

## THE REVENUE ACT OF 1934

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Congress, probably inspired by the disclosures of the investigations of the Banking and Currency Committee, passed House Resolution 183, on June 9, 1933, thereby authorizing the Ways and Means Committee to investigate methods of preventing the evasion and avoidance of taxes, means of simplifying the revenue laws and possible new sources of revenue. Pursuant to this Resolution, a Subcommittee of the Committee on Ways and Means conducted an inquiry prior to the convening of the second session of the 73d Congress. The Subcommittee filed "A Preliminary Report" <sup>1</sup> on December 4, 1933, upon the subjects of tax avoidance, evasion and simplification. In response to the Subcommittee's recommendations, the then Acting Secretary of the Treasury, Henry Morgenthau, Jr., issued a statement <sup>2</sup> differing in many important particulars from the conclusions reached by the Subcommittee.

As a result of the above investigations, H. R. 7835 was introduced in the House and referred to the Committee on Ways and Means. After extensive hearings <sup>3</sup> the bill was reported out with amendments by the Committee and a report was submitted thereon.<sup>4</sup> On February 21, 1934, the House passed the bill with minor committee amendments.<sup>5</sup> Then, having been introduced in the Senate, the bill was referred to the Finance Committee, which, after further hearings,<sup>6</sup> reported it <sup>7</sup> with substantial amendments. Further material changes were made on the floor of the Senate <sup>8</sup> before passage. Thereafter, the Conference Committee on the disagreeing votes of the two Houses made its recommendations reconciling the differ-

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1. Preliminary Report of a Subcommittee on the Committee of Ways and Means Relative to Methods of Preventing the Avoidance and Evasion of the Internal Revenue Laws together with Suggestions for the Simplification and Improvement Thereof, 73d Cong., 2d Sess. (December 4, 1933).

2. Statement of the Acting Secretary of the Treasury, 'Regarding the Preliminary Report of a Subcommittee of the Committee on Ways and Means (December 15, 1933).

3. *Hearings before Committee on Ways and Means on H. R. 7835*, 73d Cong., 2d Sess. (1933, 1934).

4. H. R. REP. No. 704, 73d Cong., 2d Sess. (1934).

5. The "Gag Rule" [H. R. RES. 266, 73d Cong., 2d Sess. (1934)] limited House debate on the bill to sixteen hours and provided that only Committee amendments (which were not subject to amendment) were in order. The result was that the bill was passed substantially as it was reported out of Committee.

6. *Hearings before Committee on Finance on H. R. 7835*, 73d Cong., 2d Sess. (1934).

7. SFN. REP. No. 558, 73d Cong., 2d Sess. (1934).

8. See 78 CONG. REC. 5827-6607 (1934).

ences, and its report<sup>9</sup> was adopted. On May 10, 1934, the bill became the Revenue Act of 1934 upon signature by the President.

This Act, by virtue of the thorough consideration which preceded its enactment and of the desire to prevent tax avoidance, has made numerous changes and novel departures from prior Revenue Acts.

### *Personal Holding Companies*

Corporate income is, in the normal case, distributed among a number of individuals. Recognizing this circumstance, the revenue acts have not applied the progressive income tax to corporations but have adopted instead a flat rate which is somewhat higher than the normal tax upon individual incomes. The mere fact that a corporation has a large income does not necessarily increase its ability to pay a large tax, for in reality the income beneficially belongs to its stockholders, whose individual incomes from dividends may be in the lower brackets. It was recognized, however, as far back as the 1913 Act<sup>10</sup> that a corporation might in effect have but one stockholder, and thus could be used as a device to avoid the progressive rates of tax upon this stockholder's individual income.

By taxing closely held corporations at very high rates unless they distributed their earnings, Congress consequently endeavored to compel a distribution, so that the income might be taxed at progressive rates in the hands of their stockholders. The difficulty lay in defining the type of corporation which would be subject to these increased taxes. Prior to the 1934 Act, a solely subjective test was used in segregating such corporations. A corporation was so taxed if it accumulated surplus for the purpose of evading the imposition of the surtax upon its stockholders.<sup>11</sup>

The main difficulties with this provision were: (1) it was almost impossible to prove the purpose to evade;<sup>12</sup> (2) by interposing a holding

9. H. R. REP. No. 1385, 73d Cong., 2d Sess. (1934).

10. Act of 1913, § II, A, 2 [38 STAT. 166 (1913)].

11. § 104, Revenue Act of 1928 [45 STAT. 814 (1928)], 26 U. S. C. A. § 2104 (1928); § 104, Act of 1932 [47 STAT. 195 (1932)], 26 U. S. C. A. § 3104 (Supp. 1934); § 220, Act of 1926 [44 STAT. 34 (1926)]; § 220, Act of 1924 [43 STAT. 277 (1924)]; § 220, Act of 1921 [42 STAT. 247 (1921)].

12. For many years no wholehearted attempt was made by the Bureau to enforce this Section. In the past few years a more determined attempt has been made, without what could candidly be called marked success. Even the presumptions of purpose to evade the surtax arising under the section in case of a holding company, or where a company has allowed gains and profits to accumulate beyond the reasonable needs of the business, have been inadequate to overcome the essential weakness of a subjective test.

In a further effort to make this section effective, the Commissioner has issued T. D. 4470, XIII-38, Int. Rev. Bull. 9, amending the Regulations under the 1932, 1928, and 1926 Acts, to provide that in determining the reasonableness of the accumulation for the particular year, the amount of undistributed gains and profits for prior years, is to be taken into consideration. The first sentence of U. S. Treas. Reg. 77, Art. 543 now reads: "An accumulation of gains and profits (including the undistributed earnings or profits or prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case." This change has been responsible for scare headlines that the Federal Government was taxing corporate surplus (See N. Y. Times, October 21, 1934, pt. 2 at 7). This, of course, is not so. The fact is that an additional tax is levied

company which would hold the stock of the corporation accumulating the surplus, the provisions of the section could be neatly avoided.<sup>13</sup> Since the holding corporation was the stockholder and was subject to no surtax, the corporation which accumulated the surplus could not be said to be availed of for the purpose of evading the imposition of the *surtax* upon its shareholders. This difficulty was partially eliminated by the National Industrial Recovery Act,<sup>14</sup> which substituted the phrase "internal revenue tax" for the word "surtax". However, since the dividends of the accumulating corporation would under Section 23 (p) be tax-free in the hands of its stockholder, the holding corporation, and since the special dividend tax<sup>15</sup> did not apply to dividends received by domestic corporations, this change in wording was ineffective.

Section 102 of the 1934 Act, although retaining the subjective test of purpose, defines that purpose as one "of preventing the imposition of the surtax upon its shareholders *or the shareholders of any other corporation.*" This effectually blocks a very serious loophole in the law.<sup>16</sup>

The Subcommittee, realizing that a solely subjective test was inherently weak, recommended an additional provision taxing "personal holding companies" and applying an objective test.<sup>17</sup> Although this plan did not meet with the entire approval of the Treasury,<sup>18</sup> it was, with some clarifying changes, adopted by Congress.

A "personal holding company" is accordingly defined by Section 351<sup>19</sup> as any corporation (with certain specific exceptions) eighty *per cent.* of whose gross income for the taxable year is derived from royalties, dividends, interest, annuities, and (except in the case of dealers) gains from the sale of securities; and of whose outstanding stock more than fifty *per cent.* in value is owned by or for not more than five individuals at any time during the last half of the taxable year (only one member of a family being

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upon the *income* of corporations who have accumulated, and are in the process of accumulating, surpluses for the purpose of preventing the imposition of the surtax on stockholders. The test is still one of *purpose* to prevent taxation of stockholders.

13. *T*, the taxpayer, formed Corporation *A* and transferred his securities to it in exchange for its stock. *T* then formed Corporation *B*, and transferred Corporation *A*'s stock to it in exchange for its stock. Corporation *A* was thus effectively "insulated" and could accumulate at will. Corporation *B*, the "stockholder", having no earnings, did not accumulate and hence was not taxable.

14. 48 STAT. 207 (1933), 26 U. S. C. A. § 3104 (Supp. 1934).

15. 48 STAT. 206 (1933), 26 U. S. C. A. § 3761 n. (Supp. 1934), no longer in force. The recent increase of four *per cent.* in the surtax, however, effectively takes its place as to incomes over \$4,000.

16. It should be noted that § 102 [48 STAT. 702, 26 U. S. C. A. § 5102 (Supp. 1934)] now imposes the additional tax only upon the undistributed income. Previously, if there was any accumulation for the purpose of evading the surtax on the stockholder, all the income was taxed, whether part had been distributed or not. Also, the additional tax has now been made a *surtax*, to remove any possible doubt that it can apply to the income from partially tax-exempt securities (*i. e.* those exempt from all income taxes except surtaxes).

17. *Op. cit. supra* note 1, at 6-8.

18. *Op. cit. supra* note 2, at 8.

19. § 351 (b) (1) [48 STAT. 751, 26 U. S. C. A. § 5351 (b) (1) (Supp. 1934)]. For the Regulations under this Section, see T. D. 4503, XIII-53 Int. Rev. Bull. 2.

counted in making up the five). If twenty-one *per cent.* of the corporate income comes from sources other than those mentioned, then the corporation is not a personal holding company. Thus a man owning an incorporated manufacturing business can put his securities in his corporation and nevertheless be without the provisions of Section 351, but if surplus is unduly accumulated, the subjective test of Section 102 may be applied. The provision that more than fifty *per cent.* in value of the outstanding stock be owned by or for not more than five individuals during the last half of the taxable year, is one which it is believed will be found difficult to circumvent. A scheme such as declaring dividends only during the first half of the taxable year and then selling the stock to the requisite number of nominees, taking back an option to rebuy the stock in six months, seems too artificial to be successful.<sup>20</sup> It is not thought that elaborate schemes to circumvent Section 351 in this manner will thrive, since Section 102 would still remain applicable, even if the former section should be avoided by taking the corporation outside the definition of personal holding company.

The object of Section 351 is to subject to a thirty to forty *per cent.* surtax the income of a personal holding company which is not distributed to its stockholders,<sup>21</sup> but still to allow a reasonable accumulation for legitimate corporate purposes.<sup>22</sup> Because, however, of the fact that ordinarily dividends *received* by a corporation are tax-free to it,<sup>23</sup> it was necessary to add to the income of personal holding companies, for the purpose of this surtax, the dividends which they received,<sup>24</sup> but at the

20. A scheme involving the retirement of stock during the latter half of the taxable year also meets with the same objection.

21. § 351 (a) [48 STAT. 751, 26 U. S. C. A. § 5351 (a) (Supp. 1934)]. "IMPOSITION OF TAX.—There shall be levied, collected, and paid, for each taxable year, upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

(1) 30 per centum of the amount thereof not in excess of \$100,000; plus

(2) 40 per centum of the amount thereof in excess of \$100,000."

The "undistributed adjusted net income" of a personal holding company (its "adjusted net income" less certain credits) is subject at any event to a thirty to forty *per cent.* surtax. This is, of course, in addition to the 13¾ *per cent.* tax imposed on all corporations by Section 13.

22. *Id.* (b) :

"(2) The term 'undistributed net income' means the adjusted net income minus the sum of:

(A) 20 per centum of the excess of the adjusted net income over the amount of dividends received from personal holding companies which are allowable as a deduction for the purposes of the tax imposed by section 13 or 204;

(B) Amounts used or set aside to retire indebtedness incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness; and

(C) Dividends paid during the taxable year."

Before the surtax is imposed, a credit of twenty *per cent.* of the "adjusted net income" is allowed, plus amounts (within limits) to retire indebtedness.

23. § 23 (p) [48 STAT. 690, 26 U. S. C. A. § 5023 (p) (Supp. 1934)].

24. § 351 (b) (3) [48 STAT. 751, 26 U. S. C. A. § 5351 (b) (3) (Supp. 1934)]. Interest on partially tax-exempt securities no longer needs to be added to net income for the purpose of the additional tax on holding companies as it was prior to the 1934 Act. See § 104, Act of 1932 [47 STAT. 195 (1932), 26 U. S. C. A. § 3104 (Supp. 1934)]. The reason for this is that under the 1932 and prior Acts partially tax-exempt interest was

same time to allow a deduction to the extent that dividends were *paid* to its stockholders.<sup>25</sup> In order to compensate for this disadvantage such corporations are allowed to deduct for the purposes of this surtax 100 *per cent.* of charitable contributions<sup>26</sup> and of capital losses<sup>27</sup>—privileges denied to corporations in computing the ordinary corporate tax under Section 13<sup>28</sup> (a tax to which of course personal holding companies are also subject). It should be noted that stockholders have the option of including (without distributing) the entire adjusted net income of the corporation in their own incomes.<sup>29</sup> Since, however, they would thus lose the benefit of the twenty *per cent.* credit,<sup>30</sup> the privilege is an empty one.

Formidable though the provisions of this section may appear at first glance it is still possible for a wealthy taxpayer to save taxes through the medium of a personal holding corporation. However, all bonds upon which the corporation is taxable, should be removed therefrom, since this will replace the 13¾ *per cent.* corporate tax<sup>31</sup> with a four *per cent.* individual normal tax. Stock and government securities, the interest on which is not taxable to a corporation under Section 13, should be left in the personal holding corporation. Income from such sources passes through the corporation tax free (so far as Section 13 is concerned), and any permitted accumulation is clear gain to the taxpayer and is a saving from the highest brackets of the individual surtax. Twenty *per cent.* of the adjusted net income may be accumulated in any event.<sup>32</sup> Furthermore, since 100 *per cent.* of the corporation's security losses may be deducted, more than twenty *per cent.* may often be accumulated in the individual case.<sup>33</sup> Any charitable

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excluded from gross income under § 22 (b) (4) [47 STAT. 178 (1932), 26 U. S. C. A. § 3022 (b) (4) (Supp. 1934)]. This is no longer so since the elimination of the words "to the taxpayer" from § 22 (b) (4). Partially tax-exempt interest is now taken out as a credit against net income under § 25 (a) (2), [48 STAT. 692, 26 U. S. C. A. § 5025 (a) (2) (Supp. 1934)], but it is included in both gross and net income.

25. § 351 (b) (2) (C) [48 STAT. 752, 26 U. S. C. A. § 5351 (b) (2) (C) (Supp. 1934)].

26. § 351 (b) (3) (B) [48 STAT. 752, 26 U. S. C. A. § 5351 (b) (3) (B) (Supp. 1934)]; cf. § 23 (o) [48 STAT. 690, 26 U. S. C. A. § 5023 (Supp. 1934)], which gives only individuals the benefit of a deduction for charitable contributions.

27. § 351, *supra* note 26, at (b) (3) (C).

28. See § 117 (d) [48 STAT. 715, 26 U. S. C. A. § 5117 (d) (Supp. 1934)], which disallows capital losses to a large extent and the discussion herein, *infra* p. 614.

29. § 351 (d) [48 STAT. 752, 26 U. S. C. A. § 5351 (d) (Supp. 1934)].

30. See note 22 *supra*.

31. § 13 [48 STAT. 686, 26 U. S. C. A. § 5013 (Supp. 1934)]. Since the surtax on personal holding companies is an "Additional Income Tax" (see tit. IA), this 13¾ *per cent.* tax must be paid on ordinary net income, in addition to the surtax on "undistributed adjusted net income".

32. § 351 (b) (2) (A) [48 STAT. 752, 26 U. S. C. A. § 5351 (Supp. 1934)].

33. For example, the personal holding corporation has an income from dividends and partially tax-exempt securities of \$100,000. Suppose \$10,000 capital loss, only forty *per cent.* of which would be allowable in the hands of an individual. The undistributed adjusted net income is then \$90,000. Twenty *per cent.* of that is \$18,000. The income subject to corporate surtax is then but \$72,000. This is distributed to the individual (thus avoiding the corporate surtax), who pays \$14,910 tax thereon. Without the interposition of the personal holding company, he would have paid \$25,500. Moreover, the accumulation is done with perfect safety, since personal holding corporations are not subject to the provisions of § 102 [48 STAT. 702, 26 U. S. C. A. § 5102 (Supp. 1934)].

contributions or gifts should also be made from the personal holding corporation, in order further to reduce the "undistributed adjusted net income", which, if there are deductions enough, may by definition equal zero, whereas in reality a large percentage is yet in fact undistributed.

Moreover, the new provisions of Sections 102 and 351, which allow "dividends paid during the taxable year" to be wholly deductible from the adjusted net income,<sup>34</sup> allow a corporation to be used safely as a device for splitting extraordinary income between two taxable periods, thereby accomplishing a considerable tax saving in some cases. Suppose *T*, an individual, is about to close a deal for the sale of property on which he will have a taxable gain of \$100,000. In July, 1934, *T* forms a corporation and sells the property to it for its stock. The corporation sells the property in August, 1934, making the \$100,000 gain, upon which it pays a tax of \$13,750. It distributes \$43,125 to its stockholder *T* in 1934, and \$43,125 in the first half of 1935 before its first taxable year has expired—the stockholder being on a calendar year basis. The stockholder pays surtax of \$5,630 in 1934 and surtax of \$5,630 in 1935, making a total tax paid on the gain of \$25,010. Had *T* sold the property himself his tax would have been \$31,460,<sup>35</sup> since it would all have been taxed to him in the same taxable period.

It should be noted that Section 351, being in a separate title, requires a separate return to be filed before the Statute of Limitations will start to run.

On the whole, it can be said that the enactment of Section 351, together with the strengthening of Section 102 and the elimination of the deduction and credit for dividends of foreign corporations,<sup>36</sup> has gone a long way towards eliminating tax avoidance by incorporation. This aim could be furthered still more by depriving foreign corporations of their dividend deduction for dividends of domestic corporations, while allowing them to credit against the tax any tax upon such dividends to which they might be subject at their domiciles.

### *Family Losses*

In the past, if the taxpayer had property upon which he wished to realize a loss, he could sell it to a member of his family or to his personal corporation, and thus get the benefit of a deduction for the loss.<sup>37</sup> As any

34. *Id.* (c); § 351 (b) (2) (C) [48 STAT. 752, 26 U. S. C. A. § 5351 (Supp. 1934)].

35. This may be a useful tax saving device, particularly since the initial payment on an installment sale may now not exceed thirty *per cent.*, whereas it was formerly forty *per cent.*

36. § 23 (p) [48 STAT. 690, 26 U. S. C. A. § 5023 (p) (Supp. 1934)], which gave a deduction to corporations, was so amended; as was also § 25 [48 STAT. 692, 26 U. S. C. A. § 5025 (Supp. 1934)], which gave a credit to individuals. Since many personal holding companies are incorporated in foreign countries, this provision prevents their stockholders from receiving any credit or deduction on their dividends.

37. Charles F. Fawcett, 31 B. T. A. 139 (1934); Frank B. Gummey, 26 B. T. A. 894 (1932).

future appreciation in the property would, however, indirectly accrue to the benefit of the taxpayer, he would thus realize a loss for income tax purposes without materially changing his position. Upon the recommendation of the Subcommittee,<sup>38</sup> Congress attempted to close this loophole by disallowing losses from sales or exchanges of property, directly or indirectly, between members of a family, or (except in the case of distributions in liquidation) between an individual and a corporation in which he owns more than fifty *per cent.* in value of the outstanding stock.<sup>39</sup> An individual is considered as owning the stock owned directly or indirectly by his family, which by definition includes only his brothers and sisters (whether by the whole or half blood) spouse, ancestors, and lineal descendants.<sup>40</sup> It is thus still possible to transfer property to "in-laws", and receive the benefit of a deduction for loss.

