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one of the earliest, if not the first, Catholic services in Delaware were held in his home.

Another pioneer from Ireland was the intrepid Father Patrick Kenny who landed at New Castle and was so disgusted with the heat and mosquitoes that he would have immediately returned had he not been persuaded to wait until the next ship for his native land. By that time, Father Kenny realized the need of a priest to administer the needs of the Catholic families in northern Delaware, particularly the increasingly large number of Irish families that were rapidly settling here. Father Kenny never did return to his Ireland but remained to hold services at little Coffee Run Church on the Lancaster Pike, where he is buried, and also to start present day St. Peter's Pro-Cathedral in Wilmington in 1816.

Another immigrant from Ireland who landed at New Castle—destined to become one of the great men of the American Revolution—was Charles Thomson. He was known as the perpetual secretary of the Continental Congresses and was influential in holding together the various factions of the Congresses through some of the trying years of the country.

The first printer in Delaware was James Adams, a native of Ireland, who worked for a while in the print shop of Benjamin Franklin in Philadelphia and in 1761, set up his own establishment in Wilmington where he published early law books, religious tracts, and possibly the first newspaper of the State.

Commodore Thomas Macdonough who gave the British such a severe and decisive trouncing in the War of 1812, was a Delawarean of Irish parentage.

Gen. Thomas A. Smyth of Wilmington and a native of Ireland was at one time commander of the famous Irish Brigade in the Civil War—and was the last general of the Union troops to be killed in that war.

A check of the men who were not only high in the military ranks but among the statesmen, literary men, and industrialists were either natives of Ireland of both Catholic and Protestant faiths or descendants of Irish immigrants.

At one time, Wilmington was a haven for one of the noted Irish patriots, Alexander Hamilton Rowan, who escaped from Newgate Prison, fled to France, came to Philadelphia in 1795, and eventually found refuge in Wilmington where he lived in relative poverty but became rich in friends here. Among them were the Rodneys, Pooles, Dickinsons, Bayards and the well-known Delaware physician, Dr. Tilton. He earned his money by printing calico and selling birchbeer from a barrow, and he even worked as a gardener.

Years later, when he was permitted to return to Ireland and received his pardon and his property, he attached to the door of one of the turret rooms of his castle home a large label bearing the word, "Wilmington" where, it is said, he would often retire for hours of relaxation and revery.

But these were the men of the headlines. Just as important were the hundreds of Irish families who settled in Delaware and participated in the development of their new State and Nation. And certainly these notes of the Irish tradition in Delaware, brief as they may be, would not be complete without reference to the Irish families who lived on the banks of the Brandywine and worked in the powder mills and worshipped in old St. Joseph's-on-the-Brandywine. Their loyalty and devotion are part of the annals of the Du Pont Co.

And down to this present day, we find in Delaware many native sons and daughters of Ireland and their children who supported the Irish cause in our time. They, too, in their way, contributed to the cause of freedom and independence in keeping with American ideals.

Revision of Our Federal Tax Laws

EXTENSION OF REMARKS
OF
HON. DANIEL A. REED
OF NEW YORK
IN THE HOUSE OF REPRESENTATIVES
Monday, January 25, 1954

Mr. REED of New York. Mr. Speaker, during the first session of the 83d Congress the Committee on Ways and Means held 2 months of public hearings on revision of our Federal tax laws. Testimony was received from over 600 witnesses and over 1,000 statements were submitted for the RECORD. The entire committee membership spent long hard hours to complete the hearings.

At the present time the Committee on Ways and Means is meeting in daily executive sessions to prepare major tax legislation which we intend to present to the House before too many weeks have elapsed. This legislation will contain a complete recodification of the Internal Revenue laws in equitable and simplified form.

Mr. Aubrey R. Marrs, formerly head of the technical staff, Bureau of Internal Revenue, has prepared an excellent summary of the testimony presented at the committee hearings. It is my opinion that this summary should be available to all Members of Congress. To that end, Mr. Speaker, I am extending my remarks in the appendix of the CONGRESSIONAL RECORD and including therewith a summary of the General Revenue Revision Hearings which is a reprint of an article contained in the Standard Federal Tax Reports published by Commerce Clearing House:

REVISION OF THE INTERNAL REVENUE CODE
(By Aubrey R. Marrs, attorney, Washington, D. C.)

The Crusade in Europe is not the only crusade of recent times. There is another one going on right here in these United States. It is being conducted against heavy odds by Congressman DAN REED and his associates in the House of Representatives. I am referring to the "Crusade for tax simplification, tax equity, and tax understanding," now being waged under the auspices of the Ways and Means Committee. The crusades abroad have been costly in blood and money. Congressman REED's crusade may actually result in reducing the tax burden of our people. If it fails so to do, the reason will be largely the fiscal necessities of the Government.

His labors for a revision of the Internal Revenue Code do not represent an eleventh-hour conversion for DAN REED. In fact, one might say that he is a "B. C." revisionist, that is, before change in the administration. Chairman REED considers that "a sound and efficient revenue system is an essential to a healthy American economy." He has a three-point program:

"The present administration is confronted with three major problems. First, Federal expenditures are at too high a level. Second, Federal, State, and local taxes are so high that they are taking almost 30 percent of our national income. And this, despite the fact that prominent economists have repeatedly stated that it is dangerous for a government, by taxation, to take more than 25 percent of the national income. Third, the Internal Revenue Code has grown to such a degree through numerous patchwork amendments that it has become complicated, unfair, and in many situations completely unworkable."

It is the revision of the code with which this article is concerned. The internal revenue laws have not had a thorough reexamination and analysis since the compilation of the revised statutes, about 80 years ago. The code must be examined from stem to stern. The substantive provisions of the code, as well as the procedural provisions, need to be carefully scrutinized to see if they are fair, workable, and understandable. "We must make a complete revision," says Chairman REED. It will be an undertaking of the first magnitude. He recognizes that due to budget limitations, "we may not be able to go as far as we would like in all respects," but we can at least adopt sound, equitable, and understandable principles in the law. Just because it can't be done in one Herculean operation is no reason why it may not be done by feasible stages. Secretary of the Treasury Salmon P. Chase once told Horace Greeley that "The only way to resumption is to resume." Or as the Chinese would put it, a 1,000-mile trip begins with the first step.

PRECODE ERA

Prior to the Revenue Act of 1928, the general scheme of internal revenue legislation was to make each revenue act a self-contained body of statutory law. For example, in the Revenue Act of 1926, there were reenacted all the provisions of the proceeding 1924 act, both substantive and procedural, with such changes and omissions as the current policy of Congress dictated; the preceding act was then repealed, with certain exceptions. The substantive law provisions of each revenue act would remain in force for the years to which applicable, except as subsequently amended; but as to adjective or procedural law, such provisions were restated as to open cases under prior acts and new provisions included for all cases to arise under the then current revenue act. The method did create some confusion especially in procedural problems. As explained by the Ways and Means Committee: "The effort in each new act to put in the same place all the law relating to the assessment and collection of taxes for earlier years, as well as the law relating to the method of assessment and collection of the taxes imposed by such new act, has resulted in many complications. Striking examples of the difficulties encountered may be found in sections 277 and 278 of the 1924 and 1926 acts, dealing with the statute of limitations, section 284 of the 1926 act dealing with refunds and credits, and section 283 of the 1926 act, dealing with appeals to the Board of Tax Appeals in cases arising under the 1924 and preceding acts. If this process is continued, it will produce more and more complexities. The committee is impressed with the importance of making a fresh start." (1939-1 (pt. 2), CB 391, at p. 421.)

The plan of the early revenue acts accounts for the arrangement employed in internal revenue laws, a compilation once issued by the Treasury Department at convenient intervals, the last one containing the internal revenue laws in force on April 1, 1927. The 1927 compilation combines the appropriate sections of the Revised Statutes, the Revenue Act of 1926, approved February 26, 1926, and such prior acts as had not become obsolete. For example, chapter 19, "Income Taxes," contains all such provisions in the Revenue Act of 1926, followed by every prior revenue act, back to and including section 38 of the act of August 5, 1909.

As a result of the study of the situation by the staff of the joint committee and others, particularly a voluntary committee the members of which served without compensation,

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certain changes were recommended which took shape in the Revenue Act of 1928. This act differed materially from previous revenue acts. After reciting the difficulties above explained, the Senate Finance Committee report says:

"Therefore, the provisions of the income tax title of the present bill apply only to the taxable year 1928 and succeeding years. They have no effect whatsoever on taxes imposed for prior taxable years, nor do the provisions of the 1926 income tax title have any effect on the computation of tax for 1928 or later years. For this reason the income tax title of the 1926 act is not repealed by the bill and remains in force for the collection of taxes for 1925, 1926, and 1927, as well as taxes under prior acts except as modified by title III, of the present bill, containing express amendments to such title, and by title IV, containing various administrative provisions, and by title V, containing a few retroactive provisions intended to relieve certain cases of hardship under prior acts. It is to be noted in particular that provisions such as those in titles X, XI, and XII of the 1926 act as well as other titles thereof remain in full force and effect (except as amended by the new act) for the taxable year 1928 and subsequent taxable years. For instance, section 1107 applies to income taxes for 1928 and future years. Its application is not restricted to 'internal revenue laws' in force at the time of its enactment.

