41.2	57.3	62.9	56.4	44.1	42.4

Another feature of the Federal income tax has been the lack of coordination between its two constituents, the tax on corporations and the tax on individuals. For example, under all the Revenue Acts prior to 1936, dividends received by individuals were credited against the individual income tax base for normal income tax purposes. This procedure would seem to be in accord with the view that the corporation is a conduit through which certain income streams flow to individuals and that these streams of income taxed to the corporation cannot to that extent properly be taxed to the individual. At the same time, however, throughout the period from 1918 to 1936, corporation income tax rates have been consistently in excess of the individual normal tax rate, indicating that at least to the extent of the excess the corporation income tax has been viewed in the nature of a privilege tax for the privilege of doing business in corporate form. Further, the excess of the corporation over the individual normal rate reached a level which made even such an interpretation of the corporation income tax doubtful. It appears that in substantial part the corporation income tax of the past cannot be explained except in terms of the revenue requirements of the Government and in terms of administrative and political convenience. Thus its coordination with the individual income tax was conspicuously lacking.

Under the Revenue Act of 1936 dividends received by individuals were for the first time subjected to the normal individual income tax. This step was in accord with the view that the corporation income tax was predicated upon corporate privilege. It was, however, in conflict with the conduit view of corporation income taxes, which appears to have governed the simultaneous imposition of the surtax on undistributed profits. Examining 1936 legislation further, it appears that the retention of the corporation normal income tax in that year was in accord with the privilege view of the corporation income tax and in conflict with the conduit view. The conclusion is inescapable that in the light of economic principles the integration of the individual and corporation income tax continues to leave much to be desired. Accordingly, income tax revision must also be directed toward a coordination of the corporation and individual income tax on a consistent principle: To tax corporate income in the hands of the individual income recipients at progressive rates and to tax corporations on a broad basis and at rates sufficiently low to make it possible to view the tax as one on corporation privilege.

Finally, the third objective of income tax revision is the making of those adjustments in the income tax base which are necessary to prevent the income tax from burdening taxpayers inequitably either because existing features of the tax are conducive to tax avoidance or because they provide intentional and unintentional bounties to some taxpayers and not to others.

It is in furtherance of these three objectives, (1) increasing reliance upon progressive taxes, (2) better coordination between the individual and corporate income taxes, and (3) the elimination of existing structural inequities, that the herein contained proposals for revision are recommended.

Structural Revisions

Individual Income Taxes

Rates

C. Structural Revisions

1. The Individual Income Tax Schedule

a. Normal and Surtax Rates

It was noted above that one major objective of the proposed revenue revision is the increasing of the role of the individual income tax in the Federal revenue structure. With general agreement that the Federal Government must place increasing reliance upon progressive direct taxes and with the realization that its opportunities for doing so are largely confined to the individual income tax and the less productive estate and gift taxes, the individual income tax looms large in the Federal tax picture. With that view in mind, it is proposed that the surtax rate schedule be revised upward. No change is proposed with respect to the normal tax on individuals. The rate is to remain at 4 percent.

Comparison of the rates in Table 5 with the present schedule will reveal that except in the first two brackets the proposed surtax rates are higher than the present surtax rates for all levels of income of $500,000 and less and are the same as the present rates for all levels of income in excess of $500,000. The proposed bracket rate increases are largest in the case of incomes of $100,000 and less. Further, it is proposed that the surtax rates begin with surtaxable net income in excess of $3,000 instead of the present $4,000 but that the rate for the first $3,000 of surtaxable income be 3 percent, applicable from the $3,000 level instead of the present 4 percent on the first $2,000 of surtaxable income above the $4,000 level. This proposed adjustment of the lowest surtaxable income level is prompted by the desirability of avoiding abrupt differentiation between individuals that have just sufficient income to emerge into the first surtaxable income bracket.

With respect to the normal tax on individuals, it has already been noted that before 1934 it has sometimes been in two or three bracket rates and has sometimes risen to a level as high as 12 percent. The Revenue Act of 1918 imposed a tax of 12 percent on normal income in excess of $4,000. Two questions arise, therefore, with respect to the normal income tax rate: (1) should it be uniform or bracketed, and (2) should it be high or low in relation to the surtax rate schedule?

The graduated normal individual income tax derives its theoretical strength from the desirability of relieving the recipients of small amounts of income from the full impact of a relatively high flat rate normal tax. So long as the normal tax is moderate, such as the proposed 4 percent rate, the need for a graduated normal tax does not arise. Although in 1917 and again in 1929 the rate was actually graduated below this level, these were exceptional occasions for, generally, graduation occurred at higher levels. Thus, the top rate in 1918 was 12 percent, in 1919-23 and again in 1932-33, 8 percent, in 1924, 6 percent and in 1925-28 and again in 1930-31, 5 percent.

Table 5: Proposed surtax schedule

Amount of surtax net income (in thousands)	Rate of tax (percent)	Total surtax (cumulative)
0 - 3	-	-
3 - 6	3	90
6 - 8	5	190
8 - 10	7	330
10 - 12	10	530
12 - 14	13	790
14 - 16	16	1,110
16 - 18	20	1,510
18 - 20	24	1,990
20 - 22	28	2,550
22 - 24	32	3,190
24 - 28	36	4,630
28 - 34	40	7,030
34 - 40	44	9,670
40 - 48	48	13,510
48 - 56	51	17,590
56 - 64	53	21,830
64 - 72	55	26,230
72 - 80	57	30,790
80 - 90	59	36,690
90 - 100	61	42,790
100 - 150	63	74,290
150 - 200	65	106,790
200 - 250	66	139,790
250 - 300	67	173,290
300 - 400	68	241,290
400 - 500	69	310,290
500 - 750	70	485,290
750 - 1,000	72	665,290
1,000 - 2,000	73	1,395,290
2,000 - 5,000	74	3,615,290
5,000 up	75	

There are two disadvantages in keeping the normal tax high in relation to the surtax rates: First, the use of a high normal rate in lieu of a high surtax rate schedule enables certain recipients of income from tax-exempt bonds to escape their proper share of the tax burden; and second, the use of a high normal tax rate renders the combined income tax scale less flexible for purposes of maintaining some desired standard of progressiveness under varying business conditions. Sharply rising prices and inflated money incomes tend to make a progressive rate scale more progressive than initially contemplated. Similarly, declining prices and a deflation of income sources tend to make the originally established progressive rate scale less progressive. In order to maintain the same degree of progressiveness during years of different business conditions it is necessary to adjust the surtax rate scale as well as the normal tax. If the normal tax is high in relation to the surtax rate scale, it becomes more difficult to adjust the combined rates and thus retain the desired standard degree of progression.

Great Britain furnishes the outstanding example of a country that has attempted to adjust a high flat standard rate in order to meet governmental revenue requirements. The surtax rates have been maintained practically unchanged since enactment. There is much to be said for this procedure on grounds of simplicity but the procedure is one which sacrifices consideration of equity. Too much stress cannot be placed upon the inability of the British procedure to maintain any standard of progressiveness during periods of fluctuating prices, although it should be noted that the maintenance of such a standard by surtax rate schedule adjustments is extremely difficult, so difficult, in fact, that the British apparently do not believe the attempt to be worthwhile.

Increasing recognition of the interdependence of business conditions and fiscal policy, however, tends to substantiate the American as opposed to the British procedure. The adjustment of rate scale progression to business fluctuations is at least recognized as theoretically desirable if not practically possible. For that reason it is recommended that the present continuation of low and stable normal rates with high and variable surtax rates be retained.

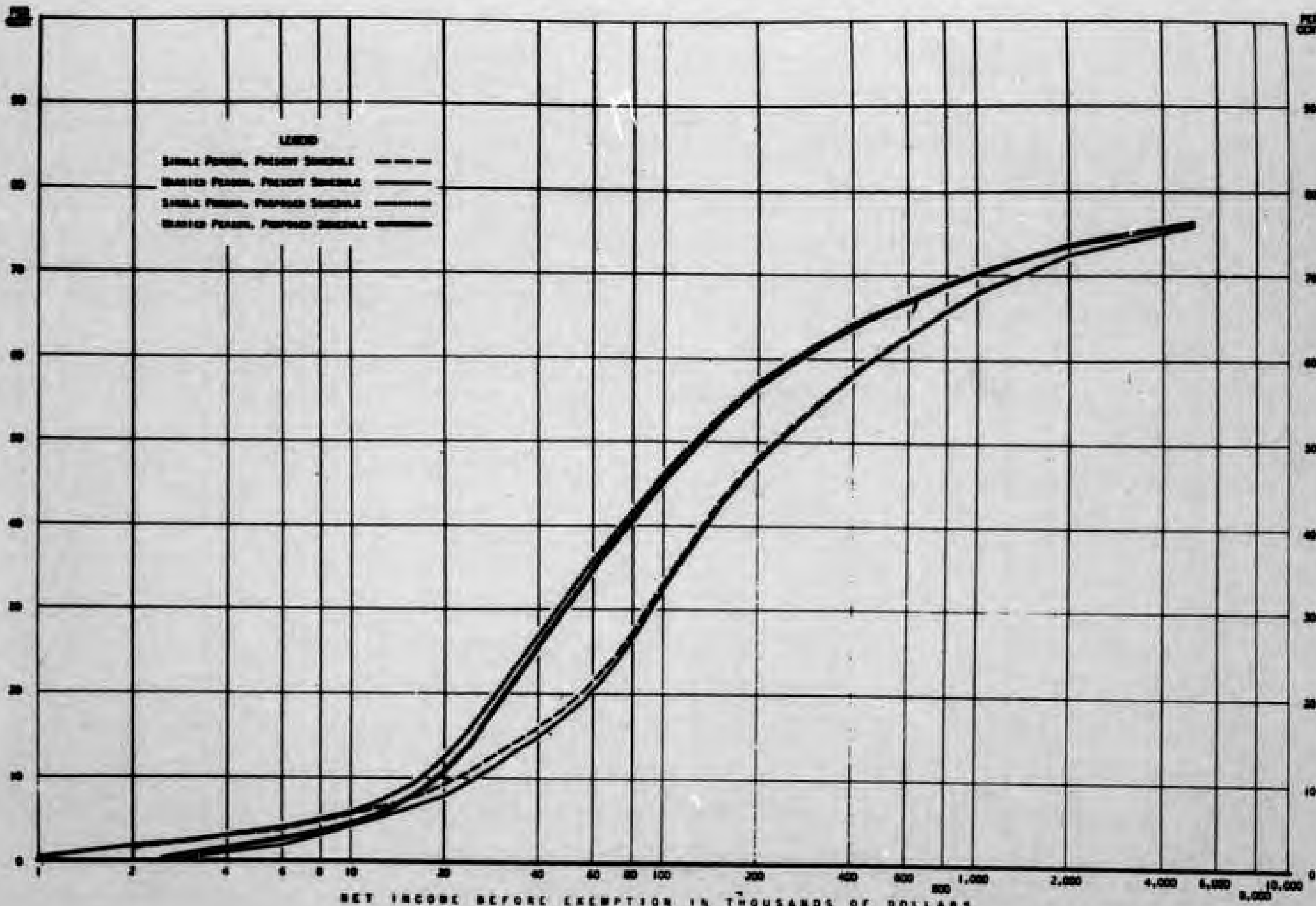
A comparison of the effective normal and surtax rates under the existing and proposed surtax schedule is presented in Table 6 and in the accompanying chart. For purposes of the comparison, recognition is given to the proposed changes in personal exemptions and in earned income credit discussed in the following section.