The free use of the phrase "directly or indirectly" in this provision of the Act should discourage devices to avoid it, but may be productive of litigation to construe the word "indirectly."<sup>41</sup> It should particularly be noted that since losses on transactions described in this provision are *disallowed*, though *recognized*, the loss is gone forever and the transferee takes the lower basis for gain or loss (cost to the transferee) rather than the higher basis of cost to the transferor.<sup>42</sup>

### Capital Gains and Losses

Originally all income, including gains derived from the sale of capital assets, was taxed at the ordinary rates without differentiation. Any doubt as to the validity of this procedure was soon dispelled by the Supreme Court's interpretation of the Sixteenth Amendment.<sup>43</sup> But granting Congress' power so to tax capital gains, it was argued with seeming plausibility that if a capital asset, *e. g.*, real estate, cost \$10,000 when purchased in 1911 and was sold in 1921 for \$110,000, the profit realized in fact represented an appreciation of \$10,000 per year, and it was therefore inequitable to subject the entire profit to the graduated surtax in 1921.

Evidently moved by this argument, Congress in the Act of 1921 segregated capital gains<sup>44</sup> for the purpose of according them special treat-

38. *Op. cit. supra* note 1, at 14.

39. § 24 (a) (6) [48 STAT. 691, 26 U. S. C. A. § 5024 (a) (6) (Supp. 1934)].

40. *Id.* at (D).

41. In any event § 117 (d) [48 STAT. 715, 26 U. S. C. A. § 5117 (d) (Supp. 1934)], limiting capital losses to capital gains plus \$2,000, has lessened the incentive to take capital losses. See *infra* pp. 613-617.

42. § 113 [48 STAT. 706, 26 U. S. C. A. § 5113 (Supp. 1934)], specifying the cases in which the transferee takes the transferor's basis is not applicable.

43. *Merchants' Loan & Trust Co. v. Smietanka*, 255 U. S. 509 (1921); *Goodrich v. Edwards*, 255 U. S. 527 (1921); *Walsh v. Brewster*, 255 U. S. 536 (1921); *Darlington v. Mager*, 256 U. S. 682 (1921). Cf. *Eisner v. Macomber*, 252 U. S. 189 (1920).

44. § 206 (a) (6), Act of 1921 [42 STAT. 233 (1921)] defined a "capital asset" to mean "property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business)". It did not include

ment. Taxpayers (other than corporations) <sup>45</sup> were given an election <sup>46</sup> of being taxed on capital gains at the flat rate of 12½ *per cent.* or of including such gains in their other income and being taxed at the ordinary graduated rates.<sup>47</sup> Since no comparable provision was included with respect to capital losses, the Government fared badly under the 1921 Act, for capital losses were taken *in toto* against other current income <sup>48</sup> and in certain cases might be carried forward and applied against income realized in the two years next succeeding.<sup>49</sup>

The succeeding Acts of 1924,<sup>50</sup> 1926,<sup>51</sup> 1928<sup>52</sup> and 1932<sup>53</sup> incorporated a compulsory provision, limiting capital losses to 12½ *per cent.* thereof, which was taken as a credit against the tax, but with the proviso that the tax should not be less than the regular normal and surtax computed without regard to the 12½ *per cent.* limitation. This provision was "safe" from the revenue standpoint to the extent that the capital loss deduction could never result in a smaller tax than would have been paid under prior provisions.

The depression with its attendant decline in the price of securities and the value of all fixed properties, caused capital losses which, even under the 12½ *per cent.* limitation, were sufficient to offset current income. Accordingly, reputedly wealthy persons often paid no tax, whereas the small-salaried man having little accumulated capital had to pay.

The Revenue Act of 1932 made no change,<sup>54</sup> in so far as capital assets held over two years were concerned, but in an endeavor to prevent the national revenues from being "dried up" by short term security losses included provisions limiting losses on securities held less than two years to the extent of similar gains.<sup>55</sup> The harshness of this arbitrary segregation was lessened somewhat by a provision permitting such losses up to an amount equal to the net income, to be carried forward and applied against

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"property held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year."

45. Corporations were taxed at the flat rate of 12½ *per cent.* on all income.

46. As to when election is binding on taxpayers see XIII-37 Int. Rev. Bull. 3 (1934).

47. § 206 (b), Act of 1921 [42 STAT. 233 (1921)]; U. S. Treas. Reg. 62, Art. 1652.

48. The Secretary of the Treasury, in his report for the fiscal year ending June 30, 1922, recommended that a limitation of 12½ *per cent.* be placed on capital losses. As an alternative it was proposed to ignore entirely capital gains and losses.

49. § 204, Act of 1921 [42 STAT. 230 (1921)].

50. § 208, Act of 1924 [43 STAT. 262 (1924), 26 U. S. C. A. § 939 n. (1928)]; U. S. Treas. Reg. 65, Art. 1654.

51. § 208, Act of 1926 [44 STAT. 19 (1926), 26 U. S. C. A. § 939 n. (1928)]; U. S. Treas. Reg. 69, Art. 1654.

52. § 101 [45 STAT. 811, 26 U. S. C. A. § 2101 (1928)]; U. S. Treas. Reg. 74, Art. 503.

53. § 101 [47 STAT. 191 (1932), 26 U. S. C. A. § 3101 (Supp. 1934)]; U. S. Treas. Reg. 77, Art. 503.

54. *Ibid.*

55. § 23 (r-t) [47 STAT. 183 (1932), 26 U. S. C. A. § 3023 (r-t) (Supp. 1934)].

similar gains in succeeding years,<sup>56</sup> but this privilege was subsequently abolished by the National Industrial Recovery Act.<sup>57</sup>

The Subcommittee, after noting certain defects in the 1932 provisions,<sup>58</sup> and having considered<sup>59</sup> the British system which disregards such gains and losses, recommended "a step toward" the British system without permitting such gains to go entirely tax free.<sup>60</sup> Taxpayers other than corporations were to be made taxable only upon a certain percentage of such gains, the exact percentage depending upon the length of time the particular asset sold had been held.<sup>61</sup> The percentage of said gain (assuming there were no losses) was to be included in other income and subject to the normal and graduated surtax rates. Losses on capital assets were to be computed upon the same percentage basis,<sup>62</sup> but they were to be deductible only to the extent of similar gains, and this latter limitation was to affect corporations as well.<sup>63</sup>

The option of being taxed at a flat rate upon capital gains<sup>64</sup> would be abolished. The short term security limitation provisions<sup>65</sup> would become obsolete, for the scale of percentages would be made to cover assets held less than two years as well as those held for longer periods.<sup>66</sup> The Subcommittee's recommendations were in substance finally enacted but only

56. § 23 (r) (2), *supra* note 55.

57. § 218 (b) [48 STAT. 209 (1933), 26 U. S. C. A. § 3023 n. (Supp. 1934)].

58. *Op. cit. supra* note 1, at 5. The defects are: unstable revenue; a tax is imposed on the mere increase in monetary value resulting from the depreciation of the dollar; taxpayers take losses before the two year period but delay taking gains until after the two year period; the provisions give relief only to the larger taxpayers with net incomes over \$16,000; normal business transactions are prevented.

59. *Op. cit. supra* note 1, at 6. In the last eleven years, the maximum British revenue was only thirty-five *per cent.* above the minimum, whereas the federal revenues have fluctuated 280 *per cent.* However, the English Act includes a much broader group of incomes, exemptions are lower and the normal rate higher. See Statement of the Acting Secretary of the Treasury, *supra* note 2, at 5. See also, MAGILL, PARKER, KING, A SUMMARY OF THE BRITISH TAX SYSTEM (1934) 21, 57.

60. *Op. cit. supra* note 1, at 6.

61. *Id.*; § 117 (a) [48 STAT. 714, 26 U. S. C. A. § 5117 (a) (Supp. 1934)]. 100 *per cent.* of the actual gain or loss upon the sale or exchange is taken into account if the asset has been held for not more than one year; eighty *per cent.* if more than one but not more than two; sixty *per cent.* if more than two but not more than five; forty *per cent.* if more than five but not more than ten; and thirty *per cent.* if more than ten years. But see § 115 (c) [48 STAT. 711, 26 U. S. C. A. § 5115 (Supp. 1934)], subjecting to both normal tax and surtax 100 *per cent.* of a stockbroker's gain on corporate distributions in liquidation irrespective of the length of the period for which the stock has been held.

62. § 117 (a), *supra* note 61. The percentage provisions for computing the portion of the gain or loss which was to enter into the computation cover taxpayers other than corporations. *Ibid.*

63. § 117 (d) [48 STAT. 715, 26 U. S. C. A. § 5117 (d) (Supp. 1934)]. Under T. D. 4511, XIV-3 Int. Rev. Bull. 6, husband and wife are regarded as separate taxpayers even though a joint return be filed, and capital losses of one may not be offset against the other's capital gains. Both apparently receive the benefit of deducting \$2,000 excess of capital losses from their other income.

64. § 101, Act of 1932 [47 STAT. 191 (1932), 26 U. S. C. A. § 3101 (Supp. 1934)].

65. § 23 (r-t), Act of 1932 [47 STAT. 183 (1932), 26 U. S. C. A. § 3023 (r-t) (Supp. 1934)].

66. § 117 (a) [48 STAT. 714, 26 U. S. C. A. § 5117 (a) (Supp. 1934)].

after the Senate Finance Committee had suggested certain changes<sup>67</sup> which were adopted. Losses to the extent of \$2,000 were permitted to reduce ordinary income, and banks and trust companies were exempted from the provision limiting capital losses to capital gains plus \$2,000.<sup>68</sup> The first change was designed to benefit the small taxpayer, who would be likely to have no offsetting capital gains. The second change was prompted by the fact that the exempted companies deal in fixed dollar obligations. Moreover, to prevent long term losses being turned into short term losses by short sales, a method which would obtain the advantage of a greater off-set against other capital gains, it was made clear that the length of time during which the "short seller" held the property he used to "cover his obligation to deliver" was the determinative period.<sup>69</sup>

The new provisions are a marked improvement. As truly stated by the Committee on Ways and Means, "The existing [prior to the 1934 Act] method which has been in force since 1921 can be defended only on the grounds of expediency."<sup>70</sup>

Further improvements could be made for the sake of clarity. Subsection (d) of Section 117 provides that "losses from sales . . . of capital assets shall be allowed only to the extent of \$2,000 plus gains from such sales . . ." The question at once arises whether the "\$2,000 plus gains" means \$2,000 plus *actual* gains or plus *percentage* gains, and conversely whether the losses allowable to the extent of \$2,000 plus gains are actual losses or percentage losses. If *A* has a \$10,000 gain (asset held eleven years; percentage gain \$3,000) and a \$20,000 loss (asset held two years; percentage loss \$16,000), does the "\$2,000 plus gains" limiting the extent to which the loss may be taken mean (1) \$2,000 plus \$10,000, which equals \$12,000, or (2) \$2,000 plus \$3,000, which equals \$5,000? The Regulations take the latter view.<sup>71</sup> Again, if *A* realizes an actual loss of \$2,000 on a capital asset held more than ten years, what is the amount of the deduction against other income? If *A* is an individual the percentage of such loss recognized under subsection (a) of Section 117 in "computing net income" is \$600. Query, whether *A* may deduct \$2,000 (actual loss) or \$600 (percentage of such loss). If the \$2,000 deduction is computed upon a percentage basis,<sup>72</sup> then it would be possible for actual capital losses to exceed gains, and yet no deduction would be available.<sup>73</sup> Conversely, where

67. *Op. cit. supra* note 7, at 12, 13.

68. § 117 (d), *supra* note 63.

69. *Op. cit. supra* note 7, at 13; § 117 (e) [48 STAT. 715, 26 U. S. C. A. § 5117 (e) (Supp. 1934)].

70. *Op. cit. supra* note 4, at 10.

71. T. D. 4511, XIV 3 Int. Rev. Bull. 6.

72. *Op. cit. supra* note 7, at 12: "\$2,000 of such excess of losses may be charged off from ordinary income". This language is persuasive that a percentage basis was intended.

73. For instance, if *A* realizes a \$25,000 actual loss on an asset held for six years (the percentage loss being \$10,000) and an actual gain of \$10,000 on an asset held for one year (the percentage gain being \$10,000), he would be allowed no deduction in spite of the fact that he has actually suffered a capital net loss of \$15,000.

actual gains preponderate, a deduction of \$2,000 may nevertheless be allowable.<sup>74</sup> There seems little doubt that corporations, on the other hand, may deduct \$2,000 actual excess of capital losses from other income.<sup>75</sup>

### Consolidated Returns

Upon this score Congress has reversed a policy of sixteen years' standing. The importance of the change from a practical standpoint can be realized from the fact that for the years 1928 to 1931, inclusive, approximately forty-six *per cent.* of the total gross income returned by corporations was returned on consolidated returns.<sup>76</sup> The matter has been especially provocative in Congress. The Revenue Bill of 1918, as passed by the House, prohibited consolidated returns, then allowed under Treasury Regulations. However, the bill, as passed by the Senate and finally enacted, specifically provided for consolidated returns. The Revenue Bill of 1928, as passed by the House, again denied the right to file consolidated returns, but this provision was once more eliminated by the Senate. During the consideration of the Revenue Act of 1932, a compromise was effected whereby the consolidated return provisions were retained, but corporations taking advantage of them were compelled to pay an additional three-fourths *per cent.* tax.<sup>77</sup> This was later raised to one *per cent.* by the National Industrial Recovery Act.<sup>78</sup>

Before the Revenue Bill of 1934 had been introduced, the Subcommittee concluded that the privilege of filing consolidated returns should be abolished<sup>79</sup> but the Treasury Department was opposed to this suggestion.<sup>80</sup> The Committee on Ways and Means reversed its Subcommittee and recommended to the House the retention of the consolidated return provisions, with an increase to two *per cent.* of the additional tax paid by corporations filing consolidated returns.<sup>81</sup> The bill embodying this recommendation passed the House, and was approved by the Senate Finance Committee.<sup>82</sup> However, the Senate, under the leadership of Senators La

74. For instance, if *A* realizes a \$10,000 actual loss on an asset held for one year (the percentage loss being \$10,000), and an actual gain of \$25,000 on an asset held for eleven years (the percentage gain being \$7,500), he would be entitled to a deduction of \$2000, in spite of the fact that he has actually realized a capital net gain of \$15,000.

75. *Op. cit. supra* note 7, at 12.

76. Gross Income (in dollars)

Year	All Corporate Returns	Consolidated Returns	Percentage
1928	\$157,254,907,731	\$69,825,396,448	44.4
1929	\$160,621,509,181	\$72,456,327,976	45.1
1930	\$138,312,059,068	\$65,906,147,467	47.6
1931	\$107,515,239,037	\$50,244,116,910	46.7

This table is taken from the House report, *supra* note 4, at 17.

77. § 141, Act of 1932, [47 STAT. 213 (1932), 26 U. S. C. A. § 3141 (Supp. 1934)].

78. 48 STAT. 209 (1933), 26 U. S. C. A. § 3141 (Supp. 1934).

79. *Op. cit. supra* note 1, at 10.

80. ". . . the Department believes that the abolition of consolidated returns might well be a backward step, which would result in little, if any, additional revenue." *Op. cit. supra* note 2, at 13.

81. *Op. cit. supra* note 4, at 17.

82. *Op. cit. supra* note 7, at 17.

Follette and Borah, by a vote of forty to thirty-seven struck from the bill the provisions giving the privilege of filing consolidated returns.<sup>83</sup> In conference the privilege was restored, but only as to "common carriers by railroad",<sup>84</sup> and in such severely restricted form was enacted.<sup>85</sup>

The Revenue Act of 1932<sup>86</sup> had given to an "affiliated group"<sup>87</sup> of corporations<sup>88</sup> the privilege of filing a consolidated return, provided every affiliated corporation joined therein and consented to be bound by the regulations prescribed by the Commissioner of Internal Revenue at the time of the filing of the return.<sup>89</sup> The new Revenue Act effects the change by adding to the definition of affiliated group<sup>90</sup> a third requirement that each of the corporations be either (a) a corporation whose principal business is that of a common carrier by railroad, or (b) a corporation the assets of which consist principally of stock in such corporations, and which does not itself operate a business other than that of a common carrier by railroad.

The only new problems confronting railroads will be confined to a construction of the phrase "principal business" and the word "railroad". The former is by the Act defined to include the business of receiving rents where a corporation has leased its properties to another corporation qualifying as a common carrier by railroad.<sup>91</sup> Nevertheless, in all probability the definition will necessitate certain shifts within the consolidated group. Railroad holding companies are not within the group if they directly operate a bus line or any type of business other than that of a common carrier by railroad.<sup>92</sup> It would seem to make no difference how small a proportion of

83. 78 CONG. REC. 6459.

84. *Op. cit. supra* note 9, at 5, 6. The exception in favor of railroads was thought justified, since they are frequently required by law to incorporate in each state through which they pass.

85. § 141, Act of 1934, [48 STAT. 720 (1934), 26 U. S. C. A. § 5141 (Supp. 1934)].

86. § 141, Act of 1932 [47 STAT. 213 (1932), 26 U. S. C. A. § 3141 (Supp. 1934)].

87. "An affiliated group" means one or more chains of corporations connected through stock ownership with a common parent corporation if—

(1) At least ninety-five *per cent.* of the stock of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations; and

(2) The common parent corporation owns directly at least ninety-five *per cent.* of the stock of at least one of the other corporations. § 141 (d), Act of 1932, *supra* note 86.

As used in this subsection the term "stock" does not include non-voting stock which is limited and preferred as to dividends.

88. The privilege was for practical purposes limited to domestic corporations. Corporations organized under the China Trade Act of 1922, corporations deriving income from possessions of the United States, and all foreign corporations (except 100 *per cent.* subsidiaries of domestic corporations formed to comply with Canadian or Mexican law) were excluded from the consolidated group. Revenue Act of 1932, § 141 (f-h) [47 STAT. 214 (1932), 26 U. S. C. A. § 3141 (b-h) (Supp. 1934)]; U. S. Treas. Reg. 77, Arts. 713, 714.

89. The filing of the return constituted a consent. For the effectiveness of the consent see the recent case of *Ilfeld Co. v. Hernandez*, 292 U. S. 62 (1934); *Niagara Share Corp. v. Commissioner*, 30 B. T. A. 668 (1934).

90. *Supra*, note 87.

91. § 141 (d) (3), Act of 1934 [48 STAT. 721, 26 U. S. C. A. § 5141 (d) (3) (Supp. 1934)].