"It is planned ultimately to combine provisions of this general nature into a compilation or code apart from the revenue acts." (1939-1 (pt. 2), CB 421.)

At the same time the 1928 act made a distinctive change in the typography and style of printing of the revenue acts. This was explained by the Ways and Means Committee Report, as follows:

"The Joint Committee on Internal Revenue Taxation in its report recently submitted to the Committee on Ways and Means and to the Finance Committee of the Senate, endorsed a recommendation that one of the most helpful steps in the simplification of the income tax would be the use of a new typograprical setup making use of bold face headings and subheadings and also making use of indentions, so that the reader may more easily find the matter he is in search of. The style approved by the Joint Committee for use in the publication of the law, when enacted, is set forth in volume II, appended to its report. The present bill makes use of the system recommended for the printing of the law, as nearly as the styles of type in bill size available at the Government Printing Office will permit." (1939-1 (pt. 2), CB 392.)

The new idea was a simplification so long as the revenue measures did not come too fast and there were few retroactive amendments. The adoption of a continuing statute applicable to the current years, with only occasional intervening amendments and few retroactive amendments, rendered it comparatively easy for taxpayers (and lawyers) to ascertain exactly what the law was during any given year. The statute applicable to the taxable period under consideration would give one the statutory law, subject to a rundown on retrospective amendments.

Meanwhile, in 1922, there appeared on the market a publication which remains to this day the most convenient medium for ascertaining the statutory law in Federal income, estate and gift taxation, applicable to past years. It is the correlation of the revenue laws by Walter E. Barton. This work is now in its 10th edition, and certain editions taken together cover the entire period from 1913 to 1949. This work is a correlation, that is, the corresponding provisions of a series of revenue acts are laid alongside each other in verticle columns so that they may be readily compared. [The same result can be accomplished through use of CCH Internal Revenue Code.] Since a period of above 6 years occurs between editions, a large portion of the retroactive amendments appears along with the original provisions. Unfortuniately, this laborious though convenient method cannot be follower by legislative bodies.

CODE ERA

As foretold above, the Internal Revenue Code was prepared and was approved by the President on February 10, 1939 (53 Statutes, pt. I). (See the explanatory Mimeograph 4909, 1939-1 (pt. 1) CB 391.) Then more revenue acts came in rapid succession, with hundreds of retroactive amendments. From the enactment of the code on February 10, 1939 to the end of 1943, there were 737 different amendments, 83 of which became effective on the date of their enactment or on the following day; 77 of which became effective from 10 days to several months after their enactment; and 577 of which were retroactive for periods ranging from less than 1 year to approximately 4 years. The same policy of frequent amendments to the code continued during the 6-year period 1944-49, when there were 380 amendments, a large number of which were retroactive.

Only a small number of the amendments since February 10, 1939, have been made by reenacting the amended sections in their entirety. Most of them have been made by striking out some language and inserting other language, the consequence of which has been that taxpayers were required to make the necessary eliminations and substitutions. The result of so many amendments to the code in such patchwork fashion has been to create unavoidable, if not unnecessary, confusion, even with the improved system inaugurated by the 1928 act. There is no way of avoiding this kind of confusion with annual and semiannual amendments of the code, sprinkled with many retroactive provisions. Such a method of revenue legislation continued over a period of years is conducive to many inequalities, complications, and unsound practices. It is no exaggeration to say that the present Federal tax structure has been thrown together by disconnected enactments, usually under the pressure of real or fancied national emergencies. Chairman REED recognizes that situation. A general revision of the code is overdue.

REVISION OF THE CODE

The staff of the Joint Committee on Internal Revenue Taxation was instructed by the chairman to undertake a revision of the Internal Revenue Code. Accordingly, the staff conducted a survey to elicit suggestions and comments from the general public relating to improvements in the internal revenue laws and their administration. The survey was conducted on the basis of a widely distributed questionnaire, the response to which was immediate and widespread from all parts of the country. On April 21, 1953, the staff released a preliminary digest of the thousands of suggestions which had been received from individual taxpayers, businesses, tax practitioners, professional groups, and trade assolcations. Anyone desiring to study the matter might well begin with this preliminary digest.

Based upon replies to the questionnaire, the preliminary digest set forth 40 carefully selected subjects upon which to conduct public hearings. This numerical list, which gives the order on which the hearings were held, is as follows:

1. Qualifications for the dependency credit (including such problems as to whether dependency exemptions should be granted for foster children, whether a dependency exemption should be apportioned where two or more taxpayers are providing the support, and the problem arising where an individual who otherwise would be a dependent earns over $600 of income).
2. The expenses of child or dependency care for working wives, widows, etc.
3. The deduction of medical and dental expenses (such as problems relating to the 5 percent minimum, the maximum dollar limits, and the coverage of the deduction).
4. Deductions of charitable contributions, interest, and taxes:
   (a) Charitable contributions.
   (b) Interest.
   (c) Taxes.
5. College and educational expenses (including the unusual school expenses of dependents and also the professional educational expenses of the taxpayers themselves).
6. Business expense deductions from adjusted gross income (such as traveling expenses, entertainment expenses, work clothes, and the relationship of these deductions to the standard deduction):
   (a) Adjusted gross income.
   (b) Traveling expenses.
   (c) Entertainment expenses.
   (d) Work clothes.
   (e) The standard deduction.
7. Alimony and separate maintenance and support payments.
8. Income-splitting and head-of-household provisions.
9. Averaging of income (such as modification of section 107 to provide a different type of averaging and coverage of types of income not now provided for by that section).
10. Earned income credit.
11. The time and manner of filing returns, and declarations for individuals:
   (a) Time and manner of filing returns.
   (b) Declarations for individuals.
12. Withholding.
13. Employee death and disability benefits:
   (a) Employee death benefits.
   (b) Employee disability benefits.
14. The 3-percent annuity rule.
15. Stock options and deferred compensation plans:
   (a) Stock options.
   (b) Deferred compensation plans.
16. Pension and profit-sharing treatment provided by sections 165 and 23 (p).
17. Techniques for alleviating double taxation of dividends.
18. Accounting principles (such as those relating to timing and correlation in reporting income and expenses).
19. LIFO inventory accounting.
20. Depreciation and amortization.
21. Research and development expenditures.
22. Capital gains and losses including problems relating to basis:
   (a) Capital gains and losses.
   (b) Problems relating to basis.
23. Income taxes of lessor paid by lessee.
24. The net operating loss.
25. Cancellation of indebtedness.
26. Consolidated returns and intercorporate dividends:
   (a) Consolidated returns.
   (b) Intercorporate dividends.
27. Corporate reorganizations and distributions:
   (a) Corporate reorganizations.
   (b) Corporate distributions.
28. Statute of limitations, assessment, and collection of taxes and penalties:
   (a) Statute of limitations.
   (b) Assessment and collection of taxes.
   (c) Penalties.
29. Partnerships.
30. The various provisions relating to income derived from foreign sources.
31 Income tax treatment of estates and trusts.
32. Treatment of bad debts (bad-debt recoveries, bad-debt reserves, and deduction of nonbusiness bad debts):

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(a) Bad-debt recoveries.
(b) Bad-debt reserves.
(c) Deduction of nonbusiness bad debts.

33. The determination of taxable income inclusions and exclusions.

34. Gift and estate tax problems:
(a) Gift tax problems.
(b) Estate tax problems.

35. Excise tax problems (exclusive of those relating to rates, to new taxes, or to removal of existing taxes).

36. Retirement funds for self-employed and others not covered by existing pension plans.

37. Exclusion of pension and retirement income for specific types of employees.

38. Depletion and exploration expenditures:
(a) Depletion.
(b) Exploration expenditures.

39. Improper accumulation of surplus (section 102).

40. Excise tax rates.

In a recent study, made by Commerce Clearing House, of the nine-thousand-odd petitions filed between November 8, 1951, and January 19, 1953, the most recurrent issues appealed by petitioners to the Tax Court were: (1) dependency exemptions; (2) partnerships; (3) capital gains and losses; (4) miscellaneous "business" deductions; (5) depreciation; (6) travel expenses; (7) medical expenses; (8) entertainment expenses. It is revealing to note that the number one issue taken to the Tax Court was the number one subject on the committee's list; also, that every one of the most recurring issues above named were covered in the committee's schedule of hearings.

The public hearings began on June 16, 1953 and were concluded on August 14, 1953. It may be that, under present conditions, the primary object of Federal revenue legislation is to find new and ever-expanding sources of taxation. But sometimes the taxpayer needs a break as well as the Government. These hearings were the first opportunity offered to the public to express itself before the Ways and Means Committee on the code in its entirety, rather than on the specific matters involved in a current revenue bill.