Table 6: Effective Normal and Surtax Rates Under Existing and Proposed Individual Income Tax Schedule

Net income before exemption 1/	Present Schedule		Proposed Schedule	
	Single Person	Married Person	Single Person	Married Person
$ 1,000	-	-	.2	-
2,000	1.6	-	1.8	-
2,500	2.0	-	2.1	.2
3,000	2.3	.3	2.3	.7
6,000	3.6	1.9	4.0	2.5
8,000	4.7	3.1	4.9	3.5
10,000	5.6	4.2	5.8	4.5
12,000	6.4	5.0	6.9	5.5
14,000	7.0	5.8	8.1	6.6
16,000	7.7	6.5	9.4	7.9
18,000	8.4	7.2	10.9	9.3
20,000	9.2	7.9	12.4	10.7
22,000	10.0	8.7	14.0	12.3
24,000	10.8	9.5	15.7	13.9
28,000	12.3	11.1	19.1	17.4
34,000	14.3	13.2	23.4	21.8
40,000	16.0	14.9	27.0	25.5
48,000	18.2	17.2	31.1	29.8
56,000	20.3	19.4	34.5	33.3
64,000	22.7	21.7	37.3	36.2
72,000	25.1	24.1	39.7	38.7
80,000	27.5	26.6	41.8	40.9
90,000	30.5	29.6	44.1	43.3
100,000	33.4	32.5	46.2	45.4
150,000	42.9	42.3	53.1	52.6
200,000	48.2	47.7	57.1	56.7
250,000	51.7	51.3	59.7	59.3
300,000	54.4	54.1	61.5	61.3
400,000	58.3	58.0	64.2	63.9
500,000	61.0	60.8	65.9	65.7
750,000	65.4	65.2	68.6	68.5
1,000,000	68.0	67.9	70.5	70.4
2,000,000	72.5	72.5	73.7	73.7
5,000,000	75.8	75.8	76.3	76.3

1/ All income is assumed earned; basis of computations: for present rate schedule earned income credit 10 percent, personal exemptions $1,000 for single person and $2,500 for married person, and for proposed rate schedule earned income credit 15 percent, personal exemptions $800 and $2,000, respectively.

EFFECTIVE NORMAL AND SURTAX RATES
UNDER PRESENT AND PROPOSED INDIVIDUAL INCOME TAX SCHEDULE



Exemptions

b. Personal Exemptions and Earned Income Credit

It is proposed to lower the personal exemptions from $1,000 to $800 for single persons and from $2,500 to $2,000 for married persons, and to simultaneously raise the earned income credit from 10 to 15 percent.

As shown previously, relatively high personal exemptions have been characteristic of the Federal income tax. The personal exemptions were lowest during the period 1917-20, when they were $1,000 and $2,000 for single and married persons, respectively. These cannot be compared, however, with the existing $1,000 and $2,500 and with the proposed $800 and $2,000 exemptions insofar as concerns individuals subject to the surtax. Whereas the present personal exemption and credit for dependents are allowable for both normal and surtax purposes, the 1917-20 levels were restricted to normal tax purposes. For the majority of persons, however, those that do not reach into the surtaxable levels, the proposed personal exemptions are comparable with those of 1917-20.

However, the personal exemptions and credit for dependents cannot be evaluated except in combination with the earned income credit.

The present personal exemptions together with the existing 10 percent earned income credit affords complete freedom of Federal income tax liability to a single person without dependents and with income of $1,111 and to a married person without dependents and with income of $2,778. In combination with the proposed 15 percent earned income credit, the proposed personal exemptions mean that single persons with income of $941 and married persons with income of $2,353 are free of the Federal income tax.

The proposed lowering of the personal exemptions would broaden the individual income tax base so that many more individuals would file Federal income tax returns. Such direct taxation of a larger number of individuals would have the tendency of making the population more keenly alert with respect to governmental problems and would yield some additional revenue.

The recommended reduction in personal exemptions serves to broaden the individual income tax base in two respects: (1) By reducing the lower limit, it reaches individuals with smaller net incomes than those at present taxable; and (2) by enlarging the tax base of individuals at present subject to tax it increases their tax liability. On both counts, this proposal would result in increased revenue and consequently make possible the relinquishment of less desirable and regressive types of taxes.

The portion of the income tax base cut away even by the lowest of personal exemptions and credit for dependents, that of the period 1917-20, is shown in the following table:

Personal exemptions and credit for dependents and net income, for calendar years 1917-1920

(In millions of dollars)

Year	Personal exemptions and credit for dependents	Net income	Personal exemptions and credit for dependents as a percentage of net income
1917	$ 3,773	$11,191	33.7
1918	8,097	15,925	50.8
1919	9,424	19,859	47.5
1920	12,835	23,736	54.1

One of the chief objections to lower personal exemptions and lower credit for dependents is that the greatly increased number of returns aggravate the problems of income tax administration. If such returns are to be audited even in the most cursory manner it will require a substantial increase in personnel. Some indication of the increase in the number of returns which is likely to result from the lower personal exemptions may be derived by reference to the data for the period 1917-20. These are shown in Table 9.

For the year 1920, for example, 72.2 percent of the total number of returns were made by persons having incomes of $3,000 or less; this large percentage of the total number of returns, however, supplied only 7.6 percent of the total individual income tax revenue. It should be noted, however, that the absolute net amount of revenue, after offsetting administrative costs, which will result from the enactment of the lower personal exemptions will by no means be inconsequential.

Personal exemptions and credit for dependents are granted in the nature of reliefs from income tax burden in recognition of the fact that a certain amount of tax-free income is essential for the maintenance of a decent standard of living. This relief granted under the income tax does not effectively accrue to the individual taxpayer unless the amount of income thus free from income tax is also free from other types of taxation. If the level of personal exemptions and credit for dependents is high, it is practically impossible for the Federal Government to pursue a tax policy which will leave the individual taxpayer with a large amount of income free from all taxation. The distribution of the burden of taxes other than the individual income tax is less rational and more regressive than the distribution of the burden of the income tax. One of the main purposes of the proposal to lower personal exemptions is not to raise additional revenue but to raise substitute revenue; to substitute income tax revenue for other tax revenue, with a view to making the aggregate distribution of the Federal tax burden more equitable.

Table 9

Individual income tax returns and taxes paid, 1917-20.
Ratio of $1,000 - $3,000 income class to total

A. Number of returns
(In millions)

Year	Taxable returns			Nontaxable returns			Total returns		
	Total	Net income class $1,000 - $3,000		Total	Net income class $1,000 - $3,000		Total	Net income class $1,000 - $3,000	
		Number	Percent		Number	Percent		Number	Percent
1917	3.232	2.265	70.1	.241	.214	89.0	3.473	2.479	71.4
1918	3.393	2.018	59.5	1.032	.996	96.4	4.425	3.014	68.1
1919	4.231	2.429	57.4	1.102	1.065	96.7	5.333	3.495	65.5
1920	5.518	3,549	64.3	1.742	1.693	97.2	7.260	5.241	72.2

B. Taxes paid
(Amounts in millions of dollars)

Year	Total	Net income class $1,000 to $3,000	
		Amount	Percent of total
1917	675	9 1/	1.3
1918	1,128	62	5.5
1919	1,270	53	4.2
1920	1,075	82	7.6

1/ Tax returned by incomes of $2,000-$3,000. No tabulation was made of the tax returned by incomes under $2,000.

Earned Income
Credit

c. Earned Income Credit

If personal exemptions were lowered without the simultaneous increase in the earned income credit, it is possible that the tax falling on small incomes would result in too great a burden. The increase in the earned income credit serves to bring additional relief to the small taxpayer.

The principle of differentiation between earned and unearned income under income tax laws is recognized in other countries. Thus, in Great Britain the earned income credit is at the rate of 20 percent, except that all income in excess of $7,500 is considered unearned instead of all income in excess of $14,000, as in our law. In Canada, instead of giving some relief to the recipients of earned income, the principle of differentiation is recognized by imposing an additional tax on unearned income, graduated from 2 to 10 percent; in Australia the principle is recognized through the use of a separate and higher progressive rate scale applicable to unearned income as against earned income.

The present law provides that there shall be allowed for purposes of the normal tax only a credit for earned income to the extent of 10 percent of earned net income. If the taxpayer's net income is not more than $3,000 his entire net income is considered to be earned net income and if his net income is more than $3,000 his earned net income is considered to be no less than $3,000. In no case, however, shall the earned net income be considered to be more than $14,000. Recognition of the fact that earned income should be given preferential treatment is first found in the Revenue Act of 1924 and was continued through the Revenue Act of 1928. It was discontinued under the Revenue Act of 1932 but reimposed under the Revenue Act of 1934. The rates and allowances during this period are shown in the following table:

Credit on earned net income

Revenue Act	Income year	Kind of credit	Earned net income subject to tax for computation of credit	Limit of credit
1924	1924	Against tax	All net income up to $5,000 whether earned or not, and up to $10,000, if earned	25 percent of normal tax on earned net income. (Cannot exceed 25 percent of normal tax on ordinary net income.)
1926	1925, 1926, 1927	....do....	All net income up to $5,000, whether earned or not, and up to $20,000, if earned.	25 percent of total tax on earned net income. (Cannot exceed the sum of 25 percent of normal tax on ordinary net income and 25 percent of surtax on earned net income.)
1928	1928, 1929, 1930, 1931	....do....	All net income up to $5,000, whether earned or not, and up to $30,000, if earned	...........Do..........
1932	1932, 1933	....	....	....
1934-1936	1934, 1935, 1936	Against net income.	All net income up to $3,000 whether earned or not, and up to $14,000, if earned.	10 percent of the earned net income, but not in excess of 10 percent of the entire net income.

It will be noted that under the present law the earned income credit is allowed on amounts of income of $3,000 and less irrespective of whether earned or not. This is justified on the grounds that recipients of small amounts of income are entitled to relief from the rate scales otherwise in effect. Further, it should be noted that irrespective of whether earned or not, incomes in excess of $14,000 are considered unearned. This procedure is justified on similar grounds, namely, that it is not essential to afford recipients of large amounts of income relief from the rate scales otherwise in effect.

Corporation Taxes

Existing Corporation Taxes

In the present law there is a little understood limitation upon the amount of earned net income credit, namely, that it must not be in excess of 10 percent of net income. It is proposed that this limitation be repealed so as to allow an unconditional credit to the extent of 15 percent of earned net income, that is, irrespective of the amount of the net income; subject to the exception, however, that incomes in excess of $14,000 shall be considered to be unearned.

2. Taxation of Corporations

In line with the previously indicated objectives of revenue revision this section examines the inequitable features of the existing complement of Federal corporation taxes and describes a more acceptable method of corporation taxation. The proposed revision is predicated upon the hypothesis that the corporations themselves should be taxed solely for the privilege of doing business in the corporate form and that the profits of corporations be taxed in the hands of the individual dividend recipient. This, it will be observed, is but the next stage of the individual-corporate inter-relationship in taxation initiated by the Revenue Act of 1936.

a. The Existing Corporation Taxes

The Federal Government at present, in addition to the undistributed profits tax, levies three taxes on corporations, a normal income tax, a capital stock tax and an excess profits tax. The most important of these from a point of view of productivity is the normal tax, now imposed at rates ranging from 8 percent on the first $2,000 of normal tax net income to 15 percent on normal tax net income in excess of $40,000. The yield from the corporate normal income tax, it is estimated, amounted roughly to $950,000,000 during the fiscal year 1937 and is estimated at approximately $1,200,000,000 for the fiscal year 1938. While collections during no recent year approached the present level, they were, nevertheless, consistently in excess of collections from individual income tax in all but two of the last thirteen years and on occasions have supplied fully one-third of Federal revenues.