92. *Cf. Woodward v. Seattle*, 140 Wash. 83, 248 Pac. 73 (1926) (power granted cities by statute to acquire and operate electric and other "railways" does not authorize operation of motor buses).

their business consisted of the direct operation of bus lines. However, they may own stock in all manner of operating companies, provided their assets consist *principally* of stock in corporations which are common carriers by railroad. Some difficulty will undoubtedly arise over the interpretation of the word "railroad", as to whether it includes interurban street car companies,<sup>93</sup> or subway, elevated and street surface car companies.<sup>94</sup>

By denying the privilege of filing consolidated returns to corporations which are not common carriers by railroad, the new provisions will certainly adversely affect such corporations, for the realities of the situation are disregarded. Modern business has found it convenient to incorporate branches, and the tax law should not discourage the legitimate incorporation of business. Probably the change was to a large extent an indictment of 1929 business methods.<sup>95</sup> However, the creation of a wide divergence between corporate practice and the tax machinery can only discourage the taxpayer's honest cooperation and make the administration of the law difficult. The 1932 Act encouraged cooperation; there was a *quid pro quo*, in that the privilege of filing a consolidated return was conditioned upon acceptance of the Commissioner's regulations,<sup>96</sup> designed to truly reflect the total income of the group, and upon the acceptance of a higher tax rate.<sup>97</sup>

Much oratory has been wasted upon the supposed evasion of taxes resulting from the income of one subsidiary being offset by the losses of another member of the affiliated group. If the New York office of a business makes a profit, while the Chicago office suffers a loss, why should a tax be paid on the profit without regard to the loss? The corporate cloak does not change the realities of the situation. Under the new Act it will in many cases merely be discarded.<sup>98</sup> In cases where the cost of revamping the capital structure is not justified, the government will be confronted with the necessity of segregating all kinds of questionable intercompany transac-

93. See *McAdow v. Kansas City Western Ry.*, 192 Mo. App. 540, 164 S. W. 188 (1916).

94. Cf. *Omaha & C. B. St. Ry. v. Interstate Commerce Comm.*, 230 U. S. 334 (1913); *In re Grafton Gas and Elec. Light Co.*, 253 Fed. 668 (N. D. W. Va. 1918); *Stark v. Wilson*, 114 Kan. 459, 219 Pac. 507 (1923); *Helena Light & Ry. v. Helena*, 47 Mont. 18, 130 Pac. 446 (1913); *State v. Omaha & B. St. Ry.*, 56 Neb. 725, 148 N. W. 946 (1914); *City of Barre v. Barre & M. Power and Traction Co.*, 88 Vt. 304, 92 Atl. 237 (1914); *Puget Sound Power & Light Co. v. Seattle*, 117 Wash. 351, 201 Pac. 449 (1921).

95. Much of the ammunition of Senator Borah's successful campaign against the privilege of consolidated returns consisted of horrible examples of sharp corporate practices and of super-holding companies resembling octopi.

96. § 141 (a) (b), Act of 1932 [47 STAT. 213 (1932)], 26 U. S. C. A. § 3141 (a) (b) (Supp. 1934)] see U. S. Treas. Reg. 77 promulgated thereunder; *Ilfeld Co. v. Hernandez*, 292 U. S. 62 (1934), cited note 89, *supra*.

97. *Supra*, notes 77, 78.

98. Corporations are taxed at a flat rate; there is no tax advantage in consolidating corporations all of which show consistent profits. However, where any corporation of the group has consistent net losses, it will be merged with a corporation which shows consistent gains, and hence has a taxable income against which the losses of the merged corporations may be offset.

tions.<sup>99</sup> It seems regrettable that Congress did not follow the recommendations of the department charged with the administration of the law.<sup>100</sup> The conditions imposed upon those filing consolidated returns were most advantageously designed to prevent tax evasion or avoidance.<sup>101</sup>

### *Allocation of Income and Deductions*

The 1928 and 1932 Acts<sup>102</sup> provided that where two or more "trades or businesses" (whether or not incorporated, organized in the United States, or affiliated) were "owned or controlled, directly or indirectly" by the "same interests", the Commissioner was authorized to allocate or apportion gross income or deductions between such trades or businesses in order (1) to prevent "evasion" of taxes, or (2) to reflect clearly the income of any of such trades or businesses.<sup>103</sup> Although this provision, a potentially powerful weapon of the Commissioner, has been rather seldom used, the Subcommittee recommended<sup>104</sup> (1) including "organizations" in addition to trades and businesses, and (2) empowering the Commissioner to prevent "avoidance" of taxation as well as "evasion".<sup>105</sup> The Treasury concurred in these recommendations.<sup>106</sup> The word "organizations" was eventually added to Section 45, but the reason for Congress' rejection of the word "avoidance" does not appear in the reports.<sup>107</sup>

99. "Subsidiary corporations now showing losses in separate statements, could arrange, by intercompany contracts and by a readjustment of accounting methods, to obtain a fair share of the profits of the affiliated group. There is no way to prevent the bulk of such contracts because the Treasury cannot hold that a contract which enables a company to make a profit is necessarily unfair or evasive. Moreover, full recognition of intercompany transactions would often result in deductible losses as well as taxable gains." *Op. cit. supra* note 2, at 13.

100. ". . . the Department believes that the abolition of consolidated returns might well be a backward step, which would result in little, if any, additional revenue. On the other hand, there are considerable savings to the Treasury, as well as to taxpayers, in the present arrangement. The administration of the law is simpler since it conforms to established business practice. The Treasury need deal with only one corporation, the parent. On the taxpayer's side, the requirement of separate returns would cause largely increased expense to set up separate sets of books for tax purposes, an undesirable result in itself. The present law permits a return in accord with business practice, and gives the Treasury broad powers to make the necessary rules and regulations to prevent escape from the tax. In the judgment of the Department, the law should not be changed in this particular." *Op. cit. supra* note 2, at 13.

101. *Supra* notes 96 and 100.

102. § 45 [45 STAT. 806 (1928)], 26 U. S. C. A. § 2045 (Supp. 1934); 47 STAT. 186 (1932), 26 U. S. C. A. § 3045 (Supp. 1934)].

103. The 1921, 1924, and 1926 Acts, §§ 240 (f), provided for a "consolidation of accounts" of related trades or businesses.

104. *Op. cit. supra* note 1, at 15.

105. This second recommendation of the Subcommittee was rejected by the experts of the Ways and Means Committee on the ground that it would be unconstitutional to authorize the Commissioner to distribute or allocate gross income or deductions in order to prevent avoidance of taxes, as opposed to evasion of them. However, the word "avoidance" seems more apt to express the intent of the section, since without fraud or concealment of some nature, evasion cannot arise. The real intent of the section is to prevent avoidance since evasion is unlawful in any event.

106. *Op. cit. supra* note 2, at 16.

107. See note 105, *supra*.

The section is undoubtedly considerably broadened by the addition of the word "organizations". Where in the past a taxpayer might have claimed that several organizations did not constitute "two or more trades or businesses" but only one, and that hence the section did not apply, it is now obvious that this objection is no longer available. The Congressional committees merely noted that, while it was believed the language of the existing law was broad enough to include "organizations", the word was added "to remove any doubt as to the application of this section to all kinds of business activity".<sup>108</sup>

This provision, although generally considered as unfavorable to the taxpayer, is not necessarily so. On the contrary, it might be construed to his advantage, particularly since the substantial repeal of the provisions permitting consolidated returns. If the income of the group cannot clearly be reflected unless there is some consolidation of accounts, the Commissioner is "authorized" to "distribute, apportion, or allocate" gross income or deductions. How far the Commissioner may be compelled<sup>109</sup> to "distribute, apportion or allocate", is uncertain, but it is possible for the Treasury to use this section to alleviate somewhat the hardships caused by substantial abolition of consolidated returns.<sup>110</sup>

### *Exchanges and Reorganizations*

The following résumé of the exchange and reorganization provisions may prove more understandable if two questions are kept constantly in mind. (1) When is a gain or loss "realized" in the legal sense?<sup>111</sup> (2) When, as a practical matter, is the most convenient and least painful time to exact payment of the tax?

The Supreme Court has, in cases involving the Revenue Acts of 1913<sup>112</sup> and 1916,<sup>113</sup> pretty thoroughly considered the first question. Con-

108. *Op. cit. supra* note 4 at 24; *op. cit. supra* note 7, at 29.

109. For a ruling that the corresponding section of the Act of 1921 [§ 240 (d), 42 STAT. 260 (1921), 26 U. S. C. A. § 993 (d) (1928)] imposed no duty on the Commissioner to consolidate accounts at the taxpayer's request, see VIII-1, Cum. Bull. 128, Gen. Counsel's Memo. 2856. But see § 240 of the 1924 and 1926 Acts [43 STAT. 288 (1924), 26 U. S. C. A. § 993 (d) (1928); 44 STAT. 46 (1926), 26 U. S. C. A. § 993 (d) (1928)], which contained mandatory language. See also the recent case of Asiatic Petroleum Co. (Del.), Ltd., 31 B. T. A. No. 206 (Jan. 31, 1935).

110. The Treasury will probably be in a mood to do this because of its opposition to the abolition of consolidated returns. See notes 80 and 100, *supra*.

111. For an exhaustive consideration of this problem, see Magill, *When Is Income Realized?* (1933) 46 HARV. L. REV. 933.

112. Income was held in *Towne v. Eisner*, 245 U. S. 418 (1918) not to have been realized upon the stockholder's receipt of a "stock dividend", where the corporation issued said shares against earned surplus transferred to its capital account. It was observed (at 426, 427), ". . . the corporation is no poorer and the stockholder is no richer than they were before. . . . What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new." Cf. *Peabody v. Eisner*, 247 U. S. 347 (1918) (a distribution in specie, *i. e.*, stock of another corporation, is taxable); *United States v. Phellis*, 257 U. S. 156 (1921) (where a reorganization results in the distribution of accumulated profits of the company, something of exchangeable value has been severed from the capital investment, and consequently a tax-

gress' power to tax exchanges and reorganizations in the year in which such transactions occurred, even though exchanges in kind were involved<sup>114</sup> and the properties possessed no readily realizable value,<sup>115</sup> is undeniable when an "exchange of interests"<sup>116</sup> occurs.

As for the considerations presented by the second question, these soon asserted themselves, and it became increasingly apparent that "gains" resulting from certain exchanges (*e. g.* a trade of one secondhand car for another) often were illusory<sup>117</sup> and that it was extremely painful to extract the payment of a tax from the better bargainer if he had received no cash from which the tax could be paid.<sup>118</sup> From the administrative standpoint, it was not only inconvenient but impossible to evaluate all exchanges. The expedient was developed of exempting certain transfers temporarily and postponing the tax until a time when there was something comparable to a cash transaction.<sup>119</sup>

able gain is realized), in accord with which is *Rockefeller v. United States*, 257 U. S. 176 (1921); *Marr v. United States*, 268 U. S. 536 (1925).

113. The Sixteenth Amendment authorizes the taxation of "incomes from whatever source derived", but as observed in *Taft v. Bowers*, 278 U. S. 470, 481 (1929), "Under former decisions here the settled doctrine is that the Sixteenth Amendment confers no power upon Congress to define and tax as income without apportionment something which theretofore could not have been properly regarded as income". In *Eisner v. Macomber*, 252 U. S. 189, 207 (1920) arising under the 1916 Act [39 STAT. 756 (1916)], income was defined "as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets"; and it was held that a "stock dividend" representing accumulated profits did not constitute realized income. *Cf. Cullinan v. Walker*, 262 U. S. 134 (1923), where a liquidating dividend was held to have resulted in taxable income; *Weiss v. Stearn*, 265 U. S. 242 (1924), where the exchange of one-half of a stockholder's interest in one Ohio corporation for a similar interest in a newly formed Ohio corporation was held not to have resulted in taxable gain.

114. *E. g.*, stock for stock of a different corporation, or of the same corporation but possessing different privileges and rights.

115. In *Eisner v. Macomber*, 252 U. S. 189, 215 (1920), it is stated, "But we regard the market prices of the securities as an unsafe criterion in an inquiry such as the present, when the question must be not what will the thing sell for, but what is it in truth and in essence." However, in *United States v. Phellis*, 257 U. S. 156, 170 (1921), cited note 112, *supra*, the Court comments upon the fact that the stock was marketable. In this connection, the Revenue Act of 1916 [39 STAT. 756 (1916)] provided that "a stock dividend shall be considered income, to the amount of its cash value"; but *Eisner v. Macomber*, *supra*, held in respect of stock dividends that this provision contravened the provisions of Art. I, § 2, cl. 3 and Art. I, § 9, cl. 4 of the Constitution and was not saved by the provisions of the Sixteenth Amendment.

116. It is held otherwise when the transaction is merely an "exchange of certificates representing the same interest", as, the Court concluded, was the situation in *Weiss v. Stearn*, 265 U. S. 242 (1924), when the stock received, though that of another corporate entity, was of one organized in the same state, with presumably the same powers. So also *Eisner v. Macomber*, 252 U. S. 189 (1920), even though there was a quantitative change in the amount of stock held. In the latter case, the situation was regarded as somewhat similar to the exchange of a 1,000-share stock certificate for ten 100-share certificates.

117. *Semble*, I. T. 2356, VI-1 Cum. Bull. 168, revoked by I. T. 2419, VII-1 Cum. Bull. 231, reinstated by I. T. 2573, X-1 Cum. Bull. 215.

118. See *United States v. Phellis*, 257 U. S. 156, cited note 108, *supra*, where the Court adverts to the hardship on one purchasing the stock of a corporation which shortly thereafter, pursuant to a plan of reorganization, organizes a corporation to which it transfers its earned surplus for stock which is distributed to its stockholders.

119. The situation where the tax is imposed but merely the collection postponed, is to be carefully distinguished.

The first indication of this development was the incorporation of an exception in the Revenue Act of 1918<sup>120</sup> postponing the tax where, in connection with a reorganization, stock was exchanged for stock having no greater par or face value. During the consideration of this Act, the Senate proposed certain amendments designed to exempt certain other exchanges, but these were defeated by the House.<sup>121</sup>

In the Revenue Act of 1921, the exemption idea was extended to exchanges in kind of investment and business properties.<sup>122</sup> Brokerage and investment houses were quick to seize upon this application and to encourage customers to "swap" securities upon a tax-free basis. This loophole was plugged by a special Act of Congress in 1923,<sup>123</sup> which abolished this exemption. Moreover, the Act of 1921 permitted individuals to transfer property tax-free to a corporation<sup>124</sup> and allowed the corporation to take as a tax basis in figuring future gains the fair market value at the time of transfer.<sup>125</sup> Thereby an individual, instead of selling an asset upon which

120. Gains continued to be taxed when realized with the following exception: "When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged." § 202 b of Revenue Act of 1918 [40 STAT. 1060 (1919)] (italics supplied).

121. *Op. cit. supra* note 1, at 37.

122. § 202 (c) [43 STAT. 230 (1921)] provided: "For the purposes of this Title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a realizable market value, no gain or loss shall be recognized—

(1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale) is exchanged for property of a like kind or use;

(2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation, a party to or resulting from such reorganization. The word "reorganization", as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation (however effected); or

(3) When (A) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities or both, received by such person are in substantially the same proportion as their interests in the property before such transfer. For the purpose of this paragraph, a person is, or two or more persons are 'in control' of a corporation when owning at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation."

123. By 42 STAT. 1560 (1923), there was inserted after the word "sale" in parentheses in § 202 (c) (1), *supra*, note 122, the following: "and in the case of property held for investment not including stocks, bonds, notes, choses in action, certificates of trust or beneficial interest or other securities or evidences of indebtedness or interest."

124. § 202 (c) (3), *supra* note 122.

125. Property could be transferred to a corporation and its cost to the corporation determined by the fair market value of the property at the time of transfer. The corporation would then use such enhanced value in computing its gain from a subsequent sale (cost being the basis for gain or loss).

there was a great potential tax liability because of the high surtax rates, could minimize his tax effectively by selling to a personal corporation and having the corporation resell.

This defect was remedied by the Revenue Act of 1924,<sup>126</sup> the provisions of which dealt minutely with each step of the reorganization procedure and were retained without substantial change in the revisions of 1928<sup>127</sup> and 1932.<sup>128</sup>

The specific provisions enabled tax experts to advise their clients with all but infallible accuracy concerning their tax liability in proposed reorganizations.<sup>129</sup> Predictability and certainty in the law are commendable, but the over-specific provisions offered the opportunity for astute lawyers so to "rig" outright sales that they would come literally within the terms of the "reorganization" provisions.<sup>130</sup>

During the era of rising values the government undoubtedly lost revenue as a result of loopholes existing in the exchange and reorganization provisions. The break in the market with its attendant decline in all property values meant a tremendous loss in government revenues, for it ended any possibility of the government's collecting taxes upon the appreciation in property values where the tax had been postponed by a tax-free exchange or reorganization.<sup>131</sup> This situation forcefully brought to the fore the fundamental defect, namely, that the longer payment was postponed the more likely it was that the government would be unable to collect its tax.<sup>132</sup> The provisions made it easier for the taxpayer to control the realization of his gains and to take them in years when there were offsetting losses.<sup>133</sup> Moreover, the probability was increased that death and other elements might enter, thereby creating a new and higher basis for determining gain or loss for the property in the hands of a new owner<sup>134</sup> and preventing the imposition of a tax upon the appreciation in value of the property.

126. § 203 [43 STAT. 256 (1924), 26 U. S. C. A. § 934 (1928)].

127. § 112 [45 STAT. 816, 26 U. S. C. A. § 934 (1928)]

128. § 112 [47 STAT. 196 (1932), 26 U. S. C. A. § 3112 (Supp. 1934)].

129. Report of the Subcommittee, *supra* note 1, at 39 states: "One of the main objections to the reorganization provisions is that the recognition of gain depends more upon the form of the transaction than upon the essential facts, undue importance being given to 'expert advice.'"

130. *Id.* at 39-42.

131. Because of the exemption of certain exchanges and reorganizations, successive transferees obtained property which had greatly appreciated in value but upon which no tax had been paid. As long as the general rise continued, such property, in theory at least, carried a potential tax liability, for the transferees were compelled to take the cost basis of their transferors.

132. The more tax free exchanges, the greater the postponement, the harder enforcement becomes, and the greater the chance for avoidance.

133. *Op. cit. supra* note 1, at 39. The transaction was made to fall within or without the excepting provisions depending upon whether the gain or loss was to be taken or postponed.

134. An heir acquires as a basis the fair market value at the time of decedent's death and not the cost or other basis of the property to the decedent.

Alarmed by the general falling-off of revenues, impressed by the complexity of the over-specific provisions of the then existing law, and disheartened by the difficulty of drafting Utopian provisions, the Subcommittee recommended<sup>135</sup> the complete abolition of the reorganization provisions. Not unmindful, however, of the problems presented by the second question above noted,<sup>136</sup> it proposed that in cases of demonstrable hardship "payment be postponed" on the portion of the tax attributable to gains on such exchanges and reorganizations rather than "postponing the tax".<sup>137</sup> This ingenious idea would seem to conform closely to the legal theory that "realization of income" takes place when the exchange or reorganization is consummated,<sup>138</sup> but it would not avoid the administrative difficulties inherent in evaluating the gain or loss on all exchanges in kind and would undoubtedly, for the time being at least, mean a reduction in revenues.<sup>139</sup>

The Treasury's experience was reported<sup>140</sup> to have indicated the inadvisability of altering the "exchange" provisions, in view of the limitation of exemption to transactions in which the extent of the gains or losses would be administratively difficult to determine. However, the "reorganization" provisions were regarded<sup>141</sup> as being over-specific, and it was stated that they should be completely redrafted. Instead of approving the expedient of postponing payment of the tax attributable to reorganizations as a suggested means of curing the real evil, tax postponement, the exemption of "reorganizations" was to be perpetuated. The "purpose" was to have been expressed in the statute, leaving to the Department the power to make rules and regulations to carry out the Congressional intent. Such a system would have been effective in plugging certain loopholes, but soon the regulations would have become even more specific than the present statutory provisions. Even granting that the general plan for dealing with such transactions could be stated simply in the statute, an era of uncertainty and much litigation would occur. It would always be claimed that the regulations did not conform to the "general plan" as expressed in the statute. These difficulties would have been minimized if the Subcommittee's suggestion of merely postponing payment of the tax had been adopted as to the reorganization provisions.<sup>142</sup>

135. *Op. cit. supra* note 1, at 8.

136. *Supra* p. 621.

137. The extension was not to exceed two years. *Op. cit. supra* note 1, at 8.

138. *Supra*, notes 112, 113, 116.