The entire list of 40 subjects was recited above not only for the convenience of interested readers but also for the purposes of this article. Each subject hereinafter will be briefly discussed in its numerical sequence. Each busy reader may pick and choose the subject in which he may be interested and thus conserve his time. The plan of treatment of each subject is as follows: (1) An historical note pointing out the origin of the item in our Federal tax structure, usually going back no further than the act of October 3, 1913,[1] which is the first enabling act under the 16th amendment; and (2) a brief statement of the existing law.[2] Then follows a brief résumé of the public testimony developed at the hearings. In this way, it is expected that the coverage will be sufficiently informative to put one on notice as to the scope of the hearings. Anyone desiring to go exhaustively into the matter is free to do so.

The testimony and the submitted statement did not always coincide with the subjects set for hearing.

Dependency credit

Historical note: The dependency credit first made its appearance in section 1203 of the Revenue Act of 1917. It granted the head of a family an additional exemption of $200 for each dependent child. The subsequent amendments have been numerous. Under present law, an exemption of $600 is allowed for each dependent in a specified degree of relationship,[3] for whom the taxpayer provides over half the support. However, the dependent's gross income for the year must be less than $600, and, if an alien, he must reside in the United States, Canada, or Mexico. (Sec. 10 (b), Individual Income Tax Act of 1944, approved May 29, 1944.) The dependency exemption is now wholly free of the concept of head of a family. (Code sec. 25 (b) (1) (D) and code sec. 25 (b) (2) and (3).)

Testimony at hearing, June 16, 1953: Numerous House bills have previously been introduced relative to this subject. Much of the testimony under this topic confuses the dependency credit with the expenses for child care for working wives. It is evident that the middle class and the laboring class have no appreciation of the budget requirements of the national debt and national security. Most of the testimony was directed to increasing the credits for dependents. The joint committee staff estimates that to increase the personal exemption from $600 to $1,000, not to mention dependents, would cost approximately $9.5 billion in revenue. The American Bar Association recommended that wages paid to the dependent by the taxpayer be disallowed, where an exemption is claimed for the dependent by the taxpayer. Considerable support developed to grant foster children dependency status on the ground that it would stimulate the adoption of children. The legislative representative of the Panama Canal Zone recommended that section 25 (b) (3) be amended to include a dependent who is a resident of the Canal Zone. The recommendations to increase the amount of the dependency exemptions sometimes had a maximum limitation based upon adjusted gross income and/or age of the dependent. The trend was to increase the amount of the dependency exemption from $600 to $1,000, which would involve an amendment of section 25 (b) (1) (A) of the code.

Expenses of child or dependency care for working wives, widows, etc.

Historical note: Medical expenses excepted, the code has never provided for the deductibility of the personal expenses of a child, nor has it permitted the deduction of expenses incurred by a working wife or by a widow for the care of a dependent.[4]

The dependency credit is supposed to represent the extent of income-tax benefit to be derived from the care of dependents.

Hearings, June 16, 1953: The unmistakable trend of the testimony was to allow a deduction as a business expense, under section 23, for child care occasioned by either parent being engaged in gainful occupation.

H. R. 305 would allow a widow or widower to deduct amounts paid in providing care for children while the parent is employed. A limitation was suggested that the amount otherwise allowable under this bill should be reduced by the amount by which the adjusted gross income exceeded $5,000. H. R. 4394 would allow the expense of providing care for children under 16 years of age, where the mother is gainfully employed. H. R. 2861 would amend section 23 to allow child care expense, but would limit it to $40 per week and require the children to be under 16 years of age and to live at home.

Medical and dental expenses

Historical note: This deduction was added to the code by section 127 of the Revenue Act of 1942. (Code section 23 (x).) This principle opened the floodgates for the retroactive deductions of the 1942 act. Prior to that time medical care was regarded as a purely personal expense, expressly made nondeductible by section 24 (a) (1) of the code. When the deduction for "extraordinary medical expenses" was added, section 24 (a) (1) was amended to conform. Originally, the deduction was allowed for medical care of the taxpayer, spouse, or dependent, but only to the extent that such expenses exceeded 5 percent of adjusted gross income. The deduction has been expanded in behalf of elderly people. The 5 percent restriction is inapplicable to such expenses for the care of the taxpayer and his spouse if either has attained the age of 65 years. There are also maximum limitations on the amount of the deduction. The statute expressly allows amounts paid for accident or health insurance. The statute has been liberally construed, but the line has to be drawn somewhere.[5]

Hearings, June 17, 1953: Numerous bills have been introduced bearing upon this subject. All were directed to a liberalization of the deduction for medical care, particularly the removal or alleviation of the 5 percent rule. There was little agitation to lift the maximum limitations. Several organizations of persons who are physically handicapped or permanently disabled presented claims for greater tax relief by way of both deductions and exemptions.

One witness would free the cost of health insurance from the 5-percent rule and from the standard deduction, on the ground that it would reduce the possibility of socialized medicine. The president of a Washington, D. C., Dye-Dee Wash concern urged an amendment to the definition of medical care to include antiseptic diaper service.

Charitable contributions, interest, and taxes.

This is an unrelated combination of deductions, although in the absence of statutory authorization, and when not connected with business or the production of income, they would all be regarded as personal or nondeductible disbursements. They now appear in the code as section 23 (o) and (g) (contributions); section 23 (b), and 24 (c) (interest); and section 23 (c) (taxes).

Historical note (contributions): The deduction to individuals for charitable contributions first appeared as section 1201 of the act of October 3, 1917, amending the act of September 8, 1916. It is now limited to 20 percent of the taxpayer's adjusted gross income. As to corporations, the charitable deduction was first granted by section 102 (c) of the Revenue Act of 1935. This deduction is still limited to 5 percent of the corporation's net income.

Hearings, June 18, 1953: The president of Community Chests and Councils of America, Inc., urged that the present allowances remain in effect, at least at their present levels. Other witnesses recommended that the charitable deduction to corporations be increased from 5 percent to 10 percent on the assumption that it would stimulate the flow of funds from successful corporations to private charities.

Historical note (interest): The interest deduction to individuals first apeared in the act of October 3, 1913, section II B (second). Today the deduction covers all interest paid on indebtedness except indebtedness incurred to purchase exempt obligations. The interest deduction to corporations began with the act of August 5, 1909, section 38 (second) (third), and, in the early acts, was subject to a maximum limitation which the courts upheld.[6] Today the deductibility of this item is geared to several restrictions respecting promptness of payment and the relationship of the taxpayer and the payee. (Code sec. 24 (c).)

Hearings, June 19, 1953: Although this section relates to a limited number of business expense deductions, occasion may be taken to bring in other matters more or less related. One witness favored H. R. 1021 which is a bill to amend section 127 (a) of the code relating to war losses, giving the taxpayer a wider choice in the treatment of such losses. (See *Shahmoon* v. *Commissioner* (50-2, U. S. T. C., par. 9500, 185 F. (2d) 384 (CA-2); I T. 4086, 1952-1 CB 29); *Kenmore* v. *Commissioner* (53-1 U. S. T. C.,

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par. 9434 (C. A.-2), affirming CCH Dec. 19, 110, 18 TC 754 (1952)).)

The Federal Tax Forum, Inc., and the American Bar Association recommended the amendment of section 24 (c) to provide that no deduction would be disallowed thereunder for an expense or interest item where the related taxpayer included the accrued item in his return and signed a binding election to be taxed thereon.

H. R. 1018 and H. R. 4166 were also urged for favorable consideration. These bills would amend section 23 (e) to allow the deduction of losses and other expenses occasioned by abnormally high-water levels in any body of water, including a river.

Historical note (taxes): This is a complicated subject. On its face it deals with the deductibility of taxes and not their imposition. The deduction to individuals for taxes began with the act of October 3, 1913, section II B (3d). To corporations, it began with the act of August 5, 1909, section 38 (2d) (4th). In the 1917 act, Federal income and profits taxes were eliminated as deductible items. By section 111 of the Revenue Act of 1943, Federal excise and stamp taxes, not deductible as business expenses, were eliminated from deductible taxes. (Sec. 23 (c) (1) (F).) To summarize the present law on this item would carry the writer beyond necessary space limitations.

Hearings, June 18, 1953: The Independent Natural Gas Association of America recommended that the stamps purchased in connection with stock issues be allowed as deductions from gross income. I. T. 3806, 1946-2 CB 41, ruled that stamp taxes on bond issues were deductible on an amortized basis over the life of the bonds. (See *Hirshon* v. *United States* (53-2 U. S. T. C., par. 9499 (Ct. Cls.)).)

An individual witness recommended an amendment to section 23 (c) which would provide that taxes will be deemed to have been paid or accrued in respect of the vendor and the vendee of real property, in accordance with the adjustments made between them on the settlement date.

College and educational expenses

Historical note: Section 23 (a) (1) (A) allows as deductions all the ordinary and necessary expenses in carrying on a trade or business. Section 24 (a) (1) expressly prohibits any deduction for personal, living, or family expenses. Educational expenses, either for the taxpayer himself or for a dependent, usually fall under the prohibition of section 24 (a) (1). However, in recent years a breach has been driven in the Government's defensive wall. In *Hill* v. *Commissioner* (50-1, USTC, par. 9310, 181 F. (2d) 906 (CA-4)), the fourth circuit reversed the Tax Court (CCH Dec. 17,166, 13 TC 291 (1949)) and held that where a public school teacher was required under State law to either attend summer school or take examination on five selected books as prerequisite for renewal of her teacher's certificate, the cost of attending summer school was an ordinary and necessary business expense. In *Coughlin* v. *Commissioner* (53-1, USTC, par. 9321, 202 F. (2d) 307 (CA-2)), the second circuit reversed the Tax Court (CCH Dec. 19,034, 18 TC 528 (1952)) and held that the expense of attending New York University's Tax Institute, incurred by a practicing lawyer, was a business expense.