Prior to the Revenue Act of 1936 the corporation income tax was in part a tax on corporate privilege and in part a tax at source, in lieu of the normal individual income tax, dividends being exempted from normal individual income taxes. However, the corporate income taxes have generally been higher than those imposed under the normal individual income tax on dividends and a portion of them were therefore in fact taxes on corporate privileges. The subjection of dividends to the individual normal income tax under the Revenue Act of 1936 rendered the entire corporate income tax one predicated upon corporate privilege. In view of that circumstance the present corporation tax must be appraised in the light of its qualifications as a privilege levy. Such an appraisal, as will be noted later, leads to the conclusion that the tax is both excessive and defective.

The corporation income tax is an unsatisfactory measure of the corporate privilege. Being based on net income it does not apply to a corporation which conducts a business which runs into millions of dollars annually for several years, as long as it produces no statutory net income.

It is true that corporations float in and out of the profitable group so that over a long stretch of time all corporations, except those that pass out through bankruptcy or are otherwise liquidated, become subject to income tax. Nevertheless such a tax is not a satisfactory corporate privilege tax because it would seem that the privilege of doing business under the corporate form must have some annual value irrespective of the corporation's ability to make profits. Further, differences in corporate capitalization affect the income tax base in a way which is altogether incongruous with the view that the normal income tax is in fact a satisfactory corporate privilege tax. Two corporations each doing the same amount of gross business and each with the same profit ratio will under the present procedure pay different amounts of normal income tax if one of the corporations operates entirely with capital derived from issues of stock and the other operates with capital derived partly from stock and partly from bond issues.

The capital stock tax is at present imposed at the rate of $1.00 per $1,000 of adjusted declared value of capital stock. It is in substance a privilege tax distinct from the normal income tax and was originally imposed under the Revenue Act of 1916. After ten years it was repealed under the Revenue Act of 1926, only to be reimposed by the National Industrial Recovery Act in 1933.

In order to prevent the avoidance of this privilege tax through understatements of capital value, Congress imposed an excess profits tax which applies to corporations reporting profits in excess of 10 percent of declared capital value. The tax is imposed at a 6 percent rate on a corporation's net income in excess of 10 percent and not in excess of 15 percent of the adjusted declared value of its capital stock and at a rate of 12 percent on a corporation's net income in excess of 15 percent of the adjusted declared value of its capital stock.

The capital stock tax has proved to be no more satisfactory as a measure of corporate privilege than the corporation normal tax. The base upon which it is imposed, as will be noted later, is incapable of exact, uniform determination with the result that the tax is frequently discriminatory as between different taxpayers.

Upon the reimposition of the capital stock tax under the National Recovery Act, the taxpayer was permitted to declare any value for the capital stock, and as a protection against tax avoidance, the excess-profits tax was also reimposed so that if capital stock were undervalued the corporation would become subject to the excess-profits tax. A re-declaration of value was permitted under the Revenue Acts of 1934-36 but since this valuation is based primarily upon taxpayer's judgment it bears no necessary relationship to book value, market value or capitalized income. Tax liability continues to be determined by an arbitrarily valued capital stock base unrelated to the privilege of doing business. Consequently the tax is devoid of certainty and results in substantially inequitable taxation as between different corporations operating under substantially identical circumstances. It cannot be emphasized too strongly that this deficiency lies not only in the base now utilized for the capital stock tax but that it was also inherent in the bases used during all past efforts at imposing capital stock taxes.

To the preceding conclusion that neither the corporate normal income tax nor the capital stock tax constitutes a satisfactory tax upon corporate privilege should be added the observation that a combination of the two taxes, as is done under the present law, is also unsatisfactory, because corporations with net income pay both taxes whereas corporations without net income pay only the capital stock tax. Even if the view is taken that this corporate normal income tax in the long run will burden all corporations as they float into the profitable group, the two taxes combined would appear to be excessive for the purpose of taxing corporate privilege and nothing else. Apparently the two taxes were originally imposed for revenue purposes without much consideration given to their economic justification and certainly without much reference to the extent to which they collectively constitute a proper tax on corporate privilege per se.

While all recognize that a corporate privilege exists, the measure of that privilege is subject to conjecture. The corporation has perpetual life, has facilities for assembling large aggregates of capital from diverse sources and gives its proprietors immunity from unlimited liability. These are tangible but not specifically measurable attributes. Because it is not possible to measure the value of corporate privilege per se, the tax imposed in large part is likely to be determined by revenue considerations but the tax should not be at a level which would make reference to the privilege basis obviously irrelevant. Further, it would seem highly desirable for this purpose to impose one tax with a base more closely related to operating profits which would

Capital Stock -
Excess Profits

result in taxing corporations according to the scope of their economic activities, than two taxes, such as the present corporate normal income tax and the capital stock tax, which are not closely related to the scope of corporate economic activity.

b. Interrelationship of capital stock and excess-profits tax

The view is sometimes taken that the existing combination of capital stock and excess-profits taxes can serve as a foundation for a future real excess-profits tax. If this claim were true, it would not be worthwhile to reexamine the corporate normal income tax base in order to make of it a more satisfactory corporate privilege tax. It is important, therefore, to examine the interrelationship of the present capital stock and excess-profits taxes.

When the existing combination of capital stock and excess-profits taxes was enacted it was not expected that the excess-profits tax would yield much revenue. Its chief function was to make the capital stock tax effective. That it is "merely an adjunct to a corporation capital stock tax" is clear from the following table which shows the yield from these taxes for the fiscal years 1933-1937:

Collections from capital stock and excess-profits taxes for fiscal years 1933-37

(In thousands of dollars)

Fiscal year ending June 30	Capital stock	Excess profits	Total
1933	-	-	-
1934	80,168	2,631	82,799
1935	91,508	6,560	98,068
1936	94,943	14,509	109,452
1937	137,499	25,105	162,604
Total	404,118	48,805	452,923

The taxpayer on each of three different occasions was given the privilege to declare whatever "initial" value of the capital stock he might choose. The last "initial" value was selected for the taxable year ended June 30, 1936, and as reflected in the collections for the fiscal year 1937 was substantially higher than the preceding ones.

The declared value hinges primarily upon the taxpayer's judgment and may not be very closely related to either book value, market value or the capitalization of income basis. Once the declaration is made, it is not recallable by the taxpayer and is not subject to review by the Bureau of Internal Revenue. Subsequent to the "initial" declaration, certain adjustments of capital inflow and outgo are provided for. These adjustments are subject to review.

Formally the two taxes are distinct. Actually they are linked together by a common base, the adjusted declared value of the capital stock, which serves both as the base for the capital stock tax and the base from which excess profits are measured. Thus, in the present law no excess profits emerge if the net income of the corporation fails to exceed 10 percent of the adjusted declared value.

By linking the two taxes together in this way the Government has imposed on the taxpayer a peculiar and perplexing valuation problem. If he declares a low capital stock value the taxpayer exposes himself to the excess-profits tax. If, on the other hand, he declares a high capital stock value he escapes the excess-profits tax but exposes himself to a higher capital stock tax. Thus, the taxpayer is enticed to strive not merely for an accurate valuation (which in itself is difficult enough to determine) but for that valuation which will result in the minimum liability for both taxes taken in combination, which is much more difficult because it involves the taxpayer in an estimate of the profits of his business over its life or else over the period that he estimates that the existing combination of the two taxes will remain in force.

The task for those taxpayers that attempt to report the true value of their capital stock is not an easy one; however, it is not human nature to resist the temptation to capitalize the future earnings of a business in such a way as will result in the least possible combined tax load. It is within the law for the taxpayers to try their skill at economic and legislative prognostication and it may be assumed that they have in large numbers done so.

Taxpayer A, who predicts a two-year life for the capital stock and excess-profits taxes and little or no profits from his business in the two income-tax taxable years ending after June 30, 1936, will have had no fear of the excess-profits tax and will have declared a very low value of his capital stock for the taxable year ending June 30, 1936. Taxpayer B, with a similar forecast of profits but with a different view relating to the permanency of the taxes will be reluctant to declare a value as low as A did lest the excess-profits tax become burdensome in the third and subsequent taxable years.

If the permanency of the taxes is taken for granted, then in declaring the value of the capital stock for the taxable year ending June 30, 1936, the taxpayers should have declared it at ten times the estimated average annual earnings for in this way they are most likely to escape the burden of the excess-profits tax. The extent to which they will escape it will depend upon the fluctuations in the profits of their business.

To illustrate these points:

Let the annual net income be	$ 1.00
Let the capital stock be declared at	10.00

There will be no excess-profits tax since net income equal to 10 percent of the value of the capital stock, that is, $1 is exempt.

The capital stock tax is 1/1000 x $10 = $0.01

If the value of capital stock were made 10.1 x net income, the excess-profits tax would still be zero but the capital stock tax is increased to $0.0101.

If the value of the capital stock were made 9.9 x net income, then:

The capital stock =	$0.0099
Excess-profits tax = 6/100 x ($1 - 0.99) =	0.0006
Total tax	$0.0105

In other words, if fixed annual earnings are assumed, the combined tax will be a minimum when the declared value of capital stock is ten times earnings.

Because earnings are not fixed but fluctuate, each taxpayer may be tempted to enter upon a more complex computation based upon his prediction of the irregularity of the income peculiar to his own business. He has now entered a hazardous no-man's land in the realm of estimates. The significance of the venture can be demonstrated by an example:

	Company A	Company B
Declared value of capital stock year ending June 30, 1936	$1,000,000	$1,000,000
Annual income each of the first nine years	100,000	none
Income in the tenth year	100,000	1,000,000
Average annual net income for the ten-year period	100,000	100,000
Capital stock for the ten-year period	10,000	10,000
Excess-profits tax for the ten-year period	none	105,000
Total of both taxes for the ten-year period	$ 10,000	$ 115,000

It is true that such inequities due to variations in the stability of net income among business firms would be characteristic of any excess-profits tax imposed on a yearly basis rather than on some base that averaged the profits of several years. Further, it may be argued that the present procedure has the merit of giving the taxpayer an opportunity to surmount the inequities of an excess-profits tax imposed on a yearly basis by allowing him to declare that value for his capital stock which for the peculiar distribution of the profits of his business over the years will reduce the aggregate of the taxes to a minimum. Such argument is not convincing, however. What is more likely is that the taxpayer's efforts to accomplish such a reduction in the aggregate tax load will result either in a staggering burden of taxes or at least in a burden disproportionate to the taxes which would have resulted if less discretion had been allowed him in establishing the value of his capital stock.

Some taxpayers will make an honest effort to declare the true value of the capital stock. Others will perhaps just as honestly match their wits with the lawmakers in an effort to reduce the combined load from the two taxes to a minimum, taking into consideration the probable life of business. Obviously between the two broad groups of taxpayers, those who seek to establish true capital value and those who seek to establish a capital value with an eye towards reduced taxes in the future, there is apt to be a wide gap.

Then, as for the latter group, there will be great differences among the taxpayers themselves or among their hired experts in their efforts to forecast the fortunes of their business so as to declare a capital value which over the life of the business will keep the two taxes in combination down to a minimum. Temperamental differences alone, aside from variations in sheer forecasting capacity, would account for substantial inequalities in the tax load.