139. The result would be that the government having already lost revenue by exempting "reorganizations" during an era of rising values would allow losses resulting from the decline to offset current national income. But the limitation on capital losses, § 117 (d) [48 STAT. 715, 26 U. S. C. A. § 5117 (d) (Supp. 1934)] would greatly minimize such losses.

140. *Op. cit. supra* note 2, at 9.

141. *Ibid.*

142. The power to tax reorganizations is established by decisions under the Acts of 1913, 1916 and 1917. See notes 112, 113, and 116, *supra*. The writers believe that in view of the administrative difficulties involved, the suggestion of the Subcommittee should not apply to exchanges.

Disregarding its Subcommittee's conclusions, the Committee on Ways and Means, probably persuaded by the Treasury, but unable to formulate any simple statutory declaration of policy, recommended<sup>143</sup> further tampering with the existing provisions. As a result the House deleted subsection (g)<sup>144</sup> and the parenthetical expression in subsection (i) (1) (A).<sup>145</sup> "A party to a reorganization" was by definition restricted to the resulting corporation.<sup>146</sup> These changes confined drastically the scope of the exempting provisions, but the Senate at the behest of its committee<sup>147</sup> extended the definition of "a party to a reorganization" to include both corporations and in effect restored the parenthetical matter<sup>148</sup> after increasing the necessary percentage of acquisition from fifty-one to eighty *per cent*. The net effect of the changes in the existing provisions has been to prevent Corporation *A* (by organizing Corporation *B* and transferring its surplus thereto in exchange for all *B*'s capital stock) from distributing tax-free *B*'s stock to its stockholders.<sup>149</sup> Despite this change, the government will continue to lose revenue by virtue of the tax-postponement feature of the exempting provisions.

The drive "to plug loopholes" has demonstrated that so far as the reorganization provisions are concerned Congress has just about run out of plugs. The danger of wholesale tax avoidance in this respect for the present may be discounted, not because of new bullet-proof provisions but because there is no pressure on the legal profession to work out procedures to reduce taxes upon appreciated assets. Assuming the continuance of the present policy of exempting certain transactions, the probability is that in

143. *Op. cit. supra* note 4, at 14.

144. "If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized." This provision was included, literally or in effect, in Act of 1924, § 203 (g) [43 STAT. 257 (1924), 26 U. S. C. A. § 934 (g) (1928)]; Act of 1926, § 203 (g) [44 STAT. 13 (1926), 26 U. S. C. A. § 934 (g) (1928)]; Act of 1928, § 112 (g) [45 STAT. 818, 26 U. S. C. A. § 2112 (g) (1928)]; Act of 1932, § 112 (g) [47 STAT. 197 (1932), 26 U. S. C. A. § 3112 (g) (Supp. 1934)].

145. "The term 'reorganization' means a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation) . . ." 47 STAT. 198 (1932), 26 U. S. C. A. § 3112 (i) (2) (Supp. 1934). The House also inserted the word "statutory" before "merger or consolidation".

146. "The term 'a party to a reorganization' includes a corporation resulting from a reorganization [and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation]." § 112 (i) (2) [47 STAT. 198 (1932), 26 U. S. C. A. § 3112 (i) (2) (Supp. 1934)]. The portion in brackets was omitted by the House.

147. *Op. cit. supra* note 7, at 16.

148. The parenthetical expression was not actually replaced, but a new subdivision (B) was drafted which accomplished the same result. 48 STAT. 705 (1934), 26 U. S. C. A. § 5112 (g) (1) (Supp. 1934).

149. This is accomplished by the elimination of § 112 (g), Act of 1932, *supra* note 144.

the future the courts will be more effective than the draftsmen in prohibiting the more flagrant cases of tax avoidance.<sup>150</sup>

### Partnerships

In exercising its power to tax partnerships,<sup>151</sup> Congress has created innumerable paradoxical situations. Having early adopted<sup>152</sup> and continuously adhered<sup>153</sup> to a policy of not taxing the partnership as an entity,<sup>154</sup> and yet desiring not to grant it tax immunity, Congress by straddling has fully achieved neither purpose.<sup>155</sup> Consequently a certain support may be found for both the administrative attitude<sup>156</sup> that the partnership is nothing more than a tax computing unit<sup>157</sup> and the legal entity theory, which is more acceptable to the judicial mind.<sup>158</sup>

When a partner's capital contribution in kind at the time of transfer to the partnership has a fair market value differing from its cost or other basis to such contributing partner, the question arises whether a personal gain or loss has been "realized".<sup>159</sup> Since the transaction consists of an exchange of the contributed asset for an undivided interest in the partnership estate, Congress' power to impose a tax seems undeniable<sup>160</sup> but a policy of "non-

150. The Report of the Acting Secretary of the Treasury, *supra* note 2, at 9, states: "The Treasury has fought a number of these cases through the courts, with results on the whole favorable. The courts have attempted to work out the general principles underlying the statute, and to interpret the specific sections in such a way as to carry out the general plan and to prevent avoidance." The Report of the Ways and Means Committee, *supra* note 4, at 13, states: "A number of these cases have been carried to the courts, with results on the whole favorable to the Government. The courts have shown a commendable tendency to look through the mere form of the transaction into its substance." Two recent cases indicate this tendency. *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U. S. 462 (1933); *Helvering v. Gregory*, 69 F. (2d) 809 (C. C. A. 2d, 1934), *aff'd* sub nom. *Gregory v. Helvering*, 55 Sup. Ct. 256 (1935).

151. *E. g.*, the profits tax of 1917 was imposed upon the partnership entity.

152. § II, D, Act of 1913 [38 STAT. 169 (1913)].

153. § 218, Act of 1921 [42 STAT. 245 (1921)]; § 218, Act of 1924 [43 STAT. 275 (1924), 26 U. S. C. A. § 959 (1928)]; § 218, Act of 1926 [44 STAT. 32 (1926), 26 U. S. C. A. § 959 (1928)]; § 182, Act of 1928 [45 STAT. 840, 26 U. S. C. A. § 2182 (1928)]; § 182, Act of 1932 [47 STAT. 222 (1932), 26 U. S. C. A. § 3182 (Supp. 1934)]; § 182, Act of 1934 [48 STAT. 730, 26 U. S. C. A. § 5182 (Supp. 1934)].

154. This attitude was probably thought to be a corollary of the theory of progressive surtaxes based on capacity to pay. But see note 151. *supra*.

155. A partnership (1) files a return; (2) has a taxable year (fiscal or calendar). A partnership pays no tax.

156. XI-1 Cum. Bull. 114, Gen. Counsel's Memo. 10092.

157. *E. g.*, § 183, Act of 1932 [47 STAT. 222 (1932), 26 U. S. C. A. § 3183 (Supp. 1934)]; § 184, Act of 1934 [48 STAT. 730, 26 U. S. C. A. § 5183 (Supp. 1934)].

158. *Helvering v. Archbald*, 70 F. (2d) 720 (C. C. A. 2d, 1934), *aff'd* 27 B. T. A. 837 (1933). The Board states at 841: "It is clear, therefore, that a doctrinaire assertion that a partnership is not an entity affords no key to the determination. Congress has not taxed partnerships directly, but, apart from that, there is no reason to think their existence was ignored or that for other purposes under the statute their legal character was not to be fully accepted."

159. "Personal gain or loss" is used herein in contradistinction to a "partner's share" of gain or loss derived as a result of being a member of a partnership.

160. See *Exchanges and Reorganizations*, *supra*, and notes 112, 113, 116. There has been a change in legal title; the character of the rights possessed differs; and the kind of property "owned" has changed.

recognition" apparently has been in vogue.<sup>161</sup> Although the partner's investment in the firm does not involve a "realization" of personal gain or loss,<sup>162</sup> a sale by the partnership of the asset contributed or a distribution upon dissolution demonstrates that postponement of the tax upon such gain does not solve the partner's personal difficulties.<sup>163</sup> The solution depends on whether the asset sold acquired a new tax basis for partnership gain or loss when contributed to the partnership. Suppose a new basis is not acquired, as was contended by those charged with the administration of the law.<sup>164</sup> Then upon a subsequent sale of the asset, the contributing partner, in addition to his share of the partnership gain or loss, was said to "realize" a personal gain or loss equal to the difference between his cost and the appreciated or depreciated value of the asset at the time of contribution.<sup>165</sup> If a new basis is acquired, each partner, upon a subsequent sale of the asset, is taxable only upon his allocable portion of the profit or loss realized by the partnership.<sup>166</sup> A new basis (value of the contributed asset at the time of contribution) is acquired by the partnership under the 1932 and prior Acts.<sup>167</sup> Upon a sale by the partnership of the contributed asset, the con-

161. "It has been the consistent position of the Bureau that no gain or loss is realized upon the contribution of assets in kind by partners to a partnership enterprise, nor upon what is obviously the exact converse—a liquidation in kind from the partnership to the partners." Gen. Counsel's Memo. 10092, *supra* note 156, at 115. See U. S. Treas. Reg. 45, Art. 1570 (Act of 1918); *id.* 62, Art. 1570 (Act of 1921); *id.* 65, Art. 1603 (Act of 1924); *id.* 69, Art. 1603 (Act of 1926); *id.* 74, Art. 604 (Act of 1928); *id.* 77, Art. 604 (Act of 1932). Congress has re-enacted these statutory provisions without substantial change. See note 153, *supra*.

The Bureau has consistently held in interpreting the Revenue Acts that no gain or loss is "realized" here. This interpretation of the Acts has received the sanction of Congress by its re-enactment of the partnership provisions without substantial change. See Gen. Counsel's Memo. 10092, *supra* note 156. No constitutional meaning can be given to the word "realization" here as only a question of statutory construction is involved.

162. As opposed to *recognition* of gain or loss. The language of the Board in Archbald v. Commissioner, 27 B. T. A. 837, 844 (1933), cited *supra* note 158, probably does not employ the word "realization" in the strict constitutional sense, but relates merely to statutory construction.

163. The following table will prove useful in discussing the different possible solutions: Partnership (consisting of A, B, C and D)

Contributing Partners	Cost or Other Basis	Value at time of contribution (1932)	1933 Sale Price	Distribution of profits (1935)	Distribution on dissolutions (1935)
A	\$ 50,000	\$100,000	\$200,000	\$12,500	\$100,000
B	\$200,000	\$100,000	\$ 50,000	\$12,500	\$100,000
C	\$ 50,000	\$100,000	\$ 75,000	\$12,500	\$100,000
D	\$200,000	\$100,000	\$125,000	\$12,500	\$100,000
	\$500,000	\$400,000	\$450,000	\$50,000	\$400,000

The "partnership profit" on the whole series of transactions is only \$50,000 [\$450,000 minus \$400,000]:

164. Gen. Counsel's Memo. 10092, *supra* note 156.

165. *E. g.* (see note 163, *supra*), A's allocable amount of the "partnership profit" on this one transaction would be \$25,000, but A would realize in addition a \$50,000 "personal gain". However, A's "partnership profit" might be offset by partnership losses on other transactions.

166. *E. g.*, A would be taxable only on his allocable share of the partnership profit or \$25,000.

167. Helvering v. Archbald, 70 F. (2d) 720 (C. C. A. 2d, 1934), *aff'g* 27 B. T. A. 837 (1933).

tributing partner realizes only his proportionate share of the partnership gain or loss; consequently no personal gain or loss on any appreciated or depreciated value of a contributed asset at the time of contribution is realized by the contributing partner upon the partnership sale. A partner's contribution is considered as an investment in the partnership enterprise,<sup>168</sup> the personal profit or loss on which is not ascertainable until his investment is liquidated by a distribution on dissolution<sup>169</sup> and, if the distribution be in kind and has no readily realizable market value, not until the property received is disposed of.<sup>170</sup>

This result has the disadvantage of postponing the tax over a considerable period,<sup>171</sup> the termination of which rests in the discretion of the taxpayer.<sup>172</sup> If the sale by the partnership of a contributed asset had been held, as contended by the Government, to result in the partner's realizing a personal gain to the extent of the appreciated value at the time of contribution to the partnership, the period of postponement would have been lessened, the administrative difficulties of valuation possibly minimized, and cash funds more probably available to pay any tax.<sup>173</sup> However, the valuation problem would really exist, for the sale would have in fact two consequences, *i. e.*, gain or loss to the partnership and personal gain or loss to the contributing partner. Consequently two bases would have to be determined. The writers suggest that the tax on the appreciated value of the asset contributed should be imposed when the partner contributes the asset to the partnership, and that in cases of demonstrable hardship the Commissioner should be allowed to grant a certain postponement of the tax attributable

168. The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation or venture is carried on, and which is not, within the meaning of the Act, a trust, or estate or a corporation. § 1111 (a) (3), Act of 1932 [47 STAT. 289 (1932), 26 U. S. C. A. § 4111 (a) (3) (Supp. 1934)].

169. Ever since the Act of 1918, the Regulations have provided that only upon the dissolution of a firm did a partner realize a gain or loss, computed on the difference between the liquidating dividend and the original cost to him of his contribution. U. S. Treas. Reg. 45, Art. 1570 (Act of 1918); *id.* 62, Art. 1570 (Act of 1921); *id.* 65, Art. 1603 (Act of 1924); *id.* 69, Art. 1603 (Act of 1926); *id.* 74, Art. 604 (Act of 1928); *id.* 77, Art. 604 (Act of 1932); but see *Helvering v. Walbridge*, 70 F. (2d) 683, 684, (C. C. A. 2d, 1934), *cert. denied*, 55 Sup. Ct. 109 (1934), implying a different conclusion where the liquidating dividend, although in kind, had a "fair market value".

170. See U. S. Treas. Reg. 77, Art. 604. Consequently, successive partnerships coupled with distribution in kind result in tax postponement. *Helvering v. Archbald*, 70 F. (2d) 720 (C. C. A. 2d, 1934), *aff'g*, 27 B. T. A. 837 (1933). But see, *Helvering v. Walbridge*, 70 F. (2d) 683 (C. C. A. 2d, 1934), *cert. denied*, 55 Sup. Ct. 109 (1934).

171. The longer the tax is postponed the greater the possibility that other factors (*e. g.*, death) will enter into the situation and create a new tax basis, with a result that the government will be prevented from ever collecting a tax upon the appreciated value.

172. Profits will be taken in years when there are offsetting losses, and losses will be taken when there are gains to be offset.

173. Of course, the taxation in the same year of the attributable share of the partnership gain of the partner's personal gain on account of the appreciated value at the time of contribution would have resulted in higher surtaxes being imposed. *Helvering v. Walbridge*, 70 F. (2d) 683 (C. C. A. 2d, 1934), *cert. denied*, 55 Sup. Ct. 109 (1934), has apparently conclusively settled this contention against the Government since the denial of *certiorari* by the Supreme Court.

thereto.<sup>174</sup> Such a rule would seem to eliminate effectively tax avoidance<sup>175</sup> and insure the prompt collection of the revenues.

The 1934 Act, however, has established the rule that the partnership takes the same basis as the contributing partner.<sup>176</sup> This rule is stated to be declaratory of existing law<sup>177</sup> but, if so, query why the partnership's basis was to be the contributing partner's basis "increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made."<sup>178</sup> Apparently an attempt was made to write into the statute Bureau contentions<sup>179</sup> which have been repudiated.<sup>180</sup> While revenue may be saved by preventing certain tax avoidance schemes,<sup>181</sup> any gain may be off-set by losses arising from the tax postponement features of the new provisions. Moreover, making each asset contributed to a partnership carry a different potential tax liability<sup>182</sup> can only result in imposing inequitable results on certain members of the partnership.<sup>183</sup>

Another important change effected by the recent Act is the effective abolition of the right of the partners to deduct partnership capital losses

174. There is no constitutional issue involved here. As noted *supra*, notes 161, 162, the statements that income is not "realized" on a contribution to a partnership were applicable only to the issue of statutory construction in view of administrative rulings of long standing. The statute could constitutionally be changed.

175. *E. g.*, in a case arising under the 1932 Act, *A* owns stock that cost \$100,000, the present fair market value of which is \$1,000,000. *A* forms a partnership with his wife, son and brother. *A* contributes said stock which is the next day sold for \$1,000,000. *A* has realized no gain on the transfer to the partnership and none on the sale. The cash may be reinvested by the partnership and all lost. When the partnership dissolves there may be losses rather than gains, or partial liquidations may be effected thus spreading over a number of taxable periods any "gain". A portion of the appreciated value may be dissipated by payments to the other members of the partnership.

Under the writers' suggestion, as well as the 1934 Act, such tax avoidance is prevented.

176. "*Partnerships*—If the property was acquired, after February 28, 1913, by a partnership and the basis is not otherwise determined under any of the paragraphs (1) to (12), inclusive, of this subsection, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. If the property was distributed in kind by a partnership to any partner, the basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property." § 113 (a) (13), Act of 1934 [48 STAT. 708, 26 U. S. C. A. § 5113 (a) (13) (Supp. 1934)].

177. *Op. cit supra* note 4, at 18: "The Committee believes that this provision simply makes specific the correct interpretation of the general provisions of the present law." At 28: "A new provision which is declaratory of existing law".

178. *Supra*, note 176.

179. Gen. Counsel's Memo. 10092, *supra* note 156.

180. *Helvering v. Archbald*, 70 F. (2d) 720 (C. C. A. 2d, 1934), *aff'g* 27 B. T. A. 837 (1933); *Helvering v. Walbridge*, 70 F. (2d) 683 (C. C. A. 2d, 1934), *cert. denied*, 55 Sup. Ct. 109 (1934).

181. See note 175, *supra*.

182. This evidences a further disregard of the partnership as a distinct entity. However, if the partnership figures the full appreciation in computing its net income, certain tax avoidance will still be possible.

183. *A* contributes securities having a cost basis of \$10,000 but a value at the time of transfer to the partnership of \$100,000 cash. The securities are sold for \$100,000. Must *B*, his partner, pay a share of the tax attributable to the \$90,000 "profit", or is *A* alone responsible for the tax?

from other income.<sup>184</sup> The forerunner of this harsh provision is found in the National Industrial Recovery Act.<sup>185</sup> The abandonment of the long-established rule effective under prior acts<sup>186</sup> can only be justified as an arbitrary measure devised to raise increased revenues.

The publicity surrounding the investigation of certain private banking and brokerage firms may have been the cause of this change. With the decline in security prices, the portfolios of many such partnerships showed losses more than sufficient to offset any other non-partnership income of the partners. The publicity given to this fact created the totally erroneous impression that tax avoidance was to blame for the non-payment of taxes. Nothing was to blame but the decline in the market, certainly in so far as the partnership losses were the result of *bona fide* sales of securities at depressed prices. Where this was the case the partners were treated no differently than the sole proprietor of an unincorporated business who suffers business losses. In so far as the partnership losses represented mere differences in inventory values, there was nothing reprehensible as long as a uniform policy of accounting was followed.<sup>187</sup>

The use of "successive partnerships"<sup>188</sup> in order to realize capital losses by the dissolution of the old partnership is apparently no longer

184. This has been accomplished by the capital gain and loss provisions, 48 STAT. 715, 26 U. S. C. A. § 5117 (d) (Supp. 1934); *op. cit. supra* note 4, at 18; note 7, at 19. The partnership in computing its net income can in no case have a deduction for a net capital loss in excess of \$2,000.