Hearings, June 18, 1953: The president-elect of the American Medical Association urged an amendment to the code authorizing the deduction of postgraduate educational expenses.

Support was urged for two bills, H. R. 1274, which would allow a deduction without limitation of expenses for the education of a dependent; and H. R. 3469, to provide a deduction for expenses for the taxpayer's own education or that of another person but not below the college level. Another witness urged the deduction of both secondary and college educational expenses.

A certified public accountant made a very interesting contribution. He recommended that no deduction be allowed to a taxpayer for educational expenses paid for dependents. The deduction should be allowed to the person receiving the education, and be written off as a capital expenditure similar to the depreciation of fixed assets. The deduction should be allowed against either employment or self-employment income in an amount not to exceed the lesser of 10 percent of cost or 25 percent of actual employment for the year. Any amount remaining after 10 years would still be available under the same rules of deduction. Refresher courses and seminar expenses of persons already started on their careers should be either fully deductible when paid or incurred, or added to the unamortized base similar to the handling of a major overhaul of assets for future amortization.

Business expenses

Historical note: The necessary expenses actually paid in carrying on any business were allowed as deductions beginning with the 1913 act. Section 214 (a) (1) of the 1918 act changed the wording to "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The concept of adjusted gross income was adopted by section 8 (a) of the Individual Income Tax Act of 1944, in connection with the simplified tax table, and for use in determining the standard deduction, medical expenses, etc. Section 22 (n) of the present Code creates a discrimination between taxpayers similarly situated for all practical purposes. A self-employed person in business, or an employer, may deduct all his section 23 expenses in arriving at adjusted gross income. He may then take the standard deduction where it is not beneficial to itemize other deductions. By contrast, a salaried employee or a person working on a commission basis may deduct business expenses other than travel, meals, and lodging while away from home, in arriving at adjusted gross income, only to the extent of the reimbursement arrangement with the employer. This places the salaried or commission salesmen at a disadvantage in respect of unreimbursed expenses, in that he must item them to obtain the deduction under section 23. This offsets much of the tax advantage connected with the standard deduction.

Hearings, June 23, 1953: The discrimination above described was attacked by several witnesses, primarily from the standpoint of the commission salesman. In this respect the commission salesman seems to be regarded as an employee. It was submitted that in arriving at adjusted gross income and in using the standard deduction, there should be no distinction as between the self-employed or an employer, and an employee. Different solutions were advanced, one of which would repeal the restrictions in respect of an employee's expenses not reimbursed by his employer.

A similar discrimination exists as between city salesmen and traveling salesmen. Traveling expenses while away from home are deductible in arriving at adjusted gross income. A salesman who is assigned to city and suburban territory incurs the same type of expenses but cannot so treat them because he is not away from home. The removal from the statute of the words "while away from home" was urged in that connection. And one witness went so far as to suggest that personal commuting expense to his place of employment should be allowed on the theory that it is imperative to be at work to earn the income taxed. The last-mentioned suggestion would apply to a number of items presently regarded as purely personal. For the traveling man, however, the foregoing suggestion is not as radical as that made by another witness to the effect that home should be deemed to be the place of the taxpayer's family residence. (See *Commissioner* v. *Flowers* (46-1 USTC, par. 9127, 326 U. S. 465).)

Alimony, etc.

In *Gould* v. *Gould* (1 U. S. T. C., par. 13, 245 U. S. 151 (1917)), the Supreme Court held that support and maintenance payments under a decree of permanent separation was not income to the former wife under the 1913 act; nor were such payments deductible from the income of the husband. Thus the matter stood until the 1942 act. (Secs. 22 (k), 23 (u), and 171 of the Internal Revenue Code.) The constitutionality of this legislation was upheld, and its provisions interpreted in *Mahana* v. *U. S.* (50-1 U. S. T. C., par. 9164, 88 F. Supp. 285 (Ct. Cls.), cer. denied, 339 U. S. 978; rehearing denied, 340 U. S. 847).

Although considerable interest was shown in replies to the questionnaire, over the many tax inequities which still beset the divorced, or legally separated man, the hearings developed nothing of significance except a recommendation by the Federal Tax Forum that section 22 (k) be amended to provide that payments for support of the wife under a private separation agreement be given the same treatment as alimony, provided the parties do not file a joint return.

Income splitting

Historical note: Since the Revenue Act of 1948, married couples are allowed to split their combined incomes in computing their tax liability. (Sec. 12 (d) of the Internal Revenue Code.) Section 301, Revenue Act of 1951, extended some of the benefit of income splitting to heads of households by giving them approximately one-half of the benefit received by married couples from full income splitting. (Sec. 12 (c).) The "head of a household" is defined by the statute as being, in general, a formerly married, but now unmarried, person who maintains a household consisting of himself, children, stepchildren, and grandchildren. The splitting of income is the solution provided by the code for the serious discrimination which formerly obtained between spouses of community-property States and those of the common-law States. After several abortive efforts to take away the tax benefit from the division of income between spouses in the community-property States, the problem was successfully approached from the standpoint of granting to common-law States substantially the same income-tax advantages enjoyed by the community-property States. This may afford a good object lesson in any attempts to iron out the inequalities in the code. Take no unfair advantage away from anybody; but extend it to everybody.

(The heads of households and certain unmarried persons who cannot qualify as such, but who have a serious burden in caring for relatives claim they are being discriminated against.)

Hearings, June 23, 1953: One witness bemoaned the fact that no benefit whatever was received from the income-splitting provisions by married couples subject only to the minimum rate of tax. (With equal force it could be said that no benefit whatever was received from sec. 12 (d) by married couples in the community-property States who fell in the highest surtax brackets.) The witness sought to correct the alleged inequality by granting a special personal exemption of $300 to heads of households in all categories, and to married couples whose adjusted gross income is less than $5,000.

The purpose of income splitting was not to reduce the tax rates but to level off the serious discrimination which obtained for so long between the community-property States and the common-law States. If everybody were taxed at one constant rate, income

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splitting would not have been necessary and the community-property States would not have enjoyed any advantage over the taxpayers in the other States. It was the progressive surtax rates on combined income of spouses which brought about the disparity. The splitting of income did not change the rates of taxation but to the extent above placed all spouses on a community-property basis. Under the proposal, the upper bracket spouses in the community-property States could also claim some special benefit from section 12 (d). If the lower income groups are entitled to relief from income taxation, it should be accomplished by a change in the minimum rate or in the exemptions. Since all married couples subject to the minimum rate have always, in effect, had the benefit of splitting income, there is no occasion to do more on that score.

It was also contended that the splitting of income created an inequality as between married couples on the one hand, and heads of households and single persons on the other. This was the occasion in the 1951 act for giving the head of a household about half of the advantage enjoyed by spouses. It was accomplished by a change in the rates for surtax. Historically speaking, the income-splitting provisions have their origin in the marital status of the civil law. Naturally the attributes of the marital status under civil law have no application to unmarried heads of households or single persons generally. In the community-property States, where spouses have always been able under Federal income taxation to divide their incomes, no great movement arose to grant similar benefits to the heads of households and single persons within those States. Now that the community-property system, as regards Federal income taxation, has been extended to the entire country, it is not clear to this writer just how far Congress should go in respect of unmarried persons. The problem does not exist so long as surtax net income is not over $2,000, and does not become serious until the unsplit surtax net income steps into the progressive rates. At least one solution is available to the taxpayer—get married. That's what the other fellow did.

Averaging of income

Historical note: The refusal of the Government to prorate the gain on capital transactions over the period of time in which the asset was held proved to be as costly as it was inequitable. To subject to the ordinary surtax rates the gain realized in the year of sale but which had been accruing over a period of years, was pretty rough. The result contributed in no small measure to the alternate method of taxing capital gains, first adopted by section 206 of the Revenue Act of 1921. A somewhat analogous situation was presented by compensation received for personal services rendered over a protracted period of time. That situation was recognized by section 220 of the Revenue Act of 1939, which added a new section 107 to the Code. By section 107, under certain circumstances, the compensation is prorated over the prior years in which the services were rendered so that a computation at the rates applicable for those years may be made, and the aggregate tax so computed becomes the maximum tax in the year of receipt. This method of proration has been extended to the gain derived by the taxpayer from a particular artistic work or invention by him; and, also, to certain kinds of back pay. The foregoing relief is probably inadequate in that it does not provide for lump-sum payments made at infrequent intervals on continuing as distinguished from completed projects; nor does it take into account lump-sum payments received as cumulative dividends and delinquent interest.