The link between the two taxes was forged to avoid the heaping up of litigation and to avoid extremely difficult administrative problems that would have emerged had the Government undertaken a valuation of all business assets, either through direct appraisal or through review of accounts submitted on tax returns for the purpose of showing the original amount of capital paid in and all subsequent adjustments on the invested capital of business.

Although the objective of the present combination of capital stock and excess-profits taxes can easily be understood, it is doubtful whether taxes that induce taxpayers to strain not merely with valuation problems but with the prospects for the repeal of the taxes, the prospects for business profits and the probable nature of the distribution of business profits over the years, can be anything less than whimsical. Some taxpayers will rely more largely than others on repeal of the taxes within a given period; some will prognosticate the future profits of their business better than others; some will guess or estimate the distribution of the profits over the years more accurately than others; but many, with or without the hire of experts, will have blundered into declarations of value for their capital stock which will penalize them for many years to come. It is extremely difficult to justify taxes with a base so lacking in objectivity as are the existing capital stock and excess-profits taxes. For this reason it is recommended that they be repealed.

Proposed Corporation Tax

c. <u>The Proposed Corporation Privilege Tax</u>

To achieve coordination between the personal and corporate taxes it is proposed that the present corporation normal income tax, the capital stock tax and the excess-profits tax be replaced by one corporation privilege tax. Corporate privilege can best be measured by taking into consideration the <u>total capital</u> employed in the business irrespective of whether derived from bond or stock issues and irrespective also of whether the corporation owns or rents its business properties. Accordingly for the purposes of the new privilege tax it is proposed to modify the base employed in conjunction with the present corporation normal tax in the following respects:

(i) Disallow the statutory deductions for interest, rent and royalties;

(ii) Disallow the credit to the extent of 85 percent of dividends received from other corporations: and

(iii) Include tax-exempt interest in the taxable base.

The present base for the corporation normal income tax appears to be unsatisfactory, primarily because it results in discrimination in favor of corporations whose capitalization includes bonds and against those whose capitalization is made up entirely of stock. If the corporation tax is to be a privilege tax, then the tax should relate to a base which reflects the return upon the corporation's entire capital and which is more closely related to the scope of its operations than the statutory net income employed for the present corporate normal income tax. The base should be such as to make the tax apply equally to corporations with similar scope of operations irrespective of whether such corporations own their business properties or operate rented properties.

The disallowance of the deduction for interest, rent and royalties will not altogether attain this latter objective because if rent and royalties are disallowed, then it would seem proper to disallow the deduction of at least a portion of taxes and depreciation. Such procedure, however, is not feasible because it is impossible to arrive at any satisfactory solution of precisely what proportion of taxes and depreciation should be disallowed in order to be equal to the component of such items in the disallowed rent. This component is known to vary for different types of property and as between properties in the same type of industry but situated in different parts of the country. Altogether, however, the failure to achieve complete parity between the owners and renters of business property does not detract seriously from the proposal.

Such changes in taxable basis as are here proposed, it should be noted, are fully within the competence of the legislature. The Supreme Court has consistently sustained the power of Congress to specify allowable deductions in computing net income. It only remains therefore to appraise these proposals in the light of economic considerations.

The proposal raises two serious problems. The first of these concerns the period of transition. The present procedure, followed from the beginning of the Federal income tax, has unduly favored the indebted corporations. A sudden reversal of policy, by disallowing the deduction of interest, may seriously hamper the operation of companies with substantial amounts of outstanding debt unless, in the transition period at least, the tax rates were made moderate. Similarly, companies with outstanding long-term rental and royalty contracts might become seriously embarrassed if the new base were adopted in combination with a high rate. In other words, during the period of transition from the present normal income tax base to the proposed corporation base, it is necessary to take some precautions lest the dislocation occasioned by the change in base seriously disrupts business equilibrium.

The second problem involved in the proposal concerns the taxation of inter-corporate items. The proposed tax would, in effect, bring much pressure to bear upon holding companies and other types of affiliates because the proposal is to include interest, rents, royalties and dividends in full as sources of corporate income. Dividends received by corporations prior to 1936 had always been excluded completely from the sources of corporate income. Under the Revenue Act of 1936, 85 percent of such dividends were excluded. Under the proposal none of such dividends will be excluded. In other words, inter-corporate dividends, rents, etc., will be taxed at least twice within the system of the proposed corporation tax and possibly several additional times if there are intermediary corporations. Furthermore, dividends will be taxed in full under the individual normal and surtax rates.

The proposal to tax inter-corporate items in full and to continue the practice adopted in 1936 of taxing dividends under the normal individual income tax is entirely consistent with the view that the new tax is a corporate privilege tax. So long as the rates are kept moderate, it would seem perfectly proper to disregard the fact that the inter-corporate income items might be taxed several times and will be taxed at least twice. If, however, the rate is not moderate, then it will be difficult to disregard this fact. In other words, irrespective of the name of the new tax, if the rate should be high, then it would be necessary to invoke the conduit view of the proposed tax and to look to the interests ultimately affected. On this basis the tax will not bear analysis. It has merit only as a corporate privilege tax and it would cease to be such unless the rate is moderate.

Since the basis for the new tax is corporate privilege, it would seem proper to include among the sources of income, tax-exempt interest because failure to include it makes it impossible for some companies, principally banks, to reflect adequately the scope of their operations-- and so the corporate privilege. It is interesting to observe that a few States, including New York State, tax what is otherwise regarded as tax-exempt interest as part of the corporation income tax base. The proposal to include such interest in the new tax is not, therefore, without any precedent. The advisability of including such interest would depend upon factors other than taxation, namely, upon legal considerations and especially upon the probable effect of the change upon the Federal Government's bond market. If this tax-exempt interest cannot be taxed for one of several reasons suggested, then it is recommended that at least expenses incurred in connection with the receipt of such tax-exempt interest be disallowed as a business expense.

The proposed new corporation tax base will serve likewise for purposes of the undistributed profits tax and the tax liability under the proposed corporate privilege tax will be allowed as a deduction for purposes of establishing the adjusted net income in the same way as the corporate normal tax is now allowed. Similarly, all the amounts paid out by the corporation, such as interest, rents and royalties, will be credited in the same way as dividends are now credited for purposes of determining the undistributed net income. The proposed treatment of corporate enterprise should result in a rational relationship between the taxation of the individual and the taxation of corporate enterprise.

The base for the corporate privilege tax would not reflect satisfactorily the corporate privilege in the case of companies whose income is almost exclusively investment income. The income of investment trusts (and to some extent also of insurance companies) comprises almost exclusively intercorporate sources. To treat investment companies in the same way as other corporations would impose upon them an undue burden not commensurate with corporate privilege. To treat such companies equitably by comparison with others it is necessary to consider part of their income purely on a conduit basis. It is suggested, therefore, that the technique now employed with respect to mutual investment companies be adopted. In other words, all the income received, whether in the nature of intercorporate items or not will be included in the corporate privilege tax base of investment companies. To relieve them from the full impact of the corporate privilege tax they may be allowed to credit against the base not the full amount of dividends paid, as is the case with mutual investment companies at present, but some percentage which, if desirable, could be made to vary according to the types of investment companies.

Separate
Returns

3. Joint and Separate Returns

It is proposed that if a husband and wife living together file separate returns, the total tax of the husband and wife shall be computed on their aggregate net income and assessed to each in accordance with the ratio of their separate net incomes to the aggregate net income.

Section 51(b) of the Revenue Act of 1936 provides that:

> "If a husband and wife living together have an aggregate net income for the taxable year of $2,500 or over, or an aggregate gross income for such year of $5,000 or over— (1) Each shall make such a return, or (2) the income of each shall be included in a single joint return, in which case the tax shall be computed on the aggregate income."

Assessment of the income tax upon husbands and wives has presented a perplexing problem of equitable administration throughout the life of the income tax system. The problem has been to determine whether or not joint returns of husbands and wives living together should be treated as one or as two separately taxable incomes.

In practice, husbands and wives filed either joint or separate returns under the earlier revenue acts, but the option granted husbands and wives living together to file either joint or separate returns was not specifically provided in the earlier laws. Such a provision appears for the first time in Section 223 of the Revenue Act of 1918. The procedure under the earlier acts indicates that the returns of husbands and wives living together presented difficult problems regardless of the type of return that they chose to file. These problems centered on the question whether the returns of husbands and wives living together constituted a unit or whether they were returns of two incomes, taxable separately, even if reported on a single return. There was some confusion. At the very beginning, the procedure for determining tax liability in some respects leaned away from the recognition of separation of interests of husbands and wives living together and in other respects seemed to recognize such a separation of interests.

Thus, under the Revenue Act of 1917, the graduated normal income taxes were assessed against the aggregate amount reported by the husband and wife <u>whether joint or separate returns were made</u>. A consistent procedure would have required that the graduated surtax under the Revenue Acts 1913 to 1917 should have been assessed in a similar way, namely against the aggregate amount of income reported by the husband and wife living together, <u>regardless of whether joint or separate returns were made</u>. However, the procedure was not consistent.

The surtax under the earlier acts was assessed against the separate income of each except when joint returns were made by husbands and wives living together, in which case the surtax was usually assessed against the aggregate amount reported. However, the assessment of the surtax on the aggregate income did not seem to derive from any clear conception that a joint return is a taxable unit; it seemed merely to be more convenient in some instances to assess it in this manner. In instances where the income and deduction items reported by the husband and wife were carefully segregated in the joint return, the surtax was assessed separately for each.

The procedure now followed seems to have been moulded during the period 1918-1920 under the Revenue Act of 1918. The practice of joining the returns of husbands and wives for purposes of the graduated normal income tax, even though made separately, was discontinued and the practice of computing the surtax on the separate incomes when separate returns were filed, but on the aggregate income when joint returns were filed, was definitely established during this period. The practice was established that the tax should be computed on the separate incomes when separately reported and on the aggregate income when jointly reported.

Upon reexamining the implications of the procedure thus established the Federal Government has come to the view that the incomes of husbands and wives constitute a unit and should be taxed as such. The problem in its present form emanates from a United States Supreme Court decision 1/ in which it was held unconstitutional to impose a tax upon one person measured by the income of another. The law of the State in which a person resides determines the rights to income as between husbands and wives. Differences in State laws, therefore, have necessitated different treatment of the incomes of husbands and wives for Federal income tax purposes and have resulted in discriminatory treatment of such taxpayers living in different States, i.e., if their incomes are viewed as a unit.

The present practice in Federal income tax administration is to recognize the basis prescribed by State statutes for the separation of interests of husbands and wives. Eight States, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington, hold to the system of community property. In substance, the system of community property existing within these States allocates one-half of the community property and income to the husband and the remaining one-half to the wife. Some other States have adopted the common law which does not recognize any separation of property interests between husbands and wives. The wife's property at date of marriage, and all property and income that she might acquire after marriage, belong to the husband. Still other States have adopted variations of one or both of these legal systems.

The accompanying Table 7 indicates the extent to which husbands and

1/ Hoeper vs. Tax Commission, 248 U. S. 206.