§ 801 (a) (14) [48 STAT. 771, 26 U. S. C. A. § 5801 (a) (14) (Supp. 1934)] defines "taxpayer" as "any person subject to a tax imposed by this Act." § 801 (a) (1) [48 STAT. 771, 26 U. S. C. A. § 5801 (a) (1) (Supp. 1934)] defines "person" as including a partnership. However, § 181 [48 STAT. 730, 26 U. S. C. A. § 5118 (Supp. 1934)] and the Regulations heretofore issued (U. S. Treas. Reg. 77, Art. 901) make it clear that a partnership is subject to no tax. Hence, the language of § 117 (a) [48 STAT. 714, 26 U. S. C. A. § 5117 (a) (Supp. 1934)], which applies the percentage gain and loss provisions to "taxpayers other than corporations", may be held to be inapplicable to partnerships, since they are not taxpayers. The Committee Reports, cited *supra* notes 4, 7, 9, make it clear, however, that § 117 (d) [48 STAT. 715, 26 U. S. C. A. § 5117 (d) (Supp. 1934)], limiting gains to losses plus \$2,000, applies to partnerships, as it also does to corporations. It is not clear, under the above, whether the percentage provisions apply to partnerships. § 183 [48 STAT. 730, 26 U. S. C. A. § 5183 (Supp. 1934)] is some indication that they do apply.

185. "No part of any loss disallowed to a partnership as a deduction by § 23 (r) shall be allowed as a deduction to a member of such partnership in computing net income." § 218 (d) [48 STAT. 209, 26 U. S. C. A. § 3181 (a) (Supp. 1934)]. This provision was limited to "security" losses, whereas the capital loss provision in the 1934 Act, § 117 (d), *supra* note 184, applies to all "capital assets".

186. § 182 (a), Act of 1932 [47 STAT. 222 (1932), 26 U. S. C. A. § 3182 (a) (Supp. 1934)]. U. S. Treas. Reg. 77, Art. 902 provides, "Where the result of partnership operation is a net loss, the loss will be divisible by the partners in the same proportion as net income would have been divisible (or if the partnership agreement provides for the division of a loss in a manner different from the division of a gain, in the manner so provided), and may be taken by the individual partners in their returns of income." The maximum net *capital* loss is now \$2,000. *Supra* note 184. Divided among ten partners, it would get pretty slim.

187. For the Commissioner's power over accounting methods, see § 41, Act of 1932 [47 STAT. 185 (1932) 26 U. S. C. A. § 3041 (Supp. 1934)]; U. S. Treas. Reg. 77, Arts. 322, 323.

188. *I. e.*, the admission of a new partner or the shifting of the percentages of the existing partners each year for tax purposes.

feasible. The recent Second Circuit case of *Helvering v. Archbald*<sup>189</sup> denied the Commissioner's authority to impose a tax upon the "gain" arising upon such a dissolution where immediately thereafter a new partnership was created. A "loss" upon such a transaction would seem, therefore, to be equally not deductible.<sup>190</sup>

### *Annuities*

The purchase of an annuity or endowment contract having been under prior Acts<sup>191</sup> regarded as an investment, the annuitant was entitled to receive tax-free his full cost,<sup>192</sup> and only amounts in excess thereof were subject to tax. Such contracts may be described as a wager by the annuitant that he will live a sufficiently long period to recoup his investment and something to boot. Premature death is regarded as a loss. Insurance companies encouraged this type of "wagering" and emphasized, among other things,<sup>193</sup> the tax postponement possibilities, if not the tax avoidance features, of such contracts.<sup>194</sup> The large increase in the number of such contracts<sup>195</sup> resulted in many wealthy persons "going off the tax rolls" for varying periods.<sup>196</sup> In an endeavor to tax such persons currently, the 1934 Act requires that three *per cent.* of the cost of such contracts be reported with other income.<sup>197</sup> The change was thought to be justified because "Pay-

189. 70 F. (2d) 720 (C. C. A. 2d, 1934), *aff'g* 27 B. T. A. 837 (1933). But note that here the articles of partnership provided for the admission of a new partner and under the NEW YORK PARTNERSHIP LAW § 62, the admission of a new partner with the consent of all does not result in a dissolution. In the event of such a theoretical dissolution, however, no tax is imposed because the interest received on dissolution possesses no "fair market value" under § III (c), Act of 1928 [45 STAT. 816 (1928)]. See also § III (b), Act of 1932 [47 STAT. 196 (1932)], 26 U. S. C. A. § 3111 (b) (Supp. 1934)].

190. § 117 (d) [48 STAT. 715, 26 U. S. C. A. § 5117 (d) (Supp. 1934)], limiting capital losses to capital gains plus \$2000 also makes the above noted plan not feasible.

191. § 22 (b) (2), Act of 1932 [47 STAT. 178 (1932)], 26 U. S. C. A. § 3022 (b) (2) (Supp. 1934)]; § 22 (b) (2), Act of 1928 [45 STAT. 797, 26 U. S. C. A. § 2022 (b) (2) (1928)]; § 213 (b) (2), Act of 1926 [44 STAT. 24 (1926)], 26 U. S. C. A. § 954 (b) (2) (1928)]; § 213 (b) (2), Act of 1924 [43 STAT. 268 (1924)], 26 U. S. C. A. § 954 (b) (2) (1928)].

192. Such amount was regarded as a return of capital.

193. *E. g.*, an insured income in old age; freedom from management difficulties; protection against the loss of one's accumulated wealth.

194. During the years when a man's earning capacity is greatest the return on his accumulated savings tends to make his income subject to higher surtax rates. By purchasing annuities with the accumulated savings, the income thereon is accrued and taxable after such a person has retired from active business and his current income is not so great. Many events may intervene (*e. g.*, death), the effects of which are that the accumulated interest is never subjected to the tax.

195. The House Report, *supra* note 4, at 21, states: "Statistics show that an increasing amount of capital is going into the purchase of annuities, with the result that income taxes are postponed indefinitely."

196. In addition, the rate imposed upon insurance companies, because of the mutual character of their business, is only one-fourth that imposed on other corporations.

197. § 22 (b) (2) [48 STAT. 687, 26 U. S. C. A. § 5022 (b) (2) (Supp. 1934)]. The Subcommittee, *op. cit. supra* note 1, at 13, proposed to tax a portion of the annuity receipts because "as a matter of fact", they represent "part interest and part return of capital. In order to facilitate administration, it is recommended that an arbitrary rule be adopted that 3 per cent. of the amount paid for the annuity shall be deemed to be interest. This rule is applied only to annuity contracts." The Statement of the then Acting Secretary of the Treasury, *supra* note 2, at 16, agreed in principle to taxing currently that portion of annuity receipts

ments to annuitants are, in fact, based upon mortality tables which purport to reflect a rate of return sufficient to enable the annuitant to recover his cost, and in addition thereto, a low rate of return on his investment."<sup>198</sup> The observation should have added if "such annuitant lives" and seems open to the objection that it views such contracts rather more from the business policies of insurance companies than from the reasonable expectations of the annuitants. A case is not hard to imagine where the likelihood of an annuitant's being conscious of any realization of gain is extremely doubtful.<sup>199</sup> Whether legally income may be said to have been realized would seem to depend upon the nature of such contracts viewed rather from the taxpayer-annuitant's standpoint<sup>200</sup> than from the accounting and actuarial methods employed by the insurance companies.<sup>201</sup>

Annuity payments to a beneficiary under a life insurance policy are not, however, taxable to any extent.<sup>202</sup> It would seem, therefore, preferable similarly to exclude expressly *all* amounts paid to beneficiaries under annuity or endowment contracts by reason of the death of the annuitant. Also, to treat gifts or bequests of annuities to the extent that they are actually paid from the income of a fund created by a donor or from a

which represents interest, but stated "The Treasury does not believe, however, that the proposed plan makes a fair allocation between principal and income. For this purpose, unless a better allocation can be devised, it would seem better to substitute such a provision as appeared in the Revenue Act of 1924, § 213 (b) (2)." The Ways and Means Committee (*op. cit. supra* note 4, at 21) states in respect to the three *per cent.*, "While the *per cent.* used is arbitrary, it approximates the rate of return in the average annuity." The Senate Finance Committee proposed to exempt all annuitants receiving not more than \$500 from the House provisions. Their report (*supra* note 7, at 23) states: "While your Committee is in agreement with the change made by the House, it was thought advisable to continue the policy of not taxing any portion of the amount received from an annuity until the aggregate amount of payments equal the total amount paid for the annuity in cases where the aggregate amount received by the annuitant from all his annuities is not more than \$500." This amendment (No. 14) was rejected by the Conference Committee, and the House provision was redrafted in conference.

198. *Op. cit. supra* note 7, at 23.

199. *E. g.*, an annuitant pursuant to his contract has paid \$100,000 for a twelve year annuity of \$10,000 per year for twelve years; it is unlikely that the receipt of the first payment of \$10,000 would be regarded as including \$300 "profit"; death before the receipt of the next payment would reasonably be regarded by the layman as resulting in a \$90,000 loss.

200. Congress' power is limited by the Sixteenth Amendment to the taxation of "income" from whatever source derived. There would seem to be no "income" until the cost of the contract had been recovered. Disregarding the contract and imposing a tax upon the receipts paid thereunder measured by an arbitrary three *per cent.* of the cost of the contract, may in fact, in some cases at least, impose a tax upon capital. In this connection, U. S. Treas. Reg 77, Art. 81, is *à propos*. "The term 'gross income' as used in the Act does not include those items of income exempted by statute or by fundamental law."

201. Suppose the facts show that the insurance company earned but two *per cent.* upon the purchase price of the annuity, and that its real hope for profit lay in the possibility of death before the life expectancy of the annuitant had expired.

202. § 22 (b) (1) [48 STAT. 687, 26 U. S. C. A. § 5022 (b) (1) (Supp. 1934)]. That this subdivision excludes life insurance annuities from gross income is plain from the House Committee Report, *supra* note 4, at 21. Since such annuities are expressly not excluded from gross income under § 22 (b) (2), it would have been preferable to have expressly excluded them under § 22 (b) (1), in so many words.

decendent's estate as income to the annuitant,<sup>203</sup> the same as gifts of income,<sup>204</sup> would certainly seem more logical.<sup>205</sup>

### *Revocable Trusts*

One of the main methods of avoiding the higher surtaxes has been to split one's income between several taxable persons, since *A* and *B* together pay less tax than *A* alone. Much ingenuity has been used by tax experts to eliminate the obvious fly in the ointment, *i. e.*, to devise means of reducing one's income tax without permanently reducing one's income as well. In the past, one of the simplest and most successful of such methods has been the revocable trust. By this device, the taxpayer could safely split this year's income with his wife or a near relative, without necessarily committing himself to splitting next year's. The 1932 Act,<sup>206</sup> and its precursors as far back as the 1924 Act, have attempted to eliminate this means of tax avoidance by taxing the entire income of a revocable trust to the grantor. Although an attack upon the constitutionality of such provisions was unsuccessful,<sup>207</sup> it was soon discovered that Congress had taxed the entire income of the trust to the grantor only when the power to revest title in the grantor existed "during the taxable year". This phrase caused a virtual nullification of the section, since by having the trust instrument provide that the power to revoke would spring into existence only if notice were given in the preceding taxable year, the terms of the statute were made inapplicable. Regardless of court decisions clearly pointing out this loophole,<sup>208</sup> the Subcommittee failed to recommend any change in Section 166. This was apparently because of grave doubts of the Subcommittee experts as to whether the income could constitutionally be taxed to the grantor where the power to revoke did not exist "during the taxable year".<sup>209</sup> The Treasury, however, recommended that Section 166 be amended to cover this situation,<sup>210</sup> and during its consideration in the Senate, an amendment pro-

203. *Heiner v. Beatty*, 17 F. (2d) 743 (1927), *aff'd*, 276 U. S. 598 (1928), is to the effect that a gift of an annuity charged upon the income of a fund is income to the recipient; but under the present law as laid down in *Burnet v. Whitehouse*, 283 U. S. 148 (1931), an annuitant is not subject to income tax where the annuity payments are charged upon the corpus of a trust fund.

204. Recipients of gifts of income are taxable thereon under the rule of *Irwin v. Gavit*, 268 U. S. 161 (1925).

205. There is no great loss of revenue in this regard because under the rule of *Helvering v. Pardee*, 290 U. S. 365 (1933), a trustee must pay the tax upon such income where it cannot be included in the income of the annuitant.

206. § 166 [47 STAT. 221 (1932), 26 U. S. C. A. § 3166 (Supp. 1934)] dealt with the power to revest the corpus in the grantor, while § 167 [47 STAT. 221 (1932), 26 U. S. C. A. § 3167 (Supp. 1934)] dealt with the power to distribute the income to the grantor.

207. *Corliss v. Bowers*, 281 U. S. 376 (1930); *DuPont v. Commissioner*, 289 U. S. 685 (1933); *Reinecke v. Smith*, 289 U. S. 172 (1933). See also *Burnet v. Wells*, 289 U. S. 670 (1933).

208. *Langley v. Commissioner*, 61 F. (2d) 796 (C. C. A. 2d, 1932); *Lewis v. White*, 56 F. (2d) 390 (D. Mass. 1932), *app. dismissed*, 61 F. (2d) 1046 (C. C. A. 1st, 1932); *Ashforth v. Commissioner*, 26 B. T. A. 1188 (1932). Cf. *Clapp v. Heiner*, 51 F. (2d) 224 (C. C. A. 3d, 1931).

209. See cases cited *supra* note 207.

210. *Op. cit. supra* note 2, at 18.

posed by Senator Murphy eliminating the "taxable year" phraseology of the section was adopted.<sup>211</sup>

The short-term trust also offers a way of tax avoidance by the split-income method. If the term of years is short, there is no need for a power of revocation, since control will automatically return to the grantor at the end of the period. The Treasury recommended that the income from such trusts also be taxed to the grantor.<sup>212</sup> However, this method of tax avoidance still remains open, because of the difficulty of defining a "short-term trust" without making the definition so arbitrary that it could not survive constitutional objections.<sup>213</sup>

### *Community Property Income*

As noted, a favorite device to avoid the graduated surtax has been to split one's income with a member of the family. In eight states<sup>214</sup> this tax avoidance is automatically accomplished by the community property laws, since half of the husband's income belongs to the wife and is taxable to her.<sup>215</sup> Under the existing law, husband and wife have the option of filing either a joint or separate return.<sup>216</sup> By pursuing the latter course, families in community property states receive a considerable tax advantage, since the wife's share of the husband's income would otherwise be subject to a high surtax if included in the husband's return.<sup>217</sup>

The Subcommittee<sup>218</sup> "in view of the legal difficulties involved" made no recommendation to remedy this situation. The Treasury, however, strongly recommended that the tax advantage of the community property States be ended by requiring a husband and wife living together to file a single joint return, each paying "the tax attributable to his share of the

211. The matter in brackets was struck from the Section:

"§ 166. Where at any time [during the taxable year] the power to revest in the grantor title to any part of the trust is vested—

(1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or

(2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom,

then the income of such part of the trust [for such taxable year] shall be included in computing the net income of the grantor."

212. *Op. cit. supra* note 2, at 18.

213. In such a case the Government might be held to be taxing *A's* income to *B*. Cf. *Hoepfer v. Tax Comm.*, 284 U. S. 206 (1931).

214. Texas, Louisiana, Arizona, New Mexico, California, Nevada, Idaho and Washington are community property states.

215. *Poe v. Seaborn*, 282 U. S. 101 (1930); *Goodell v. Koch*, 282 U. S. 118 (1930); *Hopkins v. Bacon*, 282 U. S. 122 (1930); *Bender v. Pfaff*, 282 U. S. 127 (1930); *United States v. Malcolm*, 282 U. S. 792 (1931).

216. § 51 (b) [48 STAT. 697, 26 U. S. C. A. § 5051 (b) (Supp. 1934)]. The cases in note 215, *supra*, have all been decided under existing law, and there is no indication that Congress could not, if it desired, require a joint return of husband and wife.

217. For instance, ordinarily the husband pays a tax of \$2,545 on an income of \$25,000. In a community property state, the income being automatically divided between husband and wife, both together would pay but \$1,675 tax.

218. *Op. cit. supra* note 1, at 11.

income".<sup>219</sup> The minority report of Congressman Lewis discloses that the Committee on Ways and Means first decided to eliminate this tax advantage but later reversed its decision.<sup>220</sup> Because of the Gag Rule<sup>221</sup> the House could take no action thereon.

Opponents of any change based their arguments in the main upon *Hoeper v. Tax Commission*,<sup>222</sup> which held that the income of one spouse cannot constitutionally be taxed to the other, and *Missouri v. Gehner*,<sup>223</sup> where the principle is laid down that one may not be taxed at a higher rate on his taxable property simply because he also holds some tax-exempt property. The *Hoeper* case is clearly distinguishable, since under the plan outlined by the Treasury compelling a joint return each spouse would pay the tax attributable to his share of the income, and would not pay a tax on the other's income. The principle of the *Gehner* case seems analogous in one sense, since each spouse pays more tax because of the inclusion of the other's income in the joint return. However, the case seems distinguishable upon the ground that taxing the marital community as an entity is a reasonable classification,<sup>224</sup> husband and wife each paying their share of the tax. Altogether, the constitutional difficulties do not appear conclusive enough to prevent legislation attempting to end the "Eight States' Grab".

#### *Estate Tax Amendments*

The estate tax provisions were amended in five important particulars. (1) The rates were substantially increased.<sup>225</sup> (2) The former classification of decedents into "residents" and "non-residents" was changed to "citizens and residents" on the one hand, and "non-residents not citizens" on the other.<sup>226</sup> This means that non-resident citizens are now taxed on their entire estate wherever situated, and not merely on the part of their estate

219. *Op. cit. supra* note 2, at 15.

220. H. R. Rep. No. 704, Pt. 2, 73d Cong., 2d Sess. at 10. Congressman Lewis termed this situation "the eight states' grab". The Revenue Bills of 1921 and 1924 contained similar provisions, which were struck out before passage.

221. *Supra* note 5. This in effect prevented the House from taking any action to which the majority of the Ways and Means Committee were opposed.

222. 284 U. S. 206 (1931).

223. 281 U. S. 313 (1930). Accord: *National Life Ins. Co. v. United States*, 277 U. S. 508 (1928).

224. Mr. Justice Roberts in the *Hoeper* case, *supra* note 222, says this is not a reasonable classification if one spouse has to pay all the tax. Of course, the *Gehner* case, *supra* note 219, was concerned with tax-exempt property and involved no question of classification.

225. § 405 [48 STAT. 754, 26 U. S. C. A. § 1092 (a) (Supp. 1934)]. The House bill (H. R. 7835) did not change the existing rate schedules. The Senate Finance Committee (*op. cit. supra* note 7, at 7) recommended an increase in the rates of the "Additional Estate Tax" in the case of estates of \$1,000,000 and over. The Senate, however, adopted an amendment (No. 127) carrying a general increase in rates; and in conference the House receded, with the amendment retaining the specific exemption at \$50,000, making the first bracket \$10,000 instead of \$20,000, and making such minor changes in the rate schedule as the two foregoing adjustments required.

All the estate tax amendments are applicable to decedents dying after 11:40 A. M., May 10, 1934. § 803 [48 STAT. 772, 26 U. S. C. A. § 5803 (Supp. 1934)].