Hearings, July 8, 1953: At the hearings there was considerable agitation for different methods of averaging and for covering a wider front. One proposal was to reduce the period during which personal services must be rendered from 36 to 13 calendar months and, also, permit the exclusion of taxable periods during which a small percent of the total services are rendered. H. R. 6126 has been introduced along such lines.

Another proposal would permit lifetime averaging of income by all individuals. It recommends a moving average base for the averaging of taxable income. It is claimed that this method will improve the tax structure (1) by removing the repressive effect of imposing the tax on the annual income as if each year stood by itself unrelated to any other year, and (2) by equalizing the tax burden among individuals who earn the same amount of income over the same extended period of time.

Various other methods of averaging were suggested to find the income for the taxable year, each with its distinctive features. The Associated Actors and Artistes of America recommended an amendment to the Code which would allow the averaging of irregular and fluctuating income. It presented three methods for so doing, with a preference expressed for the simple averaging method. This method contemplates that, at the end of a given period, the taxpayer shall be entitled by proper election to a credit against the tax otherwise due for the current year, measured by the excess of taxes actually paid for the averaging period over the taxes that would have been paid for such period, had the income in each year of the period been the average of his entire income for all years within the period.

The Chamber of Commerce of the United States made a strong justification for extending the principle of section 107 to all types of fluctuating income, including interest, rents, dividends, royalties, bonuses, etc., applicable to two or more years, or attributable to subsequent years. They point out that the business operating loss carryback and carryover provisions (section 122) constitute a limited and incomplete recognition of the need for a more comprehensive income averaging device. The injection of the accountant's concept of deferred income, that is, income received in the current year but attributable under accepted principles of accounting to subsequent years, is a unique contribution to this subject. The chamber also points out that a great deal of the necessity for an averaging device is due to the highly progressive rates of surtax. The best cure for the problem would be to attack the high rates.

The incentive motive as a guiding principle was also injected into this topic. Of course incentive can be raised in every detail of taxation. One witness recommended that the Federal Government offer all taxpayers a rate cut as a business incentive, to the extent that their annual earnings exceed their moving average earnings of their last 4 years. Another witness recommended as a method of incentive taxation that any employer of labor, collecting and reporting withholding taxes, may deduct from its taxable income varying amounts per worker per fiscal year, provided such amounts were reinvested in capital assets during the taxable year. Were some such provision adopted, it might also be regarded as an indirect reimbursement for all the tax collection activities to which the employers of labor are subjected.

The American Newspaper Guild recommended an amendment to section 107 (d) (2), relating to back pay, in order that severance dismissal pay, such as is provided for by American Newspaper Guild contracts, may be allocated to taxable years in which the income may be assumed to have been earned.

Earned income credit

Historical note: The underlying theory of income taxation is to place the burden of tax upon ability to pay. It would seem that, dollar for dollar, unearned income is as able to pay income taxes as earned income. Particularly, since the enactment of section 206 of the Revenue Act of 1921, giving special treatment to gains from capital transactions, the taxpayer who earns his income by the sweat of his brow or other personal services, is at a disadvantage.[7]

The first provision attempting to compensate for the unfavorable position of the taxpayer who earns his income was section 209 of the Revenue Act of 1924. It took the form of a credit of 25 percent against the tax on earned net income (not in excess of $10,000). The principle of the credit was continued in the 1926 and 1928 acts. It was eliminated in the 1932 act; but restored by the 1934 act in a limited way.[8] It was then continued in every act until repealed by section 107 (a) of the Revenue Act of 1943.

Hearings, July 9, 1953: There was very little interest shown in the hearings over this topic. This was in sharp contrast with the fine presentations made where the topic was of vital interest to well-organized businesses and professions.

The National Association of Manufacturers submitted an adverse statement on the subject. They pointed out that the major income-tax problems stem from the high rates and especially the steep progressivity of the structure. An earned income credit would not benefit retired persons, and others dependent upon income from pensions and investments. It would further complicate the tax laws and constitute a dangerous precedent to introduce gimmicks in the law which tend to divert attention from the basic problem. The association strongly recommended that excessive income taxation be dealt with directly, and not circumvented by special relief provisions for various classes of taxpayers which would have the effect of perpetuating the high-rate policy.

A lawyer in private practice submitted a statement which pointed out that one of the most significant social changes brought about by our present rates of taxation is that it has become virtually impossible for a person to accumulate out of earned income a substantial reserve for his old age, or an estate of sufficient size to support his widow or other dependents. He maintained that the Government should never take more than half of a taxpayer's earned income. He recommended a 50-percent maximum limitation on earned income, and a reasonable earned income credit for taxpayers below the 50-percent average tax rate. Under present conditions, the writer agrees with that approach to the existing inequity.

The United States Chamber of Commerce took the position that there should be a reasonable differentiation between earned income and other income. Therefore, consideration should be given to the development and allowance of "a substantial credit for earned income."

Time and manner of filing returns, and declarations for individuals

Historical note: The filing of returns of income has always been a required feature of Federal income taxation, beginning with the Civil War Acts. In fact, most all taxes except those paid by stamps require periodic returns. In the act of August 5, 1909 (sec. 38, 3d), and the act of October 3, 1913 (sec. II D and G (c)), the due date of the return was March 1 of the following year. Such date was changed by the Revenue Act of 1918 to "the 15th day of the 3d month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of March." (Sec. 227 (a) and sec. 241 (a) of the Revenue Act of 1918.) Since that time (1919), the regular filing date on the final income returns for both individuals and corporations has not been

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in the form of a contract with an insurance company or on a self-insurance basis satisfactory to State authorities. As explained above, I. T. 4107, modifying several prior rulings, has ruled that certain types of self-insured plans, although meeting the requirements under State laws, do not constitute plans of insurance within the meaning of code section 22 (b) (5).

Under these circumstances, a practicing attorney recommended that the code be amended to exclude from the employee's gross income disability benefits paid under self-insured private plans whether or not the employer is insured. The same party recommended that the code be amended to allow a deduction under section 126 (c) with respect both to installment payments and to lump-sum payments to beneficiaries of deceased members of employee retirement plans, if such payments are not made under joint and survivors' annuities described in section 113 (a) (5).

Three percent annuity rule

Historical note: The 3 percent annuity rule first appeared in section 22 (b) (2) of the Revenue Act of 1934. (See 1939-1 (pt. 2) CB 569, at pp. 604 and 628 (amendment No. 14).) It continues at code section 22 (b) (2). The 3-percent rule is not too important to retired Government annuitants since owing to their relatively small contribution their cost is recovered ordinarily in somewhat over 2 years. To a person who has acquired his annuity on less favorable terms, or by purchase from an insurance company, the rule may take on some importance. The result is that many annuitants are never able to recapture their outlay tax free, while others, through such recapture, incur a sharp rise in taxable income in the year following that in which the total cost has been recovered.

Hearings, July 14, 1953: The section of taxation of the American Bar Association proposed an amendment substituting a constant yearly exclusion for the life of the annuitant, based on his life expectancy. This is the same method contained in the Reed-Camp bill. That bill also contained provisions relating to annuities in discharge of alimony; amounts received other than annuity payments; and annuities having a refund feature.

The American Life Convention and other witnesses submitted a proposal for annuity taxation which involved changing the 3-percent factor to a 1¼-percent factor to determine the interest element in annuities, and the application of this factor continuously throughout the life of the annuity rather than terminating it upon the recovery of the capital investment.

The National Association of Life Underwriters earnestly recommended a return to the pre-1934 method of taxing annuity income, under which an annuitant would be permitted to recover, tax-free, the purchase price that he has paid for the annuity and, thereafter, be required to report all annuity as taxable income. The association favored as a strong second choice the method advanced by the American Life Convention.

Stock options and deferred compensation plans

Historical note (stock options): The proper treatment of employee stock options has always been uncertain.[10] Section 218 of the Revenue Act of 1950, added a new section (130A) to the Code, in respect to restricted employee stock options. (1950-2 CB 586-587; code sec. 130A.) A "restricted stock option" means an option granted after February 26, 1945 (the date of the Supreme Court's decision in the Smith case), to an individual for any reason connected with his employment by a corporation to purchase its stock if: (a) The option price is at least 85 percent of fair market value of the stock when the option is granted; (b) the option is not transferable inter vivos; and (c) at the time the option is granted, the employee does not own, directly or indirectly, more than 10 percent of the optionor's voting stock. Where the employee exercises a restricted stock option after 1949, and no disposition is made of the stock within 2 years from the date of granting the option nor within 6 months after the transfer of such stock to him, then (1) no income shall result at the time of acquisition of the stock upon the exercise of the option, (2) no deduction under section 23 (a) shall be allowed the corporation, and (3) no amount other than the option price shall be considered as received by the optionor; provided, the optionee, at the time he exercises the restricted stock option, is an employee of the optionor, or the option is exercised by him within 3 months after he ceases to be such employee.

Hearings, July 14, 1953: H. R. 4311 has been introduced to amend Code section 112 so that the gain shall not be recognized to the corporate employer upon a sale of treasury stock to an employee pursuant to a restricted stock option plan as defined in section 130A (d) (2) and (3). A director of the Wilcox Oil Co. urged favorable action on this bill.