Table 7: Individual Returns for 1935 by Net Income Classes, Showing Number of Returns and Net Income by Family Relationship

	Joint returns of husbands, wives, and dependent children and returns of either husband or wife if no other return is filed	Community property returns 1/	Separate returns of husbands	Separate returns of wives	Single men and single women - heads of families	Single men and single women - not heads of families	Estates and trusts	Grand total
				Number of returns				
Under 5 (Est.) 2/	1,348,761		31,063	27,737	427,029	606,396	16,166	2,457,152
Under 5	460,989		37,865	52,725	29,469	1,024,483	12,214	1,617,745
5-6 2/	4,937	108	493	374	867	174	17	6,970
5-6	88,484	7,599	5,278	3,665	5,946	13,418	1,282	125,672
6-10	130,572	12,874	16,765	8,766	11,192	24,119	2,892	207,200
10-25	57,316	8,343	20,996	8,523	6,925	18,691	2,830	123,564
25-50	7,327	1,692	7,719	2,545	1,278	4,615	913	26,029
50-100	1,396	496	3,026	880	378	1,517	340	8,033
100 and over	244	96	1,130	344	126	564	143	2,647
Total	2,100,026	31,148	124,355	105,559	483,210	1,693,917	36,797	4,575,012
				Net Income (Millions of dollars)				
Under 5 (Est.) 2/	3,254		65	42	751	709	17	4,858
Under 5	1,726		120	130	110	1,863	28	3,977
5-6 2/	27	1	3	2	5	1	3/	39
5-6	483	42	29	20	32	73	7	686
6-10	973	97	131	67	84	184	23	1,559
10-25	817	122	328	130	101	280	43	1,821
25-50	242	55	265	88	43	157	32	882
50-100	91	33	203	59	25	102	23	536
100 and over	44	22	248	77	30	115	36	572
Total	7,657	372	1,392	615	1,181	3,484	209	14,910

1/ The community property returns exclude separate returns of husband and wife showing community property income where the net income is under $5,000; joint returns of husband and wife on which the net income is under $10,000; and returns of net income of $10,000 and over not designated as returns of community property income. The returns excluded are classified, according to the status shown, as joint returns of husbands and wives or separate returns of husbands and wives. In tabulating joint returns showing community property net income of $10,000 and over, the data are divided to represent two community property returns, the net income class for each of the separate returns being one-half of the combined community income. Separate returns of husbands and wives showing community property income of $5,000 and over are classified as community property returns by net income classes according to the net income on each return.

2/ Nontaxable returns. Specific exemptions from normal tax and surtax exceed net income.

3/ Less than $500,000.

wives avail themselves of the option to file separate returns. The income reported in community property returns added to the income reported by husbands and wives making separate returns in 1935 amounted to $2.4 billions out of $14.9 billions or 16 percent of the total income reported for purposes of the Federal income tax. It is apparent that the problem under consideration is of substantial importance.

The division of the total income between the husband and wife results in a reduction of the total tax paid to the Federal Government. As a result of the double use of the lower brackets, the surtax rates applicable to the separate parts are not as high as the surtax rates that would apply to the whole income. Furthermore, the total Federal income tax of a husband and wife residing in one State may differ from that of a husband and wife residing in another State, even if identical amounts of income were received in each instance.

Specifically, no advantage accrues to married residents (without dependents) of community property States under the existing law so long as their taxable net income before personal exemption does not exceed $6,500. On incomes in excess of that amount, a tax advantage appears which gains in significance as the size of the income increases. While it amounts to only $40 in the case of $7,500 incomes, the advantage increases rapidly with the size of incomes, reaching almost $70,000 on incomes of $1,000,000. The extent of the tax advantage accruing to married residents of community property States on incomes of specified size is presented in Table 8. The contrast is greatest between community property States than the others, but there are substantial variations among all the States--even among the eight community property States.

Table 8
Federal income tax liability on incomes
of specified size in community and non-community property States 1/

Net income before exemptions (In thousands of dollars)	Income tax liability: Non-community property States	Community property States: Amount	Community property States: Advantage
$ 3,500	$ 26	$ 26	$ -
5,000	80	80	-
7,500	210	170	40
10,500	458	278	180
20,500	1,664	1,118	546
52,500	9,644	6,028	3,616
76,500	19,484	11,708	7,776
102,500	33,944	19,288	14,656
202,500	96,944	67,888	29,056
302,500	163,944	129,888	34,056
402,500	233,944	193,888	40,056
502,500	305,944	259,888	46,056
752,500	490,944	432,888	58,056
1,002,500	680,944	611,888	69,056

1/ Tax computed on basis of $2,500 exemption for married persons and maximum earned income credit.

To remove these differences it is proposed that the tax be computed on the aggregate net income of both spouses, even though they file separate returns, and assessed to each in accordance with the ratio of their separate net incomes to the aggregate. The decision in Cole vs. Commissioner may have some bearing upon the possibility of this procedure. This proposal would impose the tax uniformly on total net income of all returns of husbands and wives regardless of the State in which such persons reside. By thus effecting uniformity of assessment, this proposal would bring about greater equity within the income tax, both by the elimination of discrimination and by eliminating the possibility of avoiding high surtax rates by wealthy families. Moreover, since the tax would be computed on aggregate net income of both husbands and wives, adoption of this proposal would result in increased income tax revenues.

Loss Carry-
Forward

4. Carry-forward for Annual Net Losses

It is generally recognized that the income tax would be more equitable if it could be based on the average income over a period of several years. Some obvious administrative difficulties, however, render the use of an average base impractical. The most important objection, perhaps, is that its use is grossly inconvenient for the taxpayer who is confronted during depression periods with a sizeable tax liability based on a preceding prosperity.

For many years the British experimented with an average tax base, employing a different number of years for different kinds of income and taxing some kinds of income on an annual basis. They did not employ an average base for the individual surtax, however, and in general the use of the average base was relatively unimportant except with respect to Schedule D which applies to the profits of trades, business and professions. Prior to the taxable year beginning April 6, 1927, the tax in this schedule was assessed on a three-year average base.

In the Finance Act of 1926 (aside from certain provisions which were made to facilitate the transition from the three to the one-year basis) this procedure was abolished. Simultaneously, however, a provision was enacted which allows business losses to be carried forward for a period of six years. This liberal carry-forward of losses may be regarded as a substitute for the averaging procedure. In a similar manner, the net loss provisions in our Revenue Acts 1921-1932 (which were discontinued by the N.I.R. Act) gave partial effect to the averaging of income.

Under these net loss provisions (subject to certain exceptions and limitations) net loss was defined as the excess of the deductions allowed over gross income. The exceptions and limitations were designed to limit the net loss to be carried forward to the losses from trade or business. They were designed also to make a more realistic accounting of the loss sustained by the taxpayer than resulted from the computation of the excess of statutory deductions over statutory gross income. For example,

(a) The deduction for depletion, under statutory deductions, included deductions on bases that were in no clear way related to the true depletion charges to which the taxpayer is entitled, that is, they included depletion under the percentage and discovery value bases. The deduction for purposes of determining net loss, however, were more realistically limited to those based on cost or March 1, 1913 value.

(b) The gross income did not include certain tax-exempt interest. Such interest was included for the purpose of determining the net loss to be carried forward. These adjustments reflect, in a sense, what the legislators themselves thought of certain provisions of the income tax law employed in the determination of statutory net income. In the case of interest excluded from gross income, the obstacle is a constitutional one and so beyond speedy remedy. In other instances, it would seem proper to amend the laws so as to make the statutory concepts reflect more closely the true economic position of the taxpayer.

Capital losses were carried forward as a component of net loss in different ways under different revenue acts and differently as between individuals and corporations in the manner which is described in detail in the separate memorandum on Capital Gains and Losses.

Certain of the adjustments on net deficits that formerly were necessary for the purpose of establishing a net loss, which more accurately reflected the accounting of income for individuals and corporations, will not be required if the revisions suggested in this memorandum are adopted. For example, the need for the adjustment with respect to inter-corporate dividends will disappear if the proposed corporation tax base, which includes 100 percent of inter-corporate items (dividends, rents, royalties, interest), is adopted. Similarly, the adjustment for depletion will no longer be required if the bases for depletion are restricted, as herein proposed, to cost or March 1, 1913 value. The adjustment for tax-exempt interest, however, will still be necessary because it is not possible as yet to surmount the constitutional obstacles to the taxation of tax-exempt interest under the individual income tax. But even this adjustment may not be necessary with respect to corporations if it proves feasible to include tax-exempt interest in the new corporation tax base.

In addition to the carry-forward of adjusted net deficits of individuals and corporations for a period of two years, capital losses will be carried forward for a corresponding period in the manner detailed in the memorandum on Capital Gains and Losses. Briefly, in the case of individuals the capital loss is converted into a tax credit in the year realized and, to the extent not offset in the current year by taxes on capital gains, is carried forward as a tax credit against the tax on capital gains of the two succeeding years. In the case of corporations, for purposes of the privilege tax, the capital losses are allowed as an offset in full against capital gains in the current year, but not against any ordinary income. The excess of the capital losses over capital gains is carried forward to the next two succeeding years to be allowed as an offset only against capital gains realized in those years; and for purposes of the undistributed profits tax, capital losses are allowed in full to offset against capital gains plus ordinary income in the current year and any excess not so offset is carried forward for two years to offset the capital gains plus ordinary income before determining the adjusted net income for the undistributed profits tax of those years.

The enactment of the proposal to carry forward adjusted net deficits of individuals and corporations and to carry forward capital losses for two years will go far towards establishing the income tax on a more equitable basis. Variable sources of income will thereby be placed on a more equal footing with the more stable sources of income and taxpayers who are the recipients of variable sources of income will no longer be discriminated against as they are under the present system, which taxes income strictly on an annual basis without any averaging whatsoever and without any approach to averaging which results from the use of carry-forward of losses.

In the event that the revenue implications of this proposal are found to be such that for practical reasons it could not be included in the revenue revision for 1938, then it is suggested that the proposal be enacted with a limitation. It may be provided, for instance, that the carry-forward of the cumulative losses should in no one taxable year be allowed to reduce the net income of individuals or of corporations by more than 33-1/3, or perhaps 50 percent.

Depletion

5. **Restriction of Bases for Depletion**

It is proposed to amend Section 114 so as to limit the amount of depletion to the cost basis of the property or its 1913 value.

The general rule with regard to depletion is that provided in Section 114(b)(1) of the Revenue Act of 1936:

> "The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property***."

The exceptions to this general rule are:

(a) Discovery value in the case of mines other than those producing coal, metal or sulphur.

This basis, applicable when the market value of the property at or within thirty days of discovery is materially disproportionate to the cost, dates from the Revenue Act of 1918 and originally applied also to other mines, oil and gas wells. Its scope was restricted by the Revenue Act of 1926 which limited it to mines and again by the Revenue Act of 1932 which limited it to its present scope so that it applies only to mines other than coal, metal or sulphur. The allowance for depletion on the discovery value basis cannot exceed 50 percent of the net income computed without allowance for depletion.

(b) Percentage depletion for oil and gas wells.

This basis dates from the Revenue Act of 1926. The allowance is 27½ percent of gross income not in excess of 50 percent of the net income computed without allowance for depletion.

(c) Percentage depletion for coal, metal and sulphur mines.

This basis dates from the Revenue Act of 1932. The allowance is 5 percent in the case of coal mines, 15 percent in the case of metal mines and 23 percent in the case of sulphur mines but not in excess of 50 percent of the net income computed without allowance for depletion.

In isolated instances cost or 1913 value may still be the most favorable basis for depletion but percentage depletion has come to be used most extensively.

The use of discovery and percentage depletion bases enable the taxpayer to recover more than 100 percent of his investment tax-free, although the presumption is that the taxpayer is entitled to recover his capital but that any excess over the investment should be regarded as taxable income. The income tax provisions permitting the use of discovery and percentage depletion bases are tantamount to the granting of a bounty to the oil and mining interests. Such a bounty, even if justified on general grounds, should be granted directly, rather than in the nature of an income tax relief. The latter procedure tends to destroy the equity of the income tax.