226. § 403 [48 STAT. 753, 26 U. S. C. A. § 1095 (Supp. 1934)].

situated in the United States. (3) In case of three or more successive deaths within five years the deduction for prior taxed property is now disallowed, if such deduction was allowed the estate of the prior decedent with regard to the property.<sup>227</sup> (4) Real estate situated outside the United States is specifically excluded from the gross estate.<sup>228</sup> (5) The revocable trust section of the estate tax is amended to cover the case where the power to revoke is subject to a precedent giving of notice or takes effect only on the expiration of a stated period after the exercise of the power, such powers now being considered "to exist on the date of the decedent's death", whether or not the notice has been given or the power exercised.<sup>229</sup> However, the case where the power in terms is to terminate before the decedent's death is not covered by this amendment.<sup>230</sup>

The conclusive presumption that a power relinquished within two years of death was relinquished in contemplation of death (inadvertently left in the 1932 Act) has now been changed<sup>231</sup> to a rebuttable presumption to accord with the views of the Supreme Court.<sup>232</sup>

Although the Treasury called attention<sup>233</sup> to the fact that the federal estate tax provisions were contained in three different revenue acts<sup>234</sup> and that the computation of death duties had become highly complicated,<sup>235</sup> no effort was made by the committees in charge of the tax bill or by Congress to simplify the law in this regard. Failure to do so may be ascribed

227. § 402 [48 STAT. 753, 26 U. S. C. A. § 1095 (Supp. 1934)]. See U. S. Treas. Reg. 80, Art. 41.

228. § 404 [48 STAT. 754, 26 U. S. C. A. § 1094 (Supp. 1934)]. These merely incorporate into the law the administrative practice of the past sixteen years.

229. § 401 [48 STAT. 752 (1934)]. The section also provides that the part of the decedent's estate over which the decedent has no control at his death is not included in the gross estate. This is accomplished by allowing the elimination from the gross estate of the value of the interests of the beneficiaries for the intervening period before the power to revoke becomes effective, where such period extends after the decedent's death. The notice of revocation (if not actually given by the decedent) is for this purpose deemed to have been given, or the power exercised (to become effective later), on the date of the decedent's death. See U. S. Treas. Reg. 80, Art. 20.

230. It is surprising that the all inclusive language of § 302 (c), Act of 1926, "for any period not ascertainable without reference to his death, or for any period which does not in fact end before his death", was not repeated in this amendment to § 302 (d). It should be noted, however, that there is one school of thought which contends that § 302 (c) covers most, if not all, of the fact situations covered by § 302 (d). If this be true, the above noted omission may be immaterial.

231. § 401 [48 STAT. 752 (1934)].

232. *Heiner v. Donnan*, 285 U. S. 312 (1932).

233. *Op. cit. supra* note 2, at 18.

234. 43 STAT. 303-313 (1924), 26 U. S. C. A. §§ 1091-1121 (1928); 44 STAT. 69-87 (1926), 26 U. S. C. A. §§ 1091-1121 (1928); 45 STAT. 862, 863, 26 U. S. C. A. §§ 2401-2404 (1928); 47 STAT. 243-245 (1932), 26 U. S. C. A. §§ 3401-3403 (Supp. 1934).

235. The federal government imposes two taxes: one, an "Estate Tax" by § 301, Act of 1926 [44 STAT. 69 (1926), 26 U. S. C. A. §§ 1092, 1093 (1928)] (against which the eighty *per cent.* state credit for death duties is applicable); the second, an "Additional Estate Tax" by § 401, Act of 1932 [47 STAT. 243 (1932)] (against which the eighty *per cent.* credit is not applicable). In addition, the states impose death duties. *E. g.*, in New York, an estate tax is imposed by CONS. LAWS (Cahill, 1930), § 249. A temporary increase in rates effective until July 1, 1935 is provided for in Laws of 1933, c. 359; and c. 322 imposes "a tax equal to the maximum credit allowable to the estate of such decedent against the United States estate tax imposed with respect thereto."

to a reluctance to tamper with the eighty *per cent.* credit for state estate and inheritance taxes<sup>236</sup> and the disconcerting effect of the successful agitation for increasing the federal estate tax rates.<sup>237</sup> The difficulties inherent in adjusting the credit for state death duties to a single federal estate tax schedule,<sup>238</sup> although deserving attention, are by no means insurmountable.<sup>239</sup> A change in form designed to clarify and simplify the law, greatly facilitating the work of the taxpayer in making returns and of the Department in administering the law, would seem to merit more serious consideration.

### *Gift Tax Amendments*

The only change in the Gift Tax was an increase in rates<sup>240</sup> to correspond to the increase in the Estate Tax rates. The set-up of the Gift Tax<sup>241</sup> is such, however, that it was considered difficult to increase the rates without making them in effect retroactive, since the tax is based not only on gifts made during the calendar year, but also on gifts made prior thereto.<sup>242</sup> The tax for each calendar year is computed as follows: (1) The rate schedule is applied to the total gifts<sup>243</sup> made by the taxpayer since the effective date of the 1932 Act; (2) Against the resulting sum a credit is allowed, computed by applying the rate schedule to all gifts made prior to the current calendar year.<sup>244</sup> Hence the 1935 increased rate schedule is

236. Thirty-four jurisdictions (including the District of Columbia) have passed statutes designed to take advantage of the federal credit. Nineteen jurisdictions (including Alaska, Hawaii, Puerto Rico, and the Philippine Islands) make no statutory reference to the federal estate tax acts.

237. See note 225, *supra*. Senator La Follette was most active in this regard.

238. The statutes of twelve states (Georgia, Iowa, Kansas, Louisiana, Maine, Massachusetts, Minnesota, Missouri, New Hampshire, Oklahoma, Vermont, Wisconsin) would have to be changed if the federal rate schedules were consolidated, and the probability that the statutes of eight more States (California, Indiana, Michigan, Missouri, North Carolina, Rhode Island, Texas, Washington) would have to be amended, makes such status "doubtful".

239. The acts of fourteen jurisdictions (Alabama, Colorado, Connecticut, Delaware, Florida, Hawaii, Maryland, Mississippi, Nebraska, New York, Ohio, Pennsylvania, Tennessee, Virginia) are so drafted that a subsequent change in the federal Acts will not render their taxing systems ineffective. Moreover, the statutes of nineteen jurisdictions (see note 236, *supra*) would require no adjustment, for their present provisions make no reference to the federal Acts. Consequently, thirty-three jurisdictions would be unaffected and at the most only twenty could be possibly adversely affected (see note 238 *supra*). The last Congress, or the present Congress, by providing that the consolidated provisions should not become effective until June 30, 1935, could avoid any possible hardship on the states adversely affected for (with the possible exception of Louisiana) by that date all such states will have had a regular session of their legislatures. Louisiana would be confronted with the alternative of calling a special session or of losing some revenue (probably an insignificant amount) during the period from June 30, 1935 to May 11, 1936.

240. § 520 (a) [48 STAT. 761 (1934)].

241. Tit. III, Act of 1932 [47 STAT. 245-250, 26 U. S. C. A. § 1136 a-gg (Supp. 1934)].

242. § 502, Act of 1932 [47 STAT. 246 (1932), 26 U. S. C. A. § 1136 (b) (Supp. 1934)].

243. Gifts to the extent of \$5000 per year are tax free. In addition, the first \$50,000 of aggregate gifts is not taxable. §§ 504 (b), 505 (a), Act of 1932 [47 STAT. 247 (1932), 26 U. S. C. A. § 1136 d (b), e (a) (Supp. 1934)].

244. "The tax for each calendar year shall be an amount equal to the excess of—

(1) a tax, computed in accordance with the Rate Schedule hereinafter set forth, on the aggregate sum of the net gifts for such calendar year and for each of the preceding calendar years, over

applied to gifts made prior to the increase in rate. However, since the credit allowed in (2) above is also increased by a higher rate schedule, no higher tax is imposed on gifts for prior years. If, however, the Bureau should feel compelled to apply the lower rate schedule of former years in computing the credit under (2) above, the credit would not be raised by the new rates, and hence the gifts of prior years would in effect be taxed in 1935.<sup>245</sup> This would raise a serious constitutional question, since the Supreme Court has held that a gift tax may not be applied retroactively.<sup>246</sup> The difficulty was avoided by making the new rates apply only to the calendar year 1935 and subsequent calendar years so far as *payment* of the tax was concerned, and by applying the new rates to the calendar year 1934 and previous calendar years for the purpose of *computing* the 1935 tax, just as if the tax had actually been paid for the previous calendar years at the advanced rate.<sup>247</sup> By this method the advanced rates are *paid* only as to gifts made after December 31, 1934.<sup>248</sup>

### *Capital Stock and Excess Profits Taxes*

The Senate added amendments<sup>249</sup> to the Revenue Bill thereby in effect continuing the capital stock and excess profits taxes which had been enacted by the National Industrial Recovery Act,<sup>250</sup> but which by the terms of that Act<sup>251</sup> were about to become ineffective because of the repeal of the Eighteenth Amendment.

The former capital stock tax, which would otherwise have applied to the year ending June 30, 1934, is eliminated,<sup>252</sup> while the new capital stock tax begins with the year ending June 30, 1934, but applies only to corporations doing business after the effective date of the Act.<sup>253</sup> The provisions

(2) a tax, computed in accordance with the Rate Schedule, on the aggregate sum of the net gifts for each of the preceding calendar years." § 502, Act of 1932 [47 STAT. 246 (1932), 26 U. S. C. A. § 1136 (b) (Supp. 1934)].

245. Under the 1932 Act, if *A* had made net gifts of \$90,000 in 1933, and \$10,000 in 1934, his 1934 gift tax would be computed as follows: (1) A tax based on the aggregate of all net gifts (\$100,000) or \$3,625, less (2) a tax computed on net gifts made in 1933 (\$90,000) or \$3,125, which equals \$500 tax in 1934. *A* makes net gifts in 1935 of \$10,000. The 1934 Act applies; and his 1935 tax is computed as follows: (1) A tax based on the total gifts made (\$110,000) or \$5,100, less (2) a tax on net gifts made in 1932 and 1933 (\$100,000), or \$4,200, which equals \$900. If, however, in computing (2) the rate schedule for 1932 were applied, the credit would be only \$3,625, and the 1935 tax would be \$1,475.

246. *Blodgett v. Holden*, 275 U. S. 142 (1927); *Untermeyer v. Anderson*, 276 U. S. 440 (1928).

247. § 520 (b) [48 STAT. 762, 26 U. S. C. A. § 1136 b (b) (Supp. 1934)]. In view of the clear language of § 502 of the 1932 Act, *supra* note 244, this elaborate precaution seems unnecessary.

248. § 520 (b), *supra* note 247. The 1934 rates apply in terms only to 1935 gifts.

249. §§ 701, 702 [48 STAT. 769, 770, 26 U. S. C. A. §§ 5701, 5702 (Supp. 1934)].

250. N. I. R. A. §§ 215, 216 [48 STAT. 207, 208 (1933), 26 U. S. C. A. § 3761 n (Supp. 1934)].

251. N. I. R. A. § 217 (a) (d) (e) [48 STAT. 208 (1933), 26 U. S. C. A. § 3761 n (Supp. 1934)].

252. § 703 [48 STAT. 771 (1934), 26 U. S. C. A. § 3761 n (Supp. 1934)].

253. § 701 (c) (3) (4) [48 STAT. 769, 26 U. S. C. A. § 5701 (c) (3, 4) (Supp. 1934)]. The Act was effective May 10, 1934. Gen. Counsel's Memo. 13681, XIV-3 Int. Rev. Bull.

of the new capital stock tax are substantially the same as those of its predecessor. The main changes are the exemption of insurance companies taxable under Section 207,<sup>254</sup> and in the determination of adjusted declared value.<sup>255</sup> This latter change clarifies the additions to and deductions from the original declared value by stating them in "income tax language". The Regulations provide that even though a corporation does no business, it must still file a return and declare a value for its capital stock, since all corporations are presumptively subject to the tax.<sup>256</sup>

The old excess profits tax is repealed as of June 30, 1934, and the new excess profits tax<sup>257</sup> applies to taxable years ending thereafter.<sup>258</sup> The rate is the same, being five *per cent.* of the net income in excess of twelve and one-half *per cent.* of the adjusted declared value under the capital stock tax. Provision is made in the 1934 Act for a reduction of the adjusted declared value where the taxable year is less than twelve months. It is clear that corporations which are exempt from the capital stock tax are also exempt from the excess profits tax, since the latter tax applies only to taxable years ending after the first year in which the corporation is taxable under the capital stock tax.<sup>259</sup>

### *Bankruptcy and Receivership*

Attempts<sup>260</sup> to correlate the administrative tax collecting machinery<sup>261</sup> with the bankruptcy<sup>262</sup> and receivership<sup>263</sup> procedure have never been fully

2, provides in effect that the capital stock tax accrues upon the first day during the taxable period in which any business is done with respect to which the tax is imposed. The capital stock tax due on June 30, 1935 is, therefore, deductible in its entirety in 1934.

254. This was probably inadvertently omitted from the N. I. R. A. provisions.

255. § 701 (f). [48 STAT. 770, 26 U. S. C. A. § 5701 (f) (Supp. 1934)]. Since there is no provision allowing a company whose liabilities exceed its assets to declare a *minus* valuation, the adjusted declared value will in such cases include contributions to capital and earnings even if they go to soak up the deficit.

256. U. S. Treas. Reg. 64 (1934 ed.) Art. 89.

257. The new excess profits tax Regulations are embodied in T. D. 4469, approved Sept. 6, 1934.

258. § 703 [48 STAT. 771, 26 U. S. C. A. § 3761 n (Supp. 1934)].

259. § 702 [48 STAT. 770, 26 U. S. C. A. § 5702 (Supp. 1934)].

260. § 282, Act of 1926 [44 STAT. 62 (1926)], 26 U. S. C. A. § 1071 (1928)]; § 274, Act of 1928 [45 STAT. 856, 26 U. S. C. A. § 2274 (1928)]; § 274, Act of 1932 [47 STAT. 237 (1932), 26 U. S. C. A. § 3274 (Supp. 1934)].

261. Immediate assessment is provided in such cases. § 274 (a), Act of 1932, *supra* note 260. Since the Court has control over the assets of the insolvent taxpayer collection of taxes cannot be made by distraint. U. S. Treas. Reg. 77, Art. 1191. The claim for taxes may be filed in the insolvency proceeding, even though a controversy over the amount of the tax is pending before the Board of Tax Appeals. § 274 (a); Treas. Reg. 77, Art. 1191.

262. The National Bankruptcy Act, § 64.(a) [30 STAT. 563 (1898), 11 U. S. C. A. § 104 (a) (1927)] provides that taxes shall have priority over the claims of general creditors and gives the bankruptcy court jurisdiction to determine all disputes regarding the amount and validity of the tax claim.

263. R. v. STAT.. §§ 3466, 3467 (1898), 31 U. S. C. A. §§ 191, 192 (1927), give priority to tax claims in receivership cases and make the trustee, receiver or assignee personally liable for failure to protect the government's priority respecting taxes of which he has notice.

accomplished or entirely satisfactory.<sup>264</sup> A duty was imposed upon the Commissioner to levy an assessment "upon the adjudication<sup>265</sup> of bankruptcy" or "the appointment of a receiver for any taxpayer".<sup>266</sup> Under the existing machinery,<sup>267</sup> however, the operative facts were often not brought to the Commissioner's attention until after a court order or the Statute of Limitations had barred the claim or the distribution of the assets of the insolvent estate had rendered the collection of the tax a practical impossibility.<sup>268</sup> A new provision requires notice of the operative facts to be given by the trustee or receiver;<sup>269</sup> but for this addition, the new Act re-enacts *in toto* the prior law.<sup>270</sup> The collection of the revenues should have been further insured<sup>271</sup> by requiring notice to be given to the Commissioner in extension, composition and reorganization proceedings.<sup>272</sup>

Moreover, the opportunity was not availed of to clarify the law with respect to the status of proceedings pending before the Board of Tax

264. The Report of the Committee on Ways and Means, *supra* note 4, at 34, sums up the matter as follows:

"The result of bankruptcy or receivership is, therefore, to take the case from the jurisdiction of the United States Board of Tax Appeals in cases of deficiency. There is no specific provision, however, requiring the trustee in bankruptcy or the receiver to give notice to the Commissioner of his appointment. As a result, the statute of limitations frequently runs against the Government through inability of the Government to ascertain the status of the taxpayer."

265. Under the Bankruptcy Act, "adjudication" means the date of the entry of a decree that the defendant in a bankruptcy proceeding is a bankrupt, or if such decree is appealed from, then the date when such decree is finally confirmed. 30 STAT. 544 (1898), 11 U. S. C. A. § 1 (2) (1927).

266. § 274 (a), Act of 1932 [47 STAT. 237 (1932), 26 U. S. C. A. § 327 4 (a) (Supp. 1934)].

267. An effort was made to have someone, presumably in the Collector's office, check the bankruptcy and receivership dockets.

268. Legally the liability continued to exist because tax claims do not constitute dischargeable debts but, especially in the case of corporate taxpayers, the possibility of ever collecting from a taxpayer shorn of all assets was slight. Cf. § 274 (b) [47 STAT. 237 (1932), 26 U. S. C. A. § 327 4 (b) (Supp. 1934)]. (Unpaid portion of an allowed claim.)

269. This has been accomplished by inserting after the first sentence of § 274 (a) [48 STAT. 744, 26 U. S. C. A. § 527 4 (2) (Supp. 1934)] a new sentence. The Statute of Limitations on the making of assessments is tolled for a period from the date of adjudication or appointment of the receiver to a date thirty days after the receipt of the notice by the Commissioner, but in any event not to exceed two years. § 505 [48 STAT. 757 (1934)] amends the acts of 1932, 1928, and 1926 in the same manner.

270. The section by using the word "shall" imposes a duty to levy the assessment which has not been changed. The result is incongruous because literally the duty now is imposed before the notice may possibly be received.

271. The government should participate, in fact as well as in theory, in any proceeding the effect of which is to divest a taxpayer of his assets; the fact that the tax claim survives often proves illusory.

272. In legal effect such proceedings often operate to stay the adjudication or receivership proceedings so that no "adjudication" may take place. 47 STAT. 1467 (1933), 11 U. S. C. A. §§ 202-205 (Supp. 1934). The duty of giving notice in such cases might be imposed upon the clerk of the court in which the petition or answer was filed or upon the debtor. In the case of reorganizations under § 77 it is provided in subsection (e): "If the United States of America is directly a creditor or stockholder, the Secretary of the Treasury is hereby authorized to accept or reject a plan in respect of the interests or claims of the United States." Subsection (b) provides: "The term 'creditors' shall . . . include for all purposes of this section and of the reorganization plan, its acceptance and confirmation, all holders of claims . . . of whatever character against the debtor or its property . . ."; and "The term 'claims' includes debts, . . . liens, or other interests of whatever character."

Appeals<sup>273</sup> when bankruptcy, receivership, extension, composition or reorganization proceedings are subsequently instituted.<sup>274</sup> While clearly the Board has no jurisdiction if the adjudication or the appointment of a receiver antedates the filing of the petition for the redetermination of the deficiency, the provision so limiting the Board's jurisdiction is too broad.<sup>275</sup> The collection of the revenues might have been further facilitated by clearly subjecting to payment of the tax all assets of the taxpayer not in the possession of the court as the result of any of the above proceedings.<sup>276</sup>

*Limitation Upon Assessments, Refunds and Credits*

The limitation upon assessment of income taxes has been increased from two years to three years by the 1934 Act.<sup>277</sup> This change was requested by the Subcommittee upon the ground that two years was an inadequate time for the Bureau to audit returns, with the result that many ill-considered deficiency letters were issued.<sup>278</sup> Furthermore, since in the

273. In cases where the taxpayer's petition has been filed with the Board before an adjudication in bankruptcy or the appointment of a receiver, even though the Board has held extensive hearings and taken the case under advisement, the trustee or receiver may elect to disregard all that has been done and compel the government to relitigate the same question in the bankruptcy or receivership court. The decision of the Board rendered after adjudication in such cases is admitted to have nothing but a "moral effect". Plains Buying and Selling Ass'n, 5 B. T. A. 1147, 1152 (1927); see Treas. Reg. 77, Art. 1192: "A copy of the Board's decision may be filed by the Commissioner with the bankruptcy or equity court." (Italics added.) Undoubtedly the Board would allow a trustee or receiver to be substituted for the petitioner, but in practice the trustee or receiver almost invariably prefers to deal with tax claims the same as with all other claims against the insolvent estate. There would seem to be some merit in a provision making the decision of the Board binding in cases where a hearing had already been held, after granting the trustee or receiver some reasonable time to appear and present additional testimony and arguments.