An official of the American Telephone and Telegraph Company recommended that the tax position of capital-raising employee's stock purchase plans as opposed to incentive option plans for top management be clearly set forth in the law. He suggested adding a provisions to the code which would deal expressly with the capital-raising type of plan. The provision would exclude from gross income the entire differential between purchase price and market value of stock when issued to employees under the plan, even though such differential is in compensation. This would permit the reasonable underpricing of the stock required to induce employee participation, without fear of tax complications. Of course, the cost basis of the stock presumably for all purposes, would be the price paid by the employee.

Another recommendation was made which would permit employee's stock options granted prior to the 1950 act to be modified to prohibit their assignment without being treated as new options under section 130A (e). The full effect of such an amendment is not clear, but no objection is seen where the option can qualify under the other provisions of section 130A.

Historical note (deferred compensation plans): This subject includes employees' annuities, pension and profit-sharing plans. (Code secs. 23 (p), 165 and 22 (b).)

Code section 165 had humble origins. It began as section 219 (f) of the Revenue Act of 1921, a new subdivision providing that an irrevocable trust created by an employer as a part of a stock bonus or profit-sharing plan shall not be taxable, but that the amounts actually distributed to any employee shall be taxable to him when distributed, to the extent that they exceed the contributions made by him. (1939-1 (pt. 2) CB 192, at p. 218.) The pension concept was added to the exemption status by the 1926 act. It was renumbered to section 165 by the 1928 act. In the 1942 act, it underwent a major overhauling and enlargement, which with certain amendments represents its form today. (Code sec. 165.)

Section 165 establishes the exempt status of the trust. Section 23 (p) allows a deduction to the contributing employer. It began as section 23 (q) of the 1928 act which allowed the employer reasonable amounts in addition to the contribution needed to cover the pension liability accruing during the taxable year. The subsection was later relettered as section 23 (p), and as such, it was enlarged by the 1942 act to substantially its present form. (Code section 23 (p).)

Section 22 (b) contains the provisions respecting the taxation of annuities and the exclusions from income of death benefits to the employee's estate or beneficiaries.

The foregoing provisions contain the broad outlines of the system for tax treatment of employees' annuities, pension, and profit-sharing plans. The system now goes much further than any exact correlation of deductions and income receipts could reconcile. Business and social policy have entered into their formation. The applicable provisions are already so complicated that the complete explanation of detailed recommendations to change inequities, imaginary or real, is beyond the necessary limits of this survey. (See discussion in the joint committee's preliminary digest of suggestions, dated Apr. 21, 1953, pp. 35-40.) A number of proposed amendments will be briefly mentioned.

Hearings, July 15, 1953: Considerable interest was shown in this topic and numerous amendments were proposed, largely of a technical nature.

The section of taxation of the American Bar Association made four recommendations all of which were contained in the Reed-Camp bills introduced in the 2d session of the 82d Congress. They are:

1. The exclusion from gross income of the amounts paid by employers for life insurance protection plans created for the benefit of employees.

2. Employers on the accrual basis should be allowed 75 days, instead of 60 days, within which to make contributions to trusts for their employees—amend section 23 (p) (1) (E) accordingly.

3. Payments to union welfare funds created under the Taft-Hartley Act should be deductible under section 23 (a), whether or not they qualify as deductions under section 23 (p).

4. Provide capital-gains treatment for lump-sum payments received by employees or their beneficiaries from an employee's trust or from employee's annuities in connection with nontrusted plans—amend section 22 (b) (2) (B).

All of these recommendations were also urged by one or more other witnesses.

It was believed desirable by one party to extend the coverage of such plans to individuals who are not employees under the strict common law concept or within the statutory definition. He suggested that the definition of "employee" set forth in code section 3797 (a) (20) be amended to include all persons who perform services for a life insurance company as commission salesmen. It would be interesting to consider this suggestion from the standpoint of commission salesmen generally. Another witness recommended code amendments which would give an employer seeking to establish a pension plan greater time within which to obtain an advance ruling on the qualification of the plan under section 165 (a); also, clarify section 165 (a) (4) as to the extent to which contributions or benefits under a plan may be provided for shareholder employees.

Techniques for alleviating double taxation of dividends

Historical note: Beginning with the 1913 act, dividends were included in the statutory definition of income. (See II B of the act of October 3, 1913.) In recognition of the unfairness of the double taxation involved by including dividends in the shareholder's income, the 1913 act allowed as a deduction in computing net income for the purpose of the normal tax (sec. II B, seventh):

"The amount received as dividends upon the stock or from the net earnings of any corporation, joint stock company, association, or insurance company which is taxable upon its net income as hereinafter provided."

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In the 1916 act, the relief took the form of the allowance of a credit for normal tax purposes only. (Sec. 5 (b).)

In the Revenue Act of 1918, the relief continued to take the form of a credit for normal tax only, imposed upon individuals. (Sec. 216 (a).) In the 1918 act, corporations secured relief by way of a deduction in computing net income. (Sec. 234 (a) (6).) The 1928 act made it clear that all section 25 credits to individuals, including the dividend credit, were "against the net income." Thus the matter stood until the Revenue Act of 1936, when the relief was withdrawn completely as to individuals and reduced to 85 percent of the dividends in the case of corporations. That is the position today. (Code secs. 25 and 26 (b) (1).) Several bills are pending on the subject.

Hearings, July 16, 1953: There is a great amount of literature on this topic and from the number and character of those who testified, or submitted statements for the record, it is regarded as a major problem. Everybody was against the so-called double taxation of dividend income. The National Association of Manufacturers pointed out that aside from the discrimination against stockholders, the most serious aspect of the taxation of corporate profits which are disbursed as dividends is the bias created in favor of debt financing. If a corporation borrows at 4 percent, and has a 6 percent dividend rate, it requires three times as much gross to service new stock as it would in the case of a debt. This is doubtless one of the reasons why net new corporate stock issues during the period 1946–51 averaged only $1.6 billion a year, while new corporate borrowing averaged $11 billion a year. If that trend continues, this writer suspects that Congress will restrict the corporate deduction for interest on indebtedness, as it once did. See sec. 12 (a) (Third) of the Revenue Act of 1916.)

All interest on indebtedness is now deductible, with a limitation not here important. The trend to debt financing may have led an accountant witness to suggest that corporations be allowed to deduct dividends paid in determining their taxable income. By contrast, another witness would cure the double taxation of dividends by elimination of the second tax on noncorporate stockholders.

Many other suggestions were made to alleviate the tax pain on the stockholder. In apparent recognition of the fiscal necessities of the Government, most of the recommendations went at it by stages. Several witnesses urged lifting the corporate credit from 85 percent to 100 percent of the dividends received from domestic corporations. As to individual stockholders, the usual remedy took the form of a credit, although it was not always clear whether the witness meant a credit against tax or against net income.

Several stock exchanges were represented, the general approach being to allow as a first step a 10-percent credit against tax, that is, a credit against tax of 10 percent of the amount of dividends received. In other words, an investor with $500 of dividends would compute his tax exactly as he now does and then deduct 10 percent of $500, or $50, from the tax. This would amount to taxing dividend income at 10 points less. As soon as the Federal budget permits, a second step could increase the credit to the percentage representing the lowest combined normal and surtax bracket, presently 22.2 percent. A variation of this method would allow as a deduction from gross income a minimum amount of say $200, with an option in the taxpayer to take the percentage credit or the dollar deduction. The amount of the percentage credit varied as between witnesses.

To this writer, the best rounded-out recommendation came from a practicing attorney, as follows:

"Recommendation: Give stockholders other than corporations a credit against income tax equal to 20 percent of dividends received from domestic corporations. Such a credit should not exceed the amount of the tax imposed before allowance of the credit and it should not be allowed with respect to dividends from section 251 corporations or China Trade Act corporations. No credit should be allowed with respect to capital-gain dividends received from regulated investment companies. If the credit is allowed to nonresident aliens, it should not exceed the tax rate on their dividend income. The credit with respect to dividends received by an estate or trust should be allocated between the fiduciary and the beneficiary on a basis similar to that provided in section 163 (b) of the Internal Revenue Code with respect to partially tax-exempt interest."

Accounting principles

Historical note: This is one of the most elusive subjects in the entire field of Federal income taxation. The lawyer and the judge think in terms of equal protection of the laws. The law shall apply to all alike and have the same meaning for everybody. The accountant thinks in terms of reflection of income for a specific business. His approach is more flexible. A method of accounting may be satisfactory for one business but not for another. The same busines may change from one method to another as new management desires or new accountants advise. This explains the recurring attempts of the accounting profession to have the tax statutes recognize, without question, the net income statement of a certified public accountant as being in conformity with sound accounting principles. To a lawyer, that is like saying that the professional opinion of a member of the bar shall be accepted by the revenue authorities without question as to the state of the law. By legal standards, such an opinion may serve as an exposition of the law of a foreign jurisdiction, but not as authoritative on the law of this country. To apply the same code differently depending upon the broad limits of "generally accepted accounting principles" is to have different codes for different taxpayers.