In the first place, the enactment of percentage depletion did not bring about uniform treatment as between different types of mines and gas and oil wells. The percentages vary according to the type of property, 27½ percent in the case of gas and oil wells, 5 percent in the case of coal, 15 percent in the case of metal and 23 percent in the case of sulphur properties.

In the second place, there is no necessary relationship between the aggregate depletion that can be taken under the several percentages and the cost of the property.

Thirdly, the oil, gas and mining group generally is treated more favorably than other types of business since business discoveries that increase the value of the business do not result in the creation of some artificial base corresponding to the discovery value or depletion base, of which the taxpayer is permitted to take annually some arbitrary percentage as a deduction from gross income.

The Federal Government could justly remove discovery and percentage depletion bases even if some circumstance such as war or other extraordinary demand dictated the stimulation of mineral and oil production. It can certainly justify the removal of these bases in circumstances that appear to have dictated governmental restriction programs for the purpose of protecting natural resources and market prices.

Further, the bases for depletion provided for in the exceptions to the general rule as stated in Section 114(b) were, under the revenue acts that first enacted them and under all subsequent revenue acts (except as hereinafter noted), simultaneously excluded from the basis for depletion recognized for the purpose of adjusting the cost or March 1, 1913 value for the purpose of determining the gain or loss from sale or other disposition of capital assets. This meant that the tax avoidance from excessive depletion charges taken under the discovery value or percentage of income basis could not be nullified at the time when the depleted property was sold, because these excessive depletion deductions had no bearing upon the computation of gain or loss upon the sale of mines, oil and gas wells. The Revenue Act of 1932 changed this procedure for 1932 and subsequent years by making the same depletion deductions applicable for both purposes with the exception that "where for any taxable year prior to the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income."

This change, introduced by the Revenue Act of 1932 and continued to date, will offset some of the tax avoidance from excessive depletion bases but cannot offset the tax avoidance that had accumulated on account of excessive depletion charges prior to 1932 nor can it shut off tax avoidance in the instances where the cost of the property has been more than completely charged off. The basis for depletion can be made most uniform and equitable if the exceptions to the general rule stated in subsection (1) of Section 114(b) and the subsections (2), (3), and (4) of Section 114(b) are repealed. If these amendments are enacted, then the bases for depletion would be limited to (1) cost, or (2) March 1, 1913 value of the property; and the subsidies in the shape of tax exemption that now accrue to the mining, gas and oil interests on account of excessive depletion allowances would be discontinued.

Oil and Gas
Properties

6. Tax Limitation on Income from Sale of Oil and Gas Properties

It is proposed to repeal Section 105 of the Revenue Act of 1936 dealing with income from the sale of oil or gas properties.

Section 105 of the Revenue Act of 1936 provides that "in the case of a bona fide sale of any oil or gas property, or of any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration or discovery work done by the taxpayer, the portion of the tax imposed by Section 12 (surtax on individuals) attributable to such sale shall not exceed 30 per centum of the selling price of such property or interest."

This section is similar to sections appearing in all the revenue acts from 1918 to 1932, inclusive. Its avowed purpose was to "stimulate prospecting and exploration" with respect to mines, oil or gas properties (S. Rept. 617 - 65th Congress, 3rd Session, page 6). In 1933, the Ways and Means Subcommittee on Prevention of Tax Avoidance stated in its report that this provision was apparently inserted in the law "as a subsidy to encourage the development of new mines and oil wells." The Subcommittee went on to say that in the present state of over-production there is no need to continue the subsidy, and recommended the elimination of the entire section (p. 16). Accordingly, the section was omitted from the Revenue Acts of 1934 and 1935.

As originally proposed, the Revenue Bill of 1936 (H. R. 12395) contained no provision for preferential treatment of income from the sales of oil or gas properties. However, the Senate Finance Committee, in reporting the bill, inserted a provision which, in effect, reenacted the provisions found in the revenue acts prior to 1934. This section became Section 105 of the Revenue Act of 1936 above quoted. The reason for the reenactment of this provision is found in Report No. 2156, 74th Congress, 2nd Session (page 18), as follows:

> "It was brought to the attention of the committee that the effect of the omission in the 1934 Act of a similar provision was, in many cases, to prevent the sale of such properties and thus a tax loss has resulted, and individuals have been discouraged from embarking upon or continuing such enterprises. The result was to throw the business into the hands of corporations which, being subject only to the corporation-tax rate, would pay less tax than individuals

would. It is believed that the result of the proposed change will be to stimulate individuals to develop oil and gas properties and to sell, thus increasing the tax yield from this source."

In this connection, it should be pointed out that while it may be deemed desirable to accord special treatment in order to develop oil property at such times as is in the national interest, it is not believed that such a condition exists at the present time and that nothing short of a war or other national emergency, would merit special consideration to be given to these types of assets. Even in such instances, it would seem more desirable to grant them outright subsidies rather than to manipulate and create artificial tax bases for the accomplishment of the same end.

With respect to the argument that the oil and gas business would, but for the provisions of this section, be driven into the hands of corporations, it is no more convincing than any similar argument that could be made by the holders of any other type of saleable asset. The same disparity in the treatment of income from the sale of assets held by individuals as against corporations exists for any type of asset. There seems to be no case for the continuation of preferential treatment of income from sales of oil and gas properties at the present time. Accordingly, the repeal of Section 105 of the Revenue Act of 1936 is recommended.

Personal Hold-
ing Companies

7. Taxation of (Personal) Holding Companies

It is proposed that the existing personal holding company provisions be repealed and that the undistributed net income (as defined in Section 14) of all corporations that derive 80 percent or more of their gross income from rents, royalties, interest, dividends, interest in a trust, gains from sale of commodity futures and gains from sale of securities, etc., be taxed on the basis of the number of individuals owning 50 percent or more of the capital stock of such corporations. Banks, insurance companies, and corporations now exempt from the income tax should be exempt from the proposed tax.

It should be pointed out that the income items to be included for the purpose of determining whether a corporation comes within the scope of the proposed tax can be made identical with those now included in personal holding company income as defined in the Revenue Act of 1937. Further, all the safeguards there employed with respect to determining the percentage of income derived from the specified sources and with respect to the definition of an individual would need to be transplanted to the proposal. It does not appear to be necessary to enter upon these details here but they are of paramount importance.

Section 102, imposing a surtax on corporations improperly accumulating surplus, had been on the statute books since 1913, but has not proven a fully effectual means of stopping tax avoidance. Recognition of this fact was taken by the Subcommittee on Tax Avoidance in 1933 with particular reference to personal holding companies, as a result of which a special tax was imposed on personal holding companies. This became Section 351 of the law. Although it succeeded in a measure to overcome the use of this device for tax avoidance, there remained therein two major defects.

First, a highly complicated and artificial tax base was devised there, which served only to nullify the effectiveness of the provisions relating to the personal holding companies. This point is so well known from data developed elsewhere, especially in connection with the passage of the Revenue Act of 1937, that it can serve no useful purpose here to dwell upon it. The provisions with respect to the personal holding company in the Revenue Act of 1937 were primarily directed at the loopholes that resulted from the defective tax base employed under the Revenue Acts of 1934-36.

The tax base in this proposal ties to the tax base employed for purposes of the undistributed profits tax, a base which every corporation subject to the special tax here proposed will already have established for the purpose of determining its tax liability under Section 14. This is the logical basis for the special tax here proposed since the objective of the special tax is identical with the objective of the surtax on undistributed profits, namely, to stop the avoidance of the high individual surtax rates through corporation retention of earnings. The surtax under Section 14 strikes at the average situation. Corporations owned by a few wealthy individuals could still avoid some of the high individual surtax rates unless some additional tax were to be imposed. That is the purpose of the present personal holding company provisions and that also is the purpose of the proposal—it is to implement Section 14 in cases where the ownership of corporations is highly concentrated. For this reason, the bases for the two taxes should be identical.

Secondly, and more fundamentally, the personal holding company provisions of the Revenue Act of 1937, like Section 351, suffer from an overly precise definition of the term "personal holding company." It invites the potential taxpayers to crawl beyond the sharp line of demarcation between personal holding companies and others and thus to escape the surtax imposed. It is not possible to cure this second difficulty completely but the proposal would overcome most of it.

Recommended rates for the proposed tax are as follows:

If 50 percent of the value of the capital stock outstanding at any time during the last half of the taxable year is owned directly or indirectly by or for:	Rate on undistributed net income as defined in Section 14:
1 to 5 individuals	70%
6 to 10 "	60
11 to 20 "	50
21 to 30 "	40
31 to 40 "	30
41 to 50 "	20
51 and more "	10

The treatment of the personal holding company problem proposed above is based on the assumption that it would prove to be too difficult to treat such companies in the manner of the British and Canadian income tax laws. Otherwise, it would be simpler to treat these companies as partnerships. By adopting this procedure the British and Canadians have not only solved the problem of the domestic personal holding company but have prevented income tax avoidance by transfers of property to foreign personal holding companies.

The Canadian law, beginning with the taxable year 1925, distinguishes "personal corporations" from others. Personal corporations are those (a) that derive one quarter or more of their gross revenue from one or more of the following sources:

(1) From the ownership of or the trading or dealing in bonds, stocks, etc.;

(2) From the lending of money with or without security or by way of rent, annuity, royalty, interest or dividends; or

(3) From title or interest in or to any estate or trust;

and (b) that are controlled directly or indirectly (by ownership of stock or in any other manner) by one individual (or family) who resides in Canada. It is of no moment where such corporations are created, where they do business, or where their assets are situated.

In general, such personal corporations are not themselves taxable in Canada. Their income, whether distributed or not, is deemed to be distributed on the last day of each year as a dividend to the shareholders and the shareholders are taxable each year as if the income of the personal corporation had been distributed. The personal corporation is required to pay the corporation income tax rate on only that portion of its income which is deemed to be distributed to nonresidents.

It is clear, therefore, that a resident of Canada cannot avoid taxes through the use of a domestic personal company or by transferring assets abroad to a foreign personal corporation. Even if such corporation does not distribute its income, the resident of Canada will be liable each year for the income tax on his pro rata share of the undistributed profits in the same way as if such profits had been distributed in dividends. Except for the portion of income allocable to nonresidents, the Canadian law fixes the liability for the income of the personal company (whether organized in Canada or abroad) directly on the individual or individuals (resident in Canada) that control the company. The Canadian problem would appear to be one primarily of administration. The individuals that fail to report their pro rata share in such income become criminally liable but the administrators must ferret out those that prefer to run the gauntlet of the law to paying high income taxes.

Under British law private companies may also become liable to tax on their distributive share but the British appear to have experienced some difficulty in fixing the tax liability onto the individual in instances where the income is not distributed by private companies. Thus, under Section 21 of the Finance Act of 1922 (as amended by Sections 31 and 32 of the Finance Act of 1927 and again by Sections 19 and 20 of the Finance Act of 1936) if companies under the control of five persons or less fail to distribute a reasonable portion of their annual income (as adjudged by the Special Commissioners in charge of administering this section) the income of the company at the direction of the Special Commissioners may be deemed to be the income of the members, and the individuals are assessed on their pro rata share at the top rates applicable to them in the name of the company. If they do not elect to pay the tax, then after twenty-eight days the company must pay but if the company does not pay within three months from service of the notice of the charge, then by Section 19 (5) of the Finance Act of 1936, the Revenue is given the right to recover it from the individual members.

It remains to be seen whether much litigation will develop from these and the other provisions of the Finance Act of 1936 which attempt to stop up tax avoidance schemes by cutting through the corporate veil.