274. The courts having jurisdiction of such proceedings have the power to enjoin "suits and judicial proceedings" in other courts. Whether a reorganization proceeding under § 77 of the Bankruptcy Act, *supra*, note 272, stays a proceeding pending before the Board is an open question, although the Board has held that it does not. Missouri Pac. R. R., 30 B. T. A. 587 (1934).

275. To illustrate: under the literal wording of the section a taxpayer who was discharged in bankruptcy or for whom a receiver had been appointed would never be able to file a petition with the Board. Obviously this was not the intent of Congress. The following should be added at the end of § 274 (a) [48 STAT. 744, 26 U. S. C. A. § 5274 (a) (Supp. 1934)]: "with respect to any taxable year or part thereof prior to the date of such adjudication or the appointment of such receiver." Query, whether the Board has jurisdiction in a case where on January 1st an involuntary petition in bankruptcy was filed against A, and on January 2d A files his petition with the Board, and the adjudication of bankruptcy occurs on January 5th? In other words, does the bankruptcy rule that the adjudication relates back to the date of the filing of the petition apply?

276. This result could be accomplished by adding to the end of § 274 (b) [48 STAT. 745 (1934), 26 U. S. C. A. § 5274 (b) (Supp. 1934)], the following. "Nothing contained in this subsection shall be construed to prevent the collection at any time of any tax due and owing by any taxpayer from any assets not subject to the jurisdiction of any court in a pending cause." It might be claimed that under the present provision § 274 (b), *supra*, collection upon unpaid claims is postponed until "after the termination" of the bankruptcy or receivership proceeding. The result would be that a person realizing income subsequent to the date of the filing of his petition in bankruptcy and prior to the termination of such proceeding would enjoy immunity from tax collection in respect of such income. Query, whether the government may collect a tax from the X corporation from properties located in New York, when the corporation is in receivership in Delaware but no ancillary proceedings have been instituted in New York?

277. § 275 [48 STAT. 745, 26 U. S. C. A. § 5275 (Supp. 1934)] The time begins to run from the filing of the return.

278. *Op. cit. supra* note 1, at 20, 21.

past the Statute began to run against the Government from the *actual* filing of the return, much confusion was caused by returns filed before the last day for filing. This difficulty has been eliminated by providing that, for the purposes of the Statute of Limitations, the return shall be considered as filed on the last day for filing.<sup>279</sup> The Subcommittee also recommended the tolling of the Statute of Limitations when a taxpayer omitted from his return more than twenty-five *per cent.* of his gross income, irrespective of his intent to evade the tax.<sup>280</sup> A compromise provision extending the statutory period to five years in such cases was finally included in the Act.<sup>281</sup>

The period for filing claims for refund or credit with the Commissioner has been correspondingly increased to three years from the filing of the return,<sup>282</sup> or two years from the payment of the tax, whichever period is the longer.<sup>283</sup> Former Acts made the period run solely from the payment of the tax, thus giving an advantage to the taxpayer who paid his tax in installments. The Statute ran against the government from the filing of the return, and hence barred assessments before it barred claims for refunds and credits. Further, the Board of Tax Appeals is now empowered to determine as part of its decision whether the Statute of Limitations has run against the taxpayer.<sup>284</sup> Formerly this question, if it arose on a matter litigated in the Board, could not be decided there, but had to be determined in a separate proceeding in the courts.

The rule that income must be taxed only in the taxable year when realized and that deductions may be taken only in the year when they accrue works inequity to the government in cases in which the taxpayer has in good faith omitted items of gross income or taken improper deductions in a return upon which the Statute of Limitations has run. The taxpayer may not later be taxed upon this income and may again take such deduction in the correct year, where this is a later taxable year upon which the Statute of Limitations has not run.<sup>285</sup> On the other hand, the tax-

279. § 275 (d) [48 STAT. 745 (1934), 26 U. S. C. A. § 5275 (d) (Supp. 1934)].

280. *Op. cit. supra* note 1, at 21.

281. § 275 (c) [48 STAT. 745, 26 U. S. C. A. § 5275 (c) (Supp. 1934)].

282. Note that in this case the Statute still begins to run against the taxpayer from the *actual* filing of the return. § 275 (d), *supra* note 279, applies only to the limitation upon assessments.

283. § 322 (b) (1) [48 STAT. 750 (1934), 26 U. S. C. A. § 5322 (b) (1) (Supp. 1934)]. If no return is filed, the period is two years from the time of payment.

284. § 322 (d) [48 STAT. 751 (1934), 26 U. S. C. A. § 5322 (d) (Supp. 1934)]. The section merely empowers the Board to determine as part of its decision that the tax was *paid* within *three* years from the filing of the claim, *etc.* Such a finding may be irrelevant in view of the provision of § 322 (b) (1), *supra* note 279, that in some instances, at least, no refund can be made unless the tax was paid within *two* years before the filing of the claim for refund or credit. Therefore the language of the section may be inept to accomplish its purpose in some instances.

285. *E. g.*: I. A does not include income realized in 1930 in his 1930 return, but not from fraud or intent to evade tax. The government does not discover this until 1933, and may not tax A on this income because the Statute of Limitations has run as to the year 1930. Sugar Creek Coal & Mining Co., 31 B. T. A. 344 (1934).

payer is prejudiced in cases where he has erroneously included items in gross income or failed to take deductions in a year as to which the Statute of Limitations has run. The taxpayer loses his chance to take the deduction, and may be taxed again on the same item of income in the later year in which it accrued.<sup>286</sup>

Both the Subcommittee<sup>287</sup> and the Treasury<sup>288</sup> recommended that these inequitable situations be remedied. However, the difficulties of drafting a suitable provision which would not open up returns for past years proved insuperable.<sup>289</sup>

### *Publicity of Returns*

The Revenue Acts have consistently provided that returns filed thereunder constituted "public records"<sup>290</sup> but, with certain exceptions,<sup>291</sup> the right to inspect<sup>292</sup> such returns was not directly granted by the respective

II. *A* in 1930 takes a deduction which he should not have taken in that year, because it did not accrue until 1931. After the Statute of Limitations has run as to 1930, a ruling or decision in a similar case makes it apparent that the deduction should have been taken in 1931. *A* may still file a claim for refund as to 1931 and thus have the benefit of the deduction in 1931 also.

286. *E. g.*: III. *A* includes income in his 1930 return which is held in 1933 to have been realized in 1931, and a deficiency is assessed on this basis. *A* is compelled to include this item in his 1931 income and can get no credit for overpayment in 1930 because the Statute of Limitations has run on that year.

IV. *A* in his 1930 return does not take a deduction which accrued to him in 1930, because he, in good faith, thought it accrued in 1931. *A* took the deduction in his 1931 return. In 1933 the deduction is held to have accrued in 1930, but *A* has lost his chance to benefit from it, since the Statute of Limitations has run on the 1930 return, and he is not allowed to take the deduction in 1931.

287. *Op. cit. supra* note 1, at 12. The Subcommittee recommended the adoption of so-called "equitable provisions".

288. *Op. cit. supra* note 2, at 15.

289. The situations outlined in examples II and III in notes 285 and 286, *supra*, can be easily remedied by inserting provisions that no taxpayer shall be taxed on the same item of gross income, or allowed the same credit or deduction, in more than one taxable year. Examples I and IV, however, involve situations where opening returns for past years seems unavoidable.

290. *E. g.*, "That returns upon which the tax has been determined by the Commissioner shall constitute public records". § 257, Act of 1921 [42 STAT. 270 (1921)]. To the same effect are: § 257 (a), Act of 1924 [43 STAT. 293 (1924)], 26 U. S. C. A. § 1024 n (1928)]; § 257 (a), Act of 1926 [44 STAT. 51 (1926)], 26 U. S. C. A. § 1024 (1928)]. The clause was incorporated by reference in § 55, Act of 1928 [44 STAT. 809, 26 U. S. C. A. § 2055 (1928)] and in § 55, Act of 1932 [47 STAT. 189 (1932)], 26 U. S. C. A. § 3055 (1934)], but amended by § 218 (h), N. I. R. A. [48 STAT. 209 (1933)], 26 U. S. C. A. § 3055 (1934)], by adding the following after the incorporation by reference: ". . . and all returns made under this Act after the date of enactment of the National Industrial Recovery Act shall constitute public records and shall be open to public examination and inspection to such extent as shall be authorized in rules and regulations promulgated by the President." § 55 (a), Act of 1934 [48 STAT. 698, 26 U. S. C. A. § 5055 (a)] re-enacts the provisions of § 55, Act of 1932, *supra*, as amended by § 218 (h), N. I. R. A., *supra*. § 257 (a), Act of 1926, *supra*, incorporated by reference a "final determination" of tax in respect to income tax returns. Consequently, a "final determination" was made a prerequisite to such returns' becoming "public records". The case is otherwise under the amendment effected by § 218 (h), N. I. R. A., *supra*. The 1934 Act might well have clarified the law in this regard by a rephrasing of § 55 (a).

291. *E. g.*, certain state officers upon request of the Governor, certain Congressional committees, and *bona fide* shareholders of record owning one *per cent.* or more of the outstanding stock of any corporation. § 257 (b-d), Act of 1926 [44 STAT. 51 (1926)], 26 U. S. C. A. § 1024 (1928)].

292. The "right to inspect" is distinct from the "right to use the information obtained by such inspection". By REV. STAT. § 3167 (1864), as amended by the Act of 1918 [40 STAT.

Acts and existed only to the extent authorized by the President.<sup>293</sup> Although complete public examination by anyone might have been authorized, the practice, speaking generally, had been to confine the right of inspection to those persons having a "legal"<sup>294</sup> rather than merely a "public"<sup>295</sup> or "personal"<sup>296</sup> interest in the contents of such returns.

Under the new Act,<sup>297</sup> any person, irrespective of motive, purpose or interest, has the right<sup>298</sup> without Presidential authorization to ascertain the total gross income, total deductions, net income, total credits against net income for normal tax purposes and the tax payable<sup>299</sup> of any person<sup>300</sup> filing an income tax return. In all other respects Presidential discretion

1146 (1919), 26 U. S. C. A. § 1025 (1928)], and re-enacted without change in § 1311, Act of 1921 [42 STAT. 31 (1921), 26 U. S. C. A. § 1025 (1928)]; and in § 1018, Act of 1924 [43 STAT. 345 (1924), 26 U. S. C. A. § 1025 (1928)]; and in § 1115, Act of 1926 [44 STAT. 117 (1926), 26 U. S. C. A. § 1025 (1928)], it is made a misdemeanor for "any person to print or publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses, or expenditures, appearing in any income return. . . ." See also § 257 (d), Act of 1926 [44 STAT. 51 (1926), 26 U. S. C. A. § 1024 (1928)] in respect to shareholders. Cf. § 257 (b), Act of 1924 [43 STAT. 293 (1924), 26 U. S. C. A. § 1024 n (1928)], which provided for the public inspection of lists containing the names, addresses and amounts paid by persons filing income tax returns. *United States v. Dickey*, 268 U. S. 378 (1925), held that in respect to the information revealed in such lists the right to publish existed in spite of REV. STAT. § 3167 (1864).

293. *E. g.*, ". . . but, except as hereinafter provided in this section and section 1203, they shall be open to inspection only upon order by the President. . . ." § 257 (a), Act of 1926 [44 STAT. 51 (1926), 26 U. S. C. A. § 1024 (1928)]. The Regulations have adopted this view. See U. S. Treas. Reg. 77, Art. 421, amended by T. D. 4378, XII-34, Int. Rev. Bull. 10 (authorizing the Special Committee to Investigate Foreign and Domestic, Ocean and Air Mail Contracts to investigate returns); further amended by T. D. 4397, Oct. 18, 1933 (authorizing the Special Committee to Investigate Receivership and Bankruptcy Proceedings and Appointment of Receivers and Trustees to investigate returns).

294. *E. g.*, returns of an individual were open to inspection by (a) the person who made the return, (b) the maker's executor, administrator or trustee of his estate, and (c) in the discretion of the Commissioner, any heir at law, next of kin or beneficiary under the will, upon showing a material interest which would be affected by information contained in the return. The attorney in fact of any of the foregoing persons might inspect the return in their stead. Similar provisions were in effect, covering joint returns of husband and wife, partnership returns, estate returns, returns of a trust. U. S. Treas. Reg. 77, Art. 421.

295. A private citizen interested in seeing that the government had collected the full tax from his neighbor could not inspect his neighbor's return to ascertain the facts.

296. A bond salesman could not go through the returns of the most prominent persons in his territory for the purpose of compiling a list of prospective customers.

297. § 55 (b), Act of 1934 [48 STAT. 698 (1934), 26 U. S. C. A. § 5055 (Supp. 1934)]. T. D. 4500, XIII-51 Int. Rev. Bull. 2, requires the filing of Form 1094 with each return, giving the information noted above in the text. T. D. 4504, XIV-1 Int. Rev. Bull. 4, contains the new Regulations with respect to publicity of the *actual returns*.

298. The Treasury Department has taken the position that disclosure is mandatory. XIII-31 Int. Rev. Bull. 2 (1934). The phrase "in such manner as the Commissioner, with the approval of the Secretary, may determine", would seem to furnish an insufficient basis upon which to bar one desiring to inspect Form 1094 for merely "personal" reasons.

299. This information is filed on Form 1094. The burden of preparing the form is placed upon the taxpayer; upon the taxpayer's default, five dollars is added to the tax otherwise payable, and the form is filled in by the Collector. The advantage of this procedure is that the tax return may proceed in orderly course through the Bureau. If the tax return might be demanded by anyone, the administrative procedure would become hopelessly confused. Whether the separate form filed with the tax return will have to be corrected when, as a result of the process of "closing the return" a deficiency or overassessment is determined, has been left to conjecture.

300. "Person" means an individual, a trust or estate, a partnership, or a corporation. § 801 (a) (1), Act of 1934 [48 STAT. 771. 26 U. S. C. A. § 5801 (a) (1) (Supp. 1934)].

continues to govern the extent to which the public generally may examine the actual tax return.<sup>301</sup>

The changes affected by the new Act represent a partial acceptance of Senator LaFollette's proposal for full publicity.<sup>302</sup> On the floor of the Senate, Senator LaFollette was successful in having his amendment calling for full publicity adopted.<sup>303</sup> In conference, however, a substitute was drafted limiting the information that might be obtained as of right to the items previously referred to.<sup>304</sup>

The social worth of the new provisions may well be doubted. At present, of all the states imposing income taxes, only Wisconsin<sup>305</sup> makes the contents of the return anyone's property. A similar federal experiment proved so unpopular that it was abandoned.<sup>306</sup> From the informative standpoint, the new provisions are admittedly an improvement.<sup>307</sup> The prediction is hazarded that the new provisions will furnish more ammunition for malicious gossip than revenue, will prove a godsend to credit rating agencies, salesmen and "confidence men", and will inconvenience both the taxpayer and administrative officials. The Commissioner, by requiring from each person who exercises his right to inspect another person's return, a disclosure under oath<sup>308</sup> of his employer, the purpose of the examination, and the intended use<sup>309</sup> of the information gained therefrom might obtain some useful factual material with respect to the actual operation of the publicity provisions.

301. § 55 (a), Act of 1934 [48 STAT. 698, 26 U. S. C. A. § 5055 (a) (Supp. 1934)].

302. On April 12, 1934, Senator La Follette had printed and ordered to be laid on the table an amendment he intended to offer to H. R. 7835 (the Revenue Bill of 1934). It proposed to strike out § 55 (a), *supra* note 301, of the Bill and add in part the following: "(a) Returns made under this title upon which the tax has been determined by the Commissioner shall constitute public records and shall be open to public examination and inspection under rules and regulations promulgated by the Secretary and approved by the President".

It should be noted that this provision covered only returns made under Title I (the Income Tax Returns) and, by striking out § 55 (a), might have prevented the President from making public in any manner other returns (*e. g.*, estate tax returns, capital stock and excess profit returns). Another defect of the amendment was the failure to make the return a "public record" until the tax had been determined. Of course any other procedure would seriously hamper those charged with the administration of the Act, but the fact that the tax may not be finally determined for two or three years renders any value to be derived from publicity nugatory.

303. The vote was forty-one to thirty-four. 78 CONG. REC. 6544 (1934). This amendment was Senate Amendment No. 38.

304. The present § 55 (a), *supra* note 301, was also restored. Subsection (b) was drafted so that it was not mandatory to disclose the entire tax return.

305. From the enactment of the Wisconsin Income Tax Act in 1911, until April 17, 1923, returns were secret. § 71.20 WIS. STAT. On the latter date, this section was struck from the law. WIS. LAWS 1923, c. 39. See also HAWAII REVENUE LAW (1925), c. 102, § 1332, and c. 103.

306. See § 257 (b), Act of 1924 [43 STAT. 293 (1924), 26 U. S. C. A. § 1024 n (1928)].

307. Under the provisions of the 1924 Act, the amount of tax paid furnished very little criterion, for A, with a million dollars gross income, might pay the same or a smaller tax than B, earning only \$10,000 a year, depending upon the deductions, *etc.* The new form (*supra* note 299) will give the essential totals, and for the layman this will be more understandable than the more complex tax return.

308. T. D. 4359 provides in part, "upon written application setting forth fully the reason for the request".

309. See note 292, *supra*.

*Retaliatory Taxes*

In an endeavor to protect citizens and corporations of the United States from discriminatory taxes levied by certain foreign countries, the House Bill <sup>310</sup> imposed as an additional income tax <sup>311</sup> a retaliatory tax of fifty *per cent.* of the income tax otherwise payable upon the citizens and corporations of any country found by the President <sup>312</sup> to be discriminating against corporations or citizens of this country. The Senate Finance Committee wisely recommended <sup>313</sup> that the imposition of the retaliatory tax be extended to cases where the President found that a foreign country was levying extraterritorial taxes upon citizens or corporations of the United States, and that the rate carried in the House Bill be doubled with the proviso that in no case should the total tax exceed eighty *per cent.* of the taxpayer's net income.<sup>314</sup> The value of the provision enacted <sup>315</sup> as a weapon against discriminatory taxation by foreign countries is lessened by the ease with which a foreign corporation can, by incorporating a domestic subsidiary, avoid the imposition of the retaliatory tax. This defect should be removed.<sup>316</sup>

*Depreciation and Depletion*

The Subcommittee, while recognizing that reasonable deductions for depreciation and depletion were sound from an accounting standpoint, was alarmed at the reduction in the revenue caused by these deductions.<sup>317</sup> It therefore recommended that these deductions be arbitrarily reduced by twenty-five *per cent.* for the years 1934, 1935, and 1936.<sup>318</sup> The Treasury rejected this proposal on the ground of its doubtful constitutionality and inherent unfairness.<sup>319</sup> Upon analysis, the real cause of the reduction in the revenue because of excessive depreciation allowances was found in the

310. H. R. 7835, § 104.

311. Apparently any type of discriminatory tax, including estate or inheritance taxes, would authorize the imposition of the "additional income tax". Query, whether discriminating tariff quotas would justify the imposition of the tax?