Since the 1916 act, there has been a statutory provision in respect of the basis of keeping accounts. (Sec. 8 (g) of the Revenue Act of 1916.) Even at that time, there was a caveat that the taxpayer's method must clearly reflect his income. A clarification of the provision occurred in Section 212 (b) of the Revenue Act of 1918, and has continued to this date. Code section 41 reads:

"General rule: The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income."

As we see, the code does say, in part, that net income shall be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer. However, those who seek to open wide the floodgates for accounting convenience fail to note that setion 41 also states that, when the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. The decision as to whether a particular method of accounting does or does not clearly reflect the income is left to the administrative authorities with appeal to the courts. The certified public accountant thinks that should be his prerogative.

Hearings, July 21, 1953: The National Association of Manufacturers think that existing revenue practices are needlessly arbitrary in their invasion of managerial prerogatives and interference with sound business practices. They contend that where management is following accepted standard accounting procedures, modified consistently in some cases to reflect the taxpayer's own operating experience, the results should be conclusive as to the taxpayer's net income. In my opinion, that philosophy of tax administration is unsound. Getting down to cases, however, the association gave several specific examples where they seem to be on solid ground.

Under the elusive topic of "accounting principles," several witnesses advocated changes at complete variance with the present state of the law as to what constitutes income. For some reason, under this subject, several witnesses urged a change in the basis of depreciation which amounts in effect to a kind of percentage depreciation. Most of such witnesses recognized that the Code itself would have to be amended, althought they relied heavily upon sound accounting practice in justification for their stand.

This writer has always regarded discovery depletion and percentage depletion of minerals as a tax subsidy, not based on legal principles of income derivation. The Treasury Department has attempted on several occasions to eliminate or curtail those provisions in the statute. That approach is futile. With oil, gas and minerals, in general, setting the pace, it is curious that commerce and industry has not launched a drive for percentage depreciation, or its equivalent. One witness so did, using impressive terminology. He urged an amendment to the Code to permit a realistic and equitable computation of the cost of plant consumed. He recommended the use of an authoritative price index as a means of converting the recorded cost of varying dollars into a homogeneous deduction for tax purposes. Although suggesting the Consumers Price Index, he recognized that the Government should prescribe the indices to be used in converting recorded plant costs into allowable depreciation deductions.

Several other witnesses urged changes in the tempo of capital recovery under existing law, but the most significant contribution was the concept that the depreciation base should be adjusted from time to time to reflect changes in the purchasing power of the dollar. This method would occasion annual changes in the basis for capital recovery, measured by fluctuations in the price indices. It revives memories of the valuation problems as of March 1, 1913, and under the early revenue acts. The problem of fully depreciated assets still in use will be difficult. Perhaps the percentage depletion method with which the Revenue Service has had experience, would offer the best solution.

To a lawyer one of the most intriguing principles of income taxation is the accountant's concept of deferred income. The legal authorities are almost unanimous in saying that you cannot derive gross income after the date of receipt. You may accrue it before receipt when it becomes a fixed liability, but when received, that is the end of it. (*Automobile Underwriters, Inc.* (CCH Dec. 6088, 19 BTA 1160 (1930)); G. C. M. 20021 1938–1 CB 157; I. T. 3496, 1941–2 CB 107); *Your Health Club, Inc.* (CCH Dec. 14, 250, 4 TC 385 (1944)); Montgomery, Federal Taxes (1949–50), vol. II, pp. 354–356.) A fine technical brief was submitted urging that the code be amended to provide that

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amounts received for the servicing of television receivers and apparatus over a period of time be considered taxable income over the same period of time. It was argued that the reporting of taxable income would then match with the expenses incurred, and would reflect true economic income.

The representative of the American Institute of Accountants testified in favor of the same basic idea but in different words. He advanced the philosophy that sections 41, 42, and 43 of the code should be cross-referenced and keyed to section 22 (a), having to do with gross income, and to section 23, having to do with deductions. The Federal Tax Forum, Inc., would accomplish the same objective by a general amendment of section 42, with specific amendments providing that a successor corporation in a tax-free reorganization should step into the "tax shoes" of the predecessor corporation for all tax purposes.

LIFO inventory accounting

Historical note: The first statutory provision dealing specifically with inventories was section 203 of the Revenue Act of 1918. It has continued in almost identical language to this date. (Code sec. 22 (c).) The original regulations 45, promulgated April 16, 1919, provided that, in order to reflect the net income correctly, inventories at the beginning and end of each year were necessary in every case in which the production, purchase, or sale of merchandise was an income-producing factor. The regulations were based largely upon regulations 33, promulgated under the 1916 act. At that time, the two bases recognized for the valuation of inventories were cost, or cost or market, whichever was lower. (Where inventories are kept at cost, the effect is the same as computing the gain or loss on the sale of each item of merchandise on the basis of cost.) To a limited extent an average cost method was recognized. (See A. R. R. 18, 2 CB 50.) (Where inventories are kept on the basis of cost or market, whichever is lower, the effect is to allow a reduction in gross income of the unrealized shrinkage in value of goods on hand at the end of the year.) Article 1586 of regulations 45 (1920 edition) permitted livestock raisers and other farmers to value inventories by the "farm-price method," which provided for a valuation at market price less cost of marketing. Article 1585 of regulations 62, approved February 15, 1922, permitted dealers in securities a third method of inventory pricing, namely, market value. (To value inventories at market, is to report gain or loss on the fluctuations in market value of goods on hand in the closing inventory.) A similar result is involved in the farm-price method. The "retail method" of pricing inventories, authorized by article 1588, regulations 62, is an approximate cost method. The special method granted miners and manufacturers is an allocated cost basis of pricing inventories.

In finding cost for inventory purposes, taxpayers must use the actual cost of the particular goods in inventory, when such costs can be identified, or the latest purchase invoices when identification is not possible. The use of latest invoices has the practical result of putting inventory costs on a "first-in, first-out" basis, which, in general, has been required to the exclusion of average cost. Certain industries which carry large inventories subject to wide price fluctuations, long desired to use the "last-in, first-out" method (LIFO) of determining cost, since that method tends to prevent inflated profits in a rising commodity market, with the inevitable losses when prices turn downward. The Treasury declined to amend the regulations to accommodate such industries. The 1938 act permitted a limited use of LIFO to producers and processors of nonferrous metals and to tanners. (Code sec. 22 (d).) Finally, the 1939 act amended code section 22 (d) to permit all taxpayers using inventories to elect to use a prescribed LIFO cost for the valuation of all or part of their inventories, subject to the Commissioner's approval. The LIFO method is a substituted cost method, which uses the highest recent cost to compute profits, irrespective of which goods are sold, and keeps the low costs in inventory. The rationalization of LIFO cost is that it provides a means through which the increased cost of carrying the same required inventory investment, due to price rises, would not be considered business profits. Of course, they are business profits under the closed and completed transaction principle of income derivation. This writer admits that LIFO cost and the so-called involuntary liquidation and replacement provisions of section 22 (d) (6) are a departure from the closed and completed transaction principle of income derivation. Nevertheless, in a nation noted for its booms and its busts, it is good policy to narrow in some way the drastic income and loss effects of those extremes. When the drop in price level occurs, the losses are then computed with reference to sales of the lowest cost merchandise and inventory is replenished in a falling market.

The LIFO taxpayers soon found themselves in a jam. They had used the years 1939, 1940, and 1941 to work out their mounting high-cost goods. So, on the outbreak of World War II (not to mention the Korean war), they found themselves liquidating their original low-cost inventories at mounting prices with serious economic and governmental restrictions on the ability to replace at any cost. They ran to Congress for relief and got it. (Sec. 119 of the Revenue Act of 1942; Senate Finance Committee report, p. 82; sec. 110 of the Revenue Act of 1943; Public Law 756, 81st Cong.; sec. 306 of the Revenue Act of 1951; Montgomery, Federal Taxes (1949-50), vol. II, pp. 404-461.)

Although practically all of the inventory provisions are in theoretical conflict with the legal principles of income derivation, the writer defends them as a means of smoothing out the fiscal extremes to which this country seems addicted. Judging from some of the difficulties in administering the involuntary liquidation provisions, the objective might have been better accomplished by an income averaging device over a period of years.

Hearings, July 21, 1953: The substituted cost of LIFO is beneficial, taxwise, in a rising market; but, on a receding market which falls below the LIFO cost, LIFO loses its tax glamour. Apparently some business men are concerned lest the price level fall below their LIFO cost. Numerous witnesses testified in favor of permitting LIFO taxpayers to elect to inventory at cost or market, whichever is lower. It is presumed they mean to use the basis of LIFO cost or market, whichever is lower. This would combine the tax advantages of both systems. In an inflationary market, it would reduce income and stabilize inventory replacement; in a receding market, it would minimize losses and also permit the reduction in income of unrealized depreciation in inventory below the cost under LIFO.

One of the witnesses favoring LIFO cost or market, whichever is lower, went a step further. In order to remedy an injustice done to taxpayers who might have elected to use LIFO in the past, "but who were dissuaded from doing so by the advice of the Bureau of Internal Revenue," it was proposed to permit them now to elect LIFO cost or market, whichever is lower.