The British in Section 18 of the Finance Act of 1936 plugged the foreign personal company loophole for income tax avoidance. If an individual, ordinarily resident in the United Kingdom, transfers assets to nonresidents or persons not domiciled in the United Kingdom so that the income is payable to them while he nevertheless retains such control that some time it may inure in some way for his benefit, then the income is deemed to be his income for all the purposes of the income tax unless he can satisfy the Special Commissioners (who are given broad powers in administering this section) that the transfer and any associated operations were effected mainly for some purpose other than the purpose of avoiding liability to taxation. These provisions were made retroactive. They applied in relation to transfers of assets whether carried out before or after this enactment. Presumably to soften the blow on those that had acquired a vested interest in this tax avoidance practice, the standard rate was not to be charged the first year, 1935-36, on income from assets transferred abroad. Only the surtax rate was charged the first year. In subsequent years both the standard and surtax rates will be charged.

In the income tax law of the United States the taxation of shareholders on their pro rata shares of a corporate entity has always been optional. The individual's choice has been either to shoulder a pro rata share of the rates imposed on the corporate entity or to shoulder the individual income tax rates applicable to the undistributed income deemed to have been received by him. Under the Revenue Act of 1934, however, for purposes of determining whether certain percentages of outstanding stock are owned directly or indirectly by an individual, constructive ownership was taken into account. The principle of constructive ownership was broadened extensively under the Revenue Act of 1937. In addition, under this act, the income of foreign personal holding companies is treated as the income of the shareholders within the jurisdiction of the United States and such shareholders are required to report as their income the undistributed net income of foreign personal holding companies.

There is room for doubt whether the treatment of domestic personal holding companies as partnerships would not encounter insurmountable difficulties unless simultaneously additional discretionary powers were granted the Commissioner or some other administrative body. The granting of such additional power is likely to meet with substantial resistance in this country because it runs counter to our past practice. For this reason, even if legal obstacles to the treatment of personal holding companies as partnerships could be surmounted, it may be better to enact the proposal for domestic holding companies and to restrict the application of the partnership concept to foreign personal holding companies.

Donations

Estates &
Trusts

8. Treatment of Charitable and Other Contributions

It is proposed:

a. With respect to estates and trusts, to amend Section 162(a) so as to limit the deduction for charitable and other contributions to an amount which in the combined specified cases does not exceed 15 percent of the net income of the estate or trust as computed without the benefit of the deduction for charitable contributions.

b. With respect to partnerships to amend Section 23(o) so as to limit the deduction for charitable and other contributions to an amount which added to the individual's pro rata share in partnership deductions for charitable and other contributions does not exceed 15 percent of the taxpayer's net income, including his pro rata share in partnership income computed without the benefit of partnership deductions for charitable and other contributions.

c. With respect to individuals, to amend subsection (a), (o) and (q) of Section 23 so as to limit the contribution charges to expense under (a) and the deductions under (o) and (q) to the amounts actually paid out in the taxable year and receipted for by a charitable, etc., organization in the United States and so as to make the 15 percent limitation in (o) and the 5 percent limitation in (q) applicable to the combined charges for charitable and other contributions under subsection (a) and the deduction for such charitable and other contributions under (o) and (q).

d. To repeal Section 120.

a. Estates and Trusts

Prior to 1917 no deduction for charitable contributions was allowed for purposes of computing the net income of an estate. The Revenue Act of 1917 allowed a 15 percent deduction, which was increased to an unlimited amount under the Revenue Act of 1918 and has since been so continued.

This unlimited deduction for charitable and other contributions allowed for purposes of computing the net income of an estate or trust

Partnerships

seems to be excessive and provides a substantial loophole for tax avoidance. Thus, a wealthy individual desiring to escape the 15 percent limitation on deductions for charitable contributions under Section 23(o) may create a trust for the incidental purpose of providing income for a beneficiary and the primary purpose of taking advantage of the unlimited deduction for charitable and other contributions allowed under Section 162(a). Also, by arrangement between the settler and the beneficiary, the settler can save the benficiary substantial income tax liability by setting aside in the deed creating the trust an amount agreeable to the beneficiary for charitable purposes. Were the beneficiary to receive the entire income from the trust, he would be subject to the limitation under Section 23(o) when filing an individual income tax return. If, however, the entire income of the trust is split between the beneficiary per se and the several charitable, etc., organizations, then the beneficiary is favored by the unlimited deduction for charitable and other contributions allowed under Section 162(a).

The distinction between the two cases may be important from the legal viewpoint but appears to be altogether too formal for purposes of the income tax. The above considerations appear to be equally applicable in the case of an estate where part of the income is by the terms of the will allocated to the beneficiaries and part to the charitable and other contributions.

It is therefore proposed to limit the deduction allowed trusts and estates to 15 percent of their net income, computed without the benefit of this deduction. The chief argument against the proposed amendment is that the charitable organizations might suffer from a shrinkage of funds left to them pursuant to the terms of wills or deeds creating trusts. It cannot be denied that the proposed amendment would tend to diminish such charitable and other contributions but it can properly be doubted whether this would seriously embarrass the organizations since in substantial measure the beneficiary must choose between sharing his income with the Government or with the charities.

b. Partnerships

Previous to the Revenue Act of 1917, charitable contributions made by partnerships were not deductible. That Act, however, permitted a 15 percent deduction from net income for such purposes. Subsequently, under Section 218(d) of the Revenue Act of 1918, the deduction was disallowed, and it was not until 1934 that partnerships were again allowed a deduction for contributions made to charities.

Partnerships are at present allowed the deduction for charitable and other contributions not in excess of 15 percent of the net income computed without benefit of this deduction.

Individuals &
Corporations

If the limitation under Section 23(o) is based on the net income of individuals including the income from partnerships, the deduction for charitable and other contributions is, in effect, not limited to 15 percent of the individual's net income before the deduction for such contributions. The limitation will be in excess of 15 percent of the individual's income from all sources, because on the income from partnership the deduction for charitable and other contributions will have been made twice, once in computing the income of the partnership and again when computing the income of the individual. This duplication of the deduction for charitable and other contributions should be avoided.

It is therefore recommended that the deduction allowed under Section 23(o) be limited to an amount which added to the individual's pro rata share in partnership deductions for charitable contributions does not exceed 15 percent of the taxpayer's net income, including in his pro rata share in such partnership income computed without the benefit of partnership deductions for charitable contributions.

An alternative procedure for the avoidance of the double deduction for charitable and other contributions would be to disallow the deduction in the case of partnerships. This procedure is not recommended because it probably would embarrass many of the charities by increasing their difficulties in obtaining contributions. For example, in the case of a partnership, it is much easier for the charity to obtain a collective contribution from a partnership than separately from the individual partners.

c. Individuals and Corporations

It should be pointed out that when charitable and other contributions are taken as a deduction from gross income, the individual in the high income bracket is given greater relief from the income tax than the individual in a low income bracket even though both individuals make equivalent contributions. Thus, if two individuals, one with surtax net income of $10,000 and the other with surtax net income of $1,000,000, each make a contribution of $10,000, the first individual, in effect, donates $8,640 of his own and $1,360 of the Government's, whereas the second individual donates $2,300 of his own and $7,700 of the Government's funds for if they had not made the donation the tax applicable to the $10,000 would have been $1,360 and $7,700, respectively. Examined superficially, it would appear more equitable to make the tax value of a donation of equivalent amounts the same, irrespective of the economic status of the donor, by allowing a tax credit to individuals, corporations, estates and trusts for contributions made in lieu of allowing such contributions as a deduction from gross income. This does not seem to be a desirable procedure for the following reasons:

First, many of the private charities have been established and have operated for many years under the type of shelter which the income tax provisions for the deduction of charitable and other contributions have provided. It is true that the deduction for corporations dates only from 1936 and that the deduction for partnerships only from the Revenue Act of 1934, but the deduction in the case of individuals dates from the Revenue Act of 1917 and the unlimited deduction in the case of estates and trusts from the Revenue Act of 1918. It must, however, be recognized that at least in part some of the charities have been established because of these unduly liberal provisions and so may be said to possess a vested interest in them.

Second, it does not seem advisable to replace the present charitable deduction with a tax credit because such a procedure would be interpreted to imply a complete change in the Government's attitude towards the charities. Instead of the Government, in effect, giving a bounty to each individual making a charitable contribution without any restriction on the individual's choice among the charities, such limitations, drastically curtailing private donations, would leave the Government with the responsibility of determining the pattern and the scope of the nation's organization for charitable purposes. In other words, a measure of inequity with respect to the deduction for charitable contributions may be the price that has to be paid if the charities are to operate on a private and not a publicly subsidized basis.

In this connection, it should be pointed out that while the British do not allow contributions to charitable organisations to be deducted for purposes of the income tax, they do allow charitable, etc., organizations to claim rebates for the amount of the income tax paid at source on such contributions provided that the contribution is shown to be in the nature of an annual charge against the taxpayer's income. Further, such contributions are allowed to be deducted for purposes of the surtax. In other words, the chief difference between the British procedure and our own appears to be that whereas we limit the deduction for charitable and other contributions to a certain percentage of net income, the British do not make such limitations but do not allow casual contributions to affect the income tax.

As the law stands at present, the taxpayer can render the limitation placed upon the deduction for charitable contributions ineffective by charging such contributions in whole or in part as a business expense allowable under Section 23(a). It is proposed to make the limitation unequivocably applicable to all charitable contributions, irrespective of whether taken by the taxpayer under Section 23(a), (o) or (q).

Further, it would seem proper to restrict the deduction for charitable contributions to those made to a charity organized in the United States. Such charities may, of course, contribute funds to alleviate distress in foreign countries. It does not seem practicable to restrict the deduction to those contributions that are ultimately used for strictly domestic purposes, but if the deduction were restricted to contributions to institutions organized in the United States certain of the contributions that are now made purely for the alleviation of distress abroad or for other "causes" would no longer be allowed to affect the yield of our income tax. It may be desirable to give the Commissioner full power to determine whether the deductions claimed for charitable contributions are in accordance with the intent of the statute and to disallow the deductions made to institutions though organized in the United States which operate primarily as foreign charities.

Section 120 of the Revenue Act permits an unlimited deduction for charitable and other contributions in such instances where the amount of contributions for the taxable year and for the ten preceding years exceeds 90 percent of the taxpayer's net income for each of those years. Although this section dates back to 1924, it should be repealed not only because it is applicable only to few individuals but also because if it should be effective it would operate inequitably as between an individual who for each of ten years preceding the taxable year had a record of contributions which together with certain taxes amounted to more than 90 percent of his income and a taxpayer who had a similar record for only eight or nine years preceding the taxable year. Also, it does not seem fair to make special provision for taxpayers that pay out amounts which together with certain taxes are equal to more than 90 percent of their net income and not to make somewhat similar provision for taxpayers that pay out other very substantial percentages such as more than 80 percent, 70 percent, etc. To give effect to the variations in the different percentages paid out as well as to the number of years over which the taxpayer had maintained a record of unusually large contributions to charities, would not only require very complex legislation but would be incompatible with the main objective of the income tax law.

Pension Trusts

Worthless Stock

9. Pension Trusts

It is proposed to amend Section 165 so as to exempt from income taxation only those employees' trusts which are irrevocable, the benefits of which trusts apply at least to (1) all persons having been employed for five or more years and earning $5,000 or less per year, and (2) to 75 percent of the total number of employees earning $5,000 or less per year.