312. No hearing or investigation is provided for as a prerequisite to the finding, and no method of review is prescribed.

313. *Op. cit. supra* note 7, at 31, 32.

314. Under the House Bill, a fifty *per cent.* increase in the corporate income rate would raise the rate from 13¾ *per cent.* to a little in excess of 20½ *per cent.* In the case of an individual, the normal tax of four *per cent.* would be raised to six *per cent.*; the highest surtax rate, fifty-nine *per cent.*, would be increased to 88½ *per cent.* It was thought that a fifty *per cent.* increase in many cases would prove to be an "idle threat". The provision might have been drafted to impose "an additional income tax sufficient to impose upon the citizens or corporations of such foreign country a tax of approximately equal burden".

315. § 103 [48 STAT. 703, 26 U. S. C. A. § 5103 (Supp. 1934)].

316. As by adding, "For the purposes of this section a domestic corporation, ninety *per cent.* of whose stock is owned directly or indirectly by the citizens of and /or corporations of any foreign country found to be so discriminating or imposing extraterritorial taxes, shall be subject to the tax imposed by this section."

317. *Op. cit. supra* note 1, at 4, 5.

318. *Ibid.*

319. *Op. cit. supra* note 2, at 3.

amazing and inexplicable language of the Treasury Regulations,<sup>320</sup> which purported to put upon the taxpayer the burden of proving that a deduction for depreciation was reasonable, but in reality put upon the government the burden of proving it unreasonable. Because of the Treasury's promise to rectify its Regulations<sup>321</sup> Congress did not change the depreciation provisions in any material regard.

The Treasury further recommended the elimination of discovery and percentage depletion.<sup>322</sup> The discovery depletion provisions<sup>323</sup> depart from the ordinary cost basis for depletion in the case of certain mines,<sup>324</sup> while the percentage depletion provisions<sup>325</sup> allow the owners of certain mines and of oil and gas wells, to take  $27\frac{1}{2}$  per cent. per year of the gross income<sup>326</sup> from the property as depletion. Both provisions thus allow deductions for depletion to continue long after the taxpayer has recovered the full cost of the property. Several determined but unsuccessful attempts were made in Congress to eliminate the discovery and percentage depletion provisions, as allowing subsidies to particular classes of taxpayers.<sup>327</sup>

### Contributions

The deduction for certain philanthropic contributions heretofore allowed individuals<sup>328</sup> in computing their income,<sup>329</sup> estate,<sup>330</sup> and gift<sup>331</sup> taxes, has been abolished in certain cases where a substantial part of the

320. U. S. Treas. Reg. 77, Art. 205, and its predecessors under prior Acts. This gem read as follows: "While the burden of proof must rest upon the taxpayer to sustain the deduction taken by him, such deductions will not be disallowed unless shown by clear and convincing evidence to be unreasonable."

321. This promise was carried out by T. D. 4422, XIII-1 Int. Rev. Bull. 58, which amended U. S. Treas. Reg. 77, Art. 205, *supra* note 320, so as really to put the burden on the taxpayer. T. D. 4422 has been recently explained by I. T. 2838, XIII-52 Int. Rev. Bull. 4, which in effect provides that the taxpayer need not assume this burden unless specifically requested to do so by an agent of the Bureau.

322. *Op. cit. supra* note 2, at 3, 4.

323. § 114 (b) (2) [48 STAT. 710, 26 U. S. C. A. § 5114 (b) (2) (Supp. 1934)].

324. The value of deposits discovered by the owner after acquisition are added to the cost basis.

325. § 114 (b) (3-4) [48 STAT. 710, 26 U. S. C. A. § 5114 (b) (3-4) (Supp. 1934)]. The Act provides that the taxpayer, in making his first return under the 1934 Act, must make a *new* election with regard to depletion, and if no such election is made, he cannot claim percentage depletion. See XIII-41 Int. Rev. Bull. 2, General Counsel's Memo. 13627.

326. But not to exceed fifty per cent. of net income.

327. See Senator McKellar's extended remarks on this subject. 78 CONG. REC. 1775 (1934).

328. § 23 (n), Act of 1932 [47 STAT. 181 (1932)]. *Cf.* § 23 (a), under which corporations obtain a deduction only if the expenditure can be classified as "an ordinary and necessary business expense".

329. § 23 (n), Act of 1932 [47 STAT. 181 (1932)] (limited to fifteen per cent. of the taxpayer's net income computed without regard to this subsection). For the computation of the fifteen per cent. limitation see *Helvering v. Bliss*, 55 Sup. Ct. 17 (1934); XIII-52 Int. Rev. Bull. 5, General Counsel's Memo. 14030. But see § 120 [47 STAT. 210 (1932), 26 U. S. C. A. § 3120 (Supp. 1934)] for unlimited deduction in certain cases.

330. § 303, Act of 1926 [44 STAT. 72 (1926), 26 U. S. C. A. § 1095 (1928)], (a) (3) (resident); (b) (non-resident).

331. § 505, Act of 1932 [47 STAT. 247 (1932), 26 U. S. C. A. § 1136 (e) (Supp. 1934)], (a) (2) (resident); (b) (non-resident); but see (c).

activities of the donee consist in carrying on propaganda or in otherwise attempting to influence legislation.<sup>332</sup>

### *Deductions Allocable to Tax-Exempt Income*

The Subcommittee recommended a general provision preventing deductions allocable to wholly tax exempt income, upon the ground that it was obviously improper to allow any deduction for expenses incurred "in the *production* or *acquisition*" of such income.<sup>333</sup> In this recommendation the Treasury concurred.<sup>334</sup> The Bill as introduced disallowed as a deduction:

"(5) Any amount otherwise allowable as a deduction which is allocable to income wholly exempt to the taxpayer from the taxes imposed by this title. . . ."

However, the House Report,<sup>335</sup> in recommending the adoption of this provision, stated that it disallowed as deductions "expenses allocable to the *production* of income wholly exempt from the income tax", thus omitting the *acquisition* feature contained in the Subcommittee Report.

The House amended the provision to make it more inclusive by substituting for "income" the phrase "one or more classes of income (whether or not any amount of income of that class or classes is received or accrued)". The Senate, however, limited the provision<sup>336</sup> by restricting its application to income "other than interest".<sup>337</sup> The Section,<sup>338</sup> though stating a new

332. § 23 (o) (2), Act of 1934 [48 STAT. 690, 26 U. S. C. A. § 5023 (o) (2) (Supp. 1934)] (income tax); § 406 [48 STAT. 760, 26 U. S. C. A. § 1136 (e) (Supp. 1934)] (estate tax); § 517 [48 STAT. 760, 26 U. S. C. A. § 1095 (Supp. 1934)] (gift tax). However, (1) contributions to the United States, any State or territory or any political subdivision thereof, or the District of Columbia *exclusively* for "public purposes"; (2) to the fund established by § 12 of The World War Veterans Act of 1924 for vocational rehabilitation of veterans; (3) to posts, organizations, auxiliary units or societies of war veterans if no part of their net earnings inure to the benefit of any private shareholder or individual; (4) to a fraternal society, order or association operating under the lodge system, if used *exclusively* for religious, charitable, scientific, literary or "educational purposes", or for the prevention of cruelty to children or animals, are unaffected by the limitation. § 23 (o), *supra*. Whether attempting to influence legislation is comprehended in the phrases "public purposes" or "educational purposes" may be doubtful, but it seems clear that contributions to certain veterans' organizations, even though used to influence legislation, may still be deducted. Thus the veterans' lobby has been singularly favored, perhaps inadvertently.

333. *Op. cit. supra* note 1, at 14. The instances given were interest on state securities, salaries received by the state employees, and income from leases of state school lands.

334. *Op. cit. supra* note 2, at 16.

335. *Op. cit. supra* note 4, at 23, which gives the same examples as the Subcommittee gave.

336. This was apparently done in order to relieve the banks, who are large holders of tax-exempt securities, from what was believed to be undue hardship. The Senate also changed the provision to apply only to income "wholly exempt" rather than "wholly exempt to the taxpayer." The latter phrase was much broader in scope, particularly since certain United States bonds were exempt from all taxes except the surtax, and hence were wholly exempt only in the hands of corporations, which were subject to no surtax. With the elimination of "interest", however, it is difficult to see the reason for the elimination of the phrase "to the taxpayer", unless there was a desire to preserve the phraseology of § 23 (b) [48 STAT. 688, 26 U. S. C. A. § 5023 (b) (Supp. 1934)].

337. It should be noted, however, that interest "on indebtedness incurred or continued to purchase or carry" certain tax-exempt securities, is disallowed as a deduction under

and broad general principle, was so whittled away that probably it applies effectively only to income received from state lands by private individuals. Yet because of the vagueness of the term "allocable", it is likely that the Bureau may attempt to apply the provision more broadly, with the result that the section will prove a source of litigation.

### *Tax-Exempt Securities*

The Subcommittee refused to make a recommendation that interest on future issues of United States bonds be subject to the surtax.<sup>339</sup> The taxation of such interest would enhance state and municipal securities at the expense of federal securities, since then only the latter would be subject to federal tax.<sup>340</sup> The only successful solution is to allow each to tax without discrimination the other's securities. Of course, the federal government may tax future issues of its own securities,<sup>341</sup> and may doubtless authorize their taxation by the states.<sup>342</sup>

Assuming the desirability<sup>343</sup> of a reciprocal system of taxation, state securities might be taxed in any of three ways. Congress might repeal the provision of the Revenue Act which excludes interest on state securities from gross income.<sup>344</sup> The Sixteenth Amendment gives Congress power to tax "incomes from whatever source derived". It has not hitherto attempted to exercise this power as to interest from state securities. Such a course would ignore adverse decisions of the Supreme Court,<sup>345</sup> but in so far as they antedate the Sixteenth Amendment it might be claimed that they have been impliedly overruled thereby. In view of Supreme Court decisions interpreting the Amendment as merely relieving Congress' inability to levy a direct tax,<sup>346</sup> the success of this course seems doubtful. Moreover, the

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§ 23 (b), *supra*, note 336. The House made an ineffectual attempt to extend and enlarge the provisions of § 23 (b), but the Senate restored them to their original form.

338. § 24 [48 STAT. 691, 26 U. S. C. A. § 5024 (Supp. 1934)]. "(a) GENERAL RULE—In computing net income, no deduction shall in any case be allowed in respect of . . .

(5) Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this title . . ."

339. *Op. cit. supra* note 1, at 12.

340. For constitutional reasons explained in the early case of *McCulloch v. Maryland*, 4 Wheat. 316 (U. S., 1819), the view has been that the federal government may not tax the interest on state securities. *Collector v. Day*, 11 Wall. 113 (U. S. 1870); *United States v. Railroad Co.*, 17 Wall. 322 (U. S., 1872); *National Life Ins. Co. v. United States*, 277 U. S. 508 (1928).

341. No constitutional question is involved here as to taxation of future issues. The only question is one of policy.

342. This is upon the theory that the constitutional objection to taxation of federal instrumentalities by the states vanishes when the federal government consents to be taxed.

343. This is a controversial issue involving much conflicting data. The writers express no opinion as to the merits of such a policy.

344. § 22 (b) (4) [48 STAT. 687, 26 U. S. C. A. § 5022 (b) (4) (Supp. 1934)]

345. *Supra* note 340.

346. *Brushaber v. Union Pac. R. R.*, 240 U. S. 1 (1915); *Evans v. Gore*, 253 U. S. 245 (1920).

Supreme Court has indicated that the Sixteenth Amendment has not changed the law so as to allow taxation of state instrumentalities.<sup>347</sup>

Secondly, a Constitutional Amendment might be adopted permitting the federal government to tax the income from state securities.<sup>348</sup> Since, however, the states would lose by this procedure, ratification is problematical.<sup>349</sup>

A third possibility is to seize upon certain Supreme Court decisions allowing the interest from tax-exempt securities to be included in the measure of an excise or privilege tax, where the tax is *measured by*, as opposed to *imposed upon*, income.<sup>350</sup> Tax-exempt securities held by corporations or by individuals engaged in any trade, occupation, employment or business, might be reached by an excise tax upon the doing of business. This plan, however, would involve the disruption of the tax system, since it would necessitate a basic change in the theory underlying income taxation.

### *Corporate Salaries*

Senator Gore sponsored a provision designed to prevent the deduction as an ordinary and necessary business expense of excessive (*i. e.*, compensation in excess of \$75,000) corporate salaries. However, probably realizing the impossibility of ascertaining an arbitrary amount which would represent "just" compensation for services rendered, Congress merely required<sup>351</sup> every corporation in its return to submit a list of all officers or employees receiving a salary, commission, bonus or other compensation for personal services rendered of more than \$15,000.<sup>352</sup> The Secretary of the Treasury must submit an annual report to Congress covering the amounts paid to such persons, together with the names of the paying corporations.<sup>353</sup>

### *Tax Rate Structure*

The tax rate structure has been considerably simplified by the use of but one normal tax rate,<sup>354</sup> instead of two.<sup>355</sup> In order to compensate for the elimination of the additional normal tax, the surtax now begins at

347. *National Life Ins. Co. v. United States*, 277 U. S. 508 (1928).

348. Numerous resolutions proposing such amendments were introduced in both the House and Senate. Despite this apparent sentiment in favor of such a procedure, none of the resolutions were adopted or even came to a vote.

349. The total of state securities is much larger than that of federal securities.

350. *Pacific Co., Ltd. v. Johnson*, 285 U. S. 480 (1932). *Cf.* *Educational Films Corp. v. Ward*, 282 U. S. 379 (1931).

351. § 148 [48 STAT. 727, 26 U. S. C. A. § 5148 (d) (Supp. 1934)].

352. An individual who receives \$15,000 from each of ten subsidiary companies would not appear on any of the required lists. Whether allowing corporate officers to profit by permitting them to subscribe for options to buy stock having preferential rights, or to subscribe at prices below the market, constitutes "other compensation", probably depends upon how successful the government is in proving "intent to compensate".

353. To procure this information the Secretary has issued T. D. 4467, XIII-36 Int. Rev. Bull. 3, requiring a corporation to give this information in Schedule C-1 of its return.

354. § 11 [48 STAT. 684, 26 U. S. C. A. § 5011 (Supp. 1934)].

355. § 11, Act of 1932 [47 STAT. 174 (1932), 26 U. S. C. A. § 3011 (Supp. 1934)].

\$4,000,<sup>356</sup> and the rate is increased. The effect of this change is to increase the tax on recipients of dividends and of interest which is exempt only from the normal tax. Moreover, personal exemptions and credits for dependents are now allowed for the purpose of computing both the normal tax and the surtax.<sup>357</sup> Although, of necessity, this change is more beneficial to the taxpayers with high incomes, it seems in accord with the theory of progressive income taxation.

The credit for earned income,<sup>358</sup> which was eliminated by the 1932 Act, has been restored. The new provision is simpler than that contained in the 1928 Act,<sup>359</sup> the taxpayer for normal tax purposes being allowed a credit against net income of ten *per cent.* of the amount of *earned net income*, but not in excess of ten *per cent.* of the amount of his net income.<sup>360</sup> Net income up to \$3,000 is conclusively presumed to be *earned*,<sup>361</sup> and in no case can more than \$14,000 be considered *earned net income*.<sup>362</sup>

#### *Effective Date of the Act*

Title I provides that it shall apply "only to taxable years beginning after December 31, 1933."<sup>363</sup> This represents a change in policy, since under prior Acts a fiscal year embracing calendar years having different laws was subject to both laws.<sup>364</sup> Consequently, it was necessary to allocate income and tax it under both Acts, which often contained conflicting provisions. Under the new Act, all persons having fiscal years ending prior to December 31, 1934 will be taxable only under the lower rates of the 1932 Act. It was feared that to apply the Title to all taxable years ending after December 31, 1933, would make it unconstitutionally retroactive. Although this fear seems unfounded, a course of caution was followed, at the cost of considerable loss of revenue. This loss results from the *present* tax advantage accorded persons on a fiscal year basis. If, however, a consistent policy is followed in future Acts, the advantage will be on the side of those on a calendar year basis when, as, and if tax rates are reduced.

The effective date of the surtax on personal holding companies contained in Title IA is not specifically stated. The provision determining the

356. § 12 [48 STAT. 684, 26 U. S. C. A. § 5012 (Supp. 1934)]. The surtax rates have been materially increased, and the number of brackets reduced.

357. § 25 (b) [48 STAT. 693, 26 U. S. C. A. § 5025 (b) (Supp. 1934)].

358. § 25 (a) (5) [48 STAT. 692, 26 U. S. C. A. § 5025 (a) (5) (Supp. 1934)].

359. § 31 (b), Act of 1928 [45 STAT. 804, 26 U. S. C. A. § 2031 (1928)] provided for a credit *against the tax* of twenty-five *per cent.* of the amount of tax which would be payable if the taxpayer's earned income constituted his entire income, with a further complicating proviso.

360. This further limitation seems useless until it is recalled that only deductions allocable to "earned income" are used in determining "earned net income". Hence the "earned net income" might very well be larger than the "net income", where the general deductions were very large.

361. I. T. 2582, XIV-4 Int. Rev. Bull. 4.

362. The corresponding figures in the 1928 Act were \$5,000 and \$30,000.

363. § 1 [48 STAT. 683, 26 U. S. C. A. § 5001 (Supp. 1934)].

364. *E. g.*, § 105, Act of 1932 [47 STAT. 195 (1932), 26 U. S. C. A. § 3105 (Supp. 1934)].

effective date of Title I (Income Tax) <sup>365</sup> does not in terms apply to Title IA, which would seem at first glance to come under the general provision stating: "Except as otherwise provided, this Act shall take effect upon its enactment." <sup>366</sup> However, Title IA <sup>367</sup> provides that all provisions of law applicable in respect of the taxes imposed by Title I shall apply to the surtax on personal holding companies, unless inconsistent therewith. This makes it clear that the surtax on personal holding companies was meant to apply only to taxable years beginning after December 31, 1933. This conclusion is further borne out by the fact that Title IA was originally a section in Title I, and was made a separate title shortly before the Act was passed. The effective dates of the estate and gift tax amendments are noted above. <sup>368</sup>

### Conclusion

The Revenue Act of 1934 represents merely another skirmish in the perennial battle between the Government and the taxpayer. As the tenth revenue act since the passage of the Sixteenth Amendment in 1913, it embodies the experience gained in twenty-one years of income taxation and has plugged many loopholes discovered since the last general revision of 1932. However, only by constant alertness can the Government hope to keep abreast with astute counsel, who are quick to discover if the repairing of one leak in the complicated tax structure results in opening another. Certain substantive inequities continue to exist in spite of the 1934 revision, and while a Utopian tax system will never be devised, certainly uniformity of treatment requires, for example, that the tax advantage of the community property states be ended. Moreover, much might be accomplished in the way of simplification and consolidation of the various existing taxing acts. Although at the outset it was contemplated that the 1934 revision would direct itself largely to the simplification of the existing revenue acts, this objective was overlooked in the concerted drive to prevent tax evasion and avoidance.

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365. § 1 [48 STAT. 683, 26 U. S. C. A. § 5001 (Supp. 1934)].

366. § 803 [48 STAT. 772, 26 U. S. C. A. § 5803 (Supp. 1934)].

367. § 351 (c) [48 STAT. 752, 26 U. S. C. A. § 5351 (Supp. 1934)].

368. *Supra* note 225 (estate tax); *supra* note 248 (gift tax).