One witness made a lengthly statement in defense of LIFO as a management control tool. He contended that it is erroneous to look upon LIFO as a tax deferment device. The normal operations of business cycles can induce involuntary liquidation during peacetime, which produces extraneous charges or credits to income which tend to mitigate against the effective use of LIFO as a management control mechanism. He recommended that the code be amended to enlarge the present definition and treatment of "involuntary liquidation." (Section 22 (d) (6) (B).)

Another recommendation would amend section 22 (d) (6) (A) to provide for the payment of interest on refunds arising from adjustments occasioned by replacement of involuntary liquidations. It was also urged that the time within which replacements could be made of World War II liquidations of LIFO inventories be extended from January 1, 1953 to January 1, 1956, so that the time for replacement of World War II and Korean liquidations would expire at the same time.

Depreciation and amortization

Historical note (depreciation): Although there is respectable authority to the effect that the depreciation deduction is entirely a matter of legislative grace, the revenue acts have always treated it as a deduction from gross income in arriving at taxable net income. In the Corporation Excise Tax Act of 1909, and the regulations thereunder, the depreciation deduction was regarded as a type of loss. (Sec. 38 Second (secod).) The 1909 regulations provided that "This estimate should be formed upon the assumed life of the property, its cost value, and its use." Beginning with the Revenue Act of 1913, depreciation has been granted the dignity of a separate deduction. (Sec. II B (sixth) and sec. II G (b) (second).) By article 161 of original regulations 45, promulgated under the Revenue Act of 1918, the stated purpose of the allowance was to provide an amount which, with salvage value at the end of its useful life, would provide, in place of the property, its cost, or its value, as of March 1, 1913, if acquired by the taxpayer before that date. Prior to the Revenue Act of 1921, the statute did not specify the basis for the depreciation allowance. After the Frierson concession and the Supreme Court's decision in *Goodrich* v. *Edwards*,[11] the 1921 act attempted to remove all doubt about the matter, and, where the property was acquired prior to March 1, 1913, based the allowance upon fair market value as of that date; otherwise, the allowance would be based upon cost. (Sec. 214 (a) (8) and sec. 234 (a) (7).) In that respect, the statute has remained unchanged to this day. (Code sec. 114.)

In the purchase and sale of property, the cost must be recovered in arriving at gross income.[12] In keeping with the principle that deductions per se are a matter of legislative grace, the regulations, until recently, expressly provided that depreciation was not to be regarded as a part of the cost of goods sold. This was recently changed by T. D. 6028, promulgated July 6, 1953, 1953-16 IRB 3. Revenue Ruling 141, 1953-16 IRB 5. Even so, the allowance itself is still based upon cost, or adjusted cost. The new policy of revenue in respect of depreciation adjustments is set forth in Revenue Rulings 90 and 91, 1953-11 IRB 4-5.

Hearings, July 22 and 23, 1953: There was probably more activity concerning depreciation and amortization than any other topic except excise-tax rates. To read the oral testimony and statements submitted is to take a course in economics. The American Federation of Labor opposed most of the reforms suggested by industry. The testimony at the hearings unfolded in two directions: first, more liberal deductions under the existing conception of the depreciation allowance; and, second, an elective departure from investment cost as the basis for the allowance and the injection into the subject of replacement cost, or other

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standards, as an optional method. Taking them up in order:

1. A private practitioner observed that, in an expanding economy, a business must be able to recover the current high cost of investment out of current earnings. Today, rising prices have resulted in replacement costs far in excess of depreciation reserves. The tax policy in respect of depreciation should stand on the basic principle that the purpose of the allowance is to permit the tax-free recovery of the cost of investments. This is the orthodox conception of depreciation for tax purposes. He, therefore, recommended (1) that taxpayers be permitted, at their election, to deduct 50 percent of expenditures for depreciable property either in the year made or over a 5-year period, with the remaining 50 percent subject to the ordinary depreciation deduction; and (2) that depreciation, whether allowed or allowable, should not reduce basis unless it resulted in a tax benefit. (See Code sec. 113 (b) (1) (B) and (d), as amended by sec. 102 of the Technical Changes Act of 1953.)

The representative of the National Machine Tool Builders Association proposed a system of optional depreciation for durable productive equipment acquired after December 31, 1952. The taxpayer would have the election to write off all or any part of the cost of new equipment in the year acquired and placed in operation, the balance to be written off in a manner designated by the taxpayer.

The Association of American Railroads recommended annual depreciation, at a new rate up to a maximum of 20 percent, with respect to depreciable property acquired after December 31, 1953, until cost less the estimated salvage had been charged off. The maximum 20 percent limitation would not apply where the useful life of the property was less than 5 years; but the deductions would, in no event, exceed cost less salvage value upon retirement. It should be noted that rapid recovery of invested cost is only a palliative in an inflationary period.

Other witnesses urged various methods of accelerating cost recovery, without abandoning the present cost basis for the allowance. In general, the taxpayer would be permitted to determine the life of the asset and the manner of cost recovery. H. R. 2128 would allow depreciation to be taken on a private home. H. R. 2720 would provide for accelerated depreciation of devices, buildings, machinery and equipment for the collection at the source of atmospheric pollutants and contaminants, based on a period of 60 months. There are other similar bills. There were many statements urging relief on that and allied grounds. The smog problem and pollution abatement are getting into the act.

2. The most exciting testimony was in connection with the replacement-cost theory of depreciation. To compute depreciation on the basis of changes in price level is the same as allowing full amortization of the present economic value of capital investment. The changes in price level determine the present economic value, or the fair market value, of an asset. We hope its advocates do not mean to base the allowance on the average daily price index for each day of the year. The representatives of certain public utilities recommended that, where the regulatory body determines in its rate-making process that the tax depreciation is inadequate, and that a larger amount is necessary to keep intact the service capacity of the plant, then the public utility, at its election, may deduct for tax purposes the additional amount of depreciation, so determined by the regulatory body. To this writer, it all adds up to the same thing. It is an elective abandonment of the cost recovery basis for the depreciation allowance. In all fairness, however, it must be conceded that these unorthodox theories for computing the depreciation allowance are as sound, or more so, than the triumphant argument for discovery value and percentage depletion of natural resources. (Code secs. 114 (b) (2) (3) and (4) and 117 (k) (1).) The "gross income from the property," whether we regard the price in the immediate vicinity of a well, or the selling price of extracted and treated ores, is substantially the same as the economic value or replacement cost at the time, of depreciated assets exhausted in business during the taxable year. It all represents a departure from the theory of recovery of investment cost. It would seem that industry and public utilities have as much justification in pressing their claim as anyone else. Under present conditions, they labor under a gross discrimination when compared with the tax position of natural resources. To smooth out the existing discrimination, all industrial and commercial businesses should be granted a depreciation allowance measured by the full economic or service value of all plant consumed.

One witness stated that the principle of removing inequities in the computation of depreciation, resulting from varying price levels, is not new. It is recognized, he asserted, by the use of March 1, 1913 value of all plant constructed prior to that date. Of course, that is a complete misconception of the significance of the March 1, 1913 valuation date. It had nothing to do with price levels as such.

The 16th amendment is a comparative newcomer to the United States Constitution. It was proclaimed adopted on February 25, 1913. The first enabling act under the new amendment was the act of October 3, 1913, which selected the date of March 1, 1913 as a convenient time for its effect. After the Frierson concession and the decision in *Goodrich* v. *Edwards*, above, the 1921 act based depreciation upon fair market value as of March 1, 1913. (Sec. 214 (a) (8) of the Revenue Act of 1921.) Only constitutional law and statutory construction are responsible for the March 1, 1913, valuation date.

Historical note (amortization): Amortization provides for exhaustion by the efflux of time. The terminology is applicable to bonds sold at a premium or at a discount. (See art. 544 of Regulations 45 (1920 edition); code sec. 125.) In income taxation, the word is generally associated with the rapid recovery of capital expenditures made for facilities necessitated by virtue of war emergency. (Sec. 124 (a) (9), and sec. 234 (a) (8), Revenue Acts of 1918 and 1921.) The rearmament program preceding World War II brought forth a new code section 124 dealing with the amortization of the adjusted basis of any "emergency facility," based on a period of 60 months, or a shorter period if the emergency sooner terminated. (Title III of the Second Revenue Act of 1940.) With amendments, section 124 still remains in the code. By section 216 of the Revenue Act of 1950, a new section 124A was added to the code, providing for a special, 60-month amortization period for certified properties, acquired or completed after December 31, 1949, in lieu of regular depreciation. Section 124A is generally similar to section 124 which was enacted for World War II purposes.

Hearings, July 22, 1953: H. R. 421 purports to allow relief to small businessmen by permitting a taxpayer, who has not heretofore elected to take an amortization deduction under section 124, to apply for the proper certificate retroactively. The sponsor of the bill and several witnesses urged its passage.

A practitioner recommended that section 124A be amended to provide, at the taxpayer's election, for "compression" of the emergency period if the emergency ended before the close of the 60-month period, or if the certifying authority determined that the facility was no longer necessary in the interest of national defense. In respect of World War II (sec. 124), the President issued a proclamation on September 28, 1945, terminating the emergency period as of September 30, 1