This provision would restrict the scope of tax-exempt employees' pension trusts to those which are irrevocable only, thereby insuring that all payments made into such trusts could not be returned to the employer at some future date. Such a provision would eliminate the loophole in the 1936 law whereby an employer may use the pension trust as a device to reduce his taxable income in one year and receive back this same income in a subsequent year when his tax on this income may be less. Moreover, the proposed limitation would restrict such pension trusts to those designed to benefit the rank and file of employees rather than a limited number of executives who, by virtue of receiving a large part of their compensation through a pension trust, would avoid the high surtax rates.

Further, as a qualification for the exemption privilege, employees' trusts should be required to provide a plan for the distribution of their funds to the employees upon liquidation of the employer's business.

Such provision would insure the irrevocable nature of employees' trusts by requiring such trusts to provide a plan of distributing their funds to employees in the event of the failure and dissolution of the employer's business. Thus the possibility of the employer or any of his creditors receiving the trust funds through dissolution proceedings would be eliminated.

10. Treatment of Worthless Stock as a Capital Loss

It is proposed to:

Disallow the deduction for worthless stock and in lieu thereof in all instances where the market value of the stock at the end of the taxable year is less than 3 percent of its cost or other basis as determined and adjusted under Section 113, allow the taxpayer to take a capital loss, provided that if such loss is taken the basis for such stock for the determination of future capital gain or loss shall become the market value used in the determination of the capital loss.

The deduction for worthless stock has been allowed as a deduction from gross income under all the revenue acts since 1913 and in effect enables the taxpayer to offset other income with capital losses. This procedure is not consistent with the treatment of capital losses in the event of sale of stocks. Losses on such stocks are subject to the five-step scale system, which accounts different percentages of the capital loss according to the period that the asset was held and are rigidly limited to capital gains plus $2,000. The present procedure of allowing the deduction for worthless stock would be no more tenable under the plan for treating capital gains and losses, as proposed in a separate memorandum on that subject, for similar reasons: (a) Because no effect would be given to the time element as it is proposed to do in the computation of the tax on capital gains and the credit on capital losses, and (b) because the proposed segregation of capital losses would be violated in general as well as for purposes of the carry-forward.

The recommended change surmounts these difficulties by accounting the loss in the case of worthless stock under the capital loss provisions, and it would surmount the difficulty with respect to an unexpected subsequent appreciation in value of "worthless" stock, since the basis of the stock for the determination of future gain or loss would become the "market" value used in the determination of the capital loss.

The proposal does not, however, surmount one of the difficulties now encountered. The worthlessness of a stock when it falls to low levels is in large part a matter of fiat and depends upon the ability of the taxpayer to make a "satisfactory showing." The distinction between stock that is worthless and stock that has fallen to very low levels is not altogether a marked one; hence the proposal is to select some arbitrary point of division between stocks that are in the twilight zone of worth and others. The distinction between stock that has fallen to 4 or 5 percent of its basis and one that has fallen to 3 percent is admittedly illogical. Some point of division is necessary, however, and it seems better to make the arbitrary division than to adhere to the present division between "worthless" and other stocks. The proposal that the deduction for worthless stocks be treated as a capital loss would seem to be acceptable irrespective of whether the division is made between worthless and other stocks as at present, or between stocks that meet some arbitrary test of approximate worthlessness and others, as is suggested.

The deductions allowable under Section 23(e)(3) dealing with losses of property by fire, storm, shipwreck, etc., while involving capital items, do not fall into the same category as the deduction for worthless stock allowable under Section 23(e)(2). On strictly logical grounds, perhaps some case can be made for the treatment of such losses as capital losses, but there does not appear to be the same opportunity for the taxpayer to devise schemes for tax avoidance with respect to fires, storms, shipwrecks, thefts, etc., as there may be with respect to worthless stock.

Income of Non-resident Americans

Also, to view the deductions allowable under Section 23(e)(3) as capital items would seem to make of the income tax a more heartless instrument for the extraction of the Government's due from the taxpayer than the Government in its wisdom can afford to take.

11. Earned Income of Nonresident Americans

> It is proposed to repeal Section 116(a) of the Revenue Act of 1936 dealing with the exclusion from gross income of earned income from sources without the United States in the case of an individual citizen of the United States who is a bona fide nonresident of the United States for more than six months during the taxable year.

Section 213(b)(14) of the Revenue Act of 1926 provided for the exclusion from gross income in the case of an individual citizen of the United States who is a bona fide nonresident of the United States for more than six months during the taxable year, of amounts received from sources without the United States if such amounts constitute earned income as defined in Section 209. Similar provisions have been continued in all the revenue acts subsequent to the 1926 Act.

In the Hearings before the Committee on Ways and Means in 1925, and in congressional debate, it was pointed out that the United States was the only country which imposed a tax on the foreign income of its nonresident citizens; that while a tax credit is granted with respect to taxes paid by American citizens to foreign countries, this credit is allowed only with respect to income or excess-profits taxes of foreign countries; that there are a multitude of other taxes paid by Americans abroad which cannot be taken as a tax credit; that these Americans abroad promote the foreign trade of the United States, and unless some relief were granted them from taxes upon income earned in foreign countries, it would tend to hamper and restrict American salesmanship and enterprise abroad. In view of the fact that the exemption was sought only for Americans who are bona fide foreign residents engaged in the pursuit of some legitimate business, profession or other occupation, the exemption granted was limited to earned income of such individuals.

In general, the policy of the United States is to tax American citizens on their income wheresoever it may have been derived. American citizens are required to include in their income tax returns all income from sources both within and without the United States. In order to eliminate double taxation, a tax credit is granted with respect to income or excess-profits taxes paid abroad. The treatment of earned income of bona fide nonresident citizens of the United States under Section 116(a) of the Revenue Act of 1936 is an exception to the general procedure. The exemption does not apply with respect to their unearned income.

Building
and Loans

The concession was granted in recognition of the fact that for the most part those citizens who are bona fide nonresidents of the United States for more than six months during the year or those who are more or less permanently established abroad whose chief sources of income are abroad are taxed as residents by the various foreign countries. It is clear that a substantial tax saving may be realized by an individual earning income abroad if he remains abroad one day more than six months rather than one day less than six months. Aside from such considerations, however, if it is to be the policy of the United States to tax individuals on the basis of citizenship, then on strictly logical grounds, there seems to be no basis for the arbitrary exclusion of this segment of income for a special group of citizens.

It is admitted that the repeal of Section 116(a) is likely to cause a measure of inequity and discrimination to this group of nonresident citizens due to the fact that they may be required to pay taxes abroad which are not deductible in the form of tax credit. This inequity it is believed, however, is in no wise proportionate to the inequity to the Government which now exists through the arbitrary exclusion of this source of income. It would seem proper to require nonresidents to file returns on the basis of their total income and to allow them tax credit for amounts of tax paid abroad. It is recommended, therefore, that Section 116(a) of the Revenue Act of 1936 be repealed.

12. Building and Loan Associations

It is proposed to amend Section 101(4) of the Revenue Act of 1936 so as to limit the exempt building and loan associations to those types operating on a mutual basis.

The types of corporations that are exempt from the Federal income tax are enumerated in Section 101 of the Revenue Act of 1936. Subsection (4), relating to building and loan associations, reads as follows:

> "Domestic building and loan associations, substantially all the business of which is confined to making loans to members; and cooperative banks without capital stock organized and operated for mutual purposes and without profit."

This provision appears in all the revenue acts since 1913. The inclusion of building and loan associations with the exempt corporations enumerated in Section 101 implies that the exemption of building and loan associations derives from the theory that they are non-profit organizations. To the extent to which that theory is inapplicable the case for the exemption is weakened.

Distributions
in Liquidation

Many State laws allow building and loan associations to accept deposits, to pay interest thereon, and in general to conduct a regular banking business, thereby competing in effect with regular banking institutions. To the extent they do so, it would seem proper for the purposes of the Federal income tax to place them in the same category as banks and trust companies. Exemption from the income tax should be granted only to those building and loan associations which operate on a mutual basis with respect to all parties that advance money to the association.

It seems evident that the mutual basis is violated as soon as the building and loan association accepts substantial deposits and obligates itself to pay interest to depositors. Such obligation differs fundamentally from one to pay a return on the investment of the proprietary group. The very act of accepting deposits with an obligation to pay a fixed return of interest sets the shareholders up as a proprietary group as against the depositors. Furthermore, the payment on founders', organization, or preferred shares of a return higher than the return on the ordinary shares is in violation of the principles of mutuality and constitutes sufficient ground for confiscating the tax-exempt privilege granted under Section 101(4).

Since building and loan associations have been tax-exempt, it might be advisable to give them a period of grace within which to make the necessary adjustments that would enable them to retain this privilege. Otherwise it is recommended that the tax-exempt privilege be granted only those building and loan associations that operate on a mutual basis, meaning that all classes of the proprietary group, "depositors" and stockholders, are paid interest or dividends at the same rate and on the same basis. Unless this definition of mutuality is drafted into the law, the proposed amendment would lack force. In substance then, it is recommended that in those instances in which building and loan associations disqualify as non-profit organizations they should be deprived of the privilege of tax exemption.

13. Dividends Paid Credit in Connection with Tax-Free Distributions

It is proposed to repeal Section 27(f) dealing with distributions in liquidation; to amend Section 27(h) dealing with nontaxable distributions so as to make an exception in the case of distributions in liquidation by allowing such distributions for the purposes of determining the dividends paid credit.

Section 27(f) of the Revenue Act of 1936 provides that "in the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the dividends paid credit under this section, be treated as a taxable dividend paid." On the fact of it, this section would appear to allow distribution of the entire accumulated profits and earnings of a corporation in liquidation for the purposes of the dividends paid credit and leave such corporation no undistributed profits tax liability provided that the accumulated earnings or profits exceeded the adjusted net income. If, however, reference is made to Section 112(b)(6) wherein it is provided that "no gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation" and to Section 27(h) which provides that "if any part of a distribution is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part," it seems clear that Section 27(f) is nullified and a corporation in liquidation is subject to the undistributed profits tax on its entire adjusted net income.

The Bureau has taken the position that a strict interpretation of Section 27(h) would impose an undue hardship in the case of complete liquidation of a subsidiary. Such a subsidiary would be liable to the severest of the undistributed profits tax rates on the full amount of its adjusted net income accounted for the portion of its taxable year up to the date of liquidation. In interpreting Section 27(f) it has, therefore, ruled (Article 27(f)-1-(c) of Regulations 94) that, subject to certain limitations, the portion of a distribution of earnings made by a corporation which has just received the total assets of another corporation representing earnings and profits of the liquidated corporation, may be allocated for the purpose of the dividends paid credit to the liquidated corporation.

As the statute now stands, Sections 27(f) and (h) appear to conflict; further conflict seems to exist between the statute and the regulations. In order to clarify the procedure, it is suggested that Section 27(f) be repealed and Section 27(h) be amended to read:

> "(h) Nontaxable Distributions.—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part; <u>except that distributions in liquidation shall be allowed for the purposes of determining the dividends paid credit subject to the limitations of Section 115(b) and to the extent and in accordance with regulations that shall be prescribed by the Commissioner, with the approval of the Secretary</u>."

Thus, the law will be clear to the effect that a corporation in liquidation cannot claim a dividends paid credit for distributions made if such distributions are not taxable in the hands of the recipient except that distributions made in liquidation by a subsidiary corporation to a parent corporation may be claimed as a dividends paid credit to the extent that the earnings and profits of the subsidiary are in turn paid out as taxable dividends by the parent corporation. (Article 27(f)-1-(c) Regulations 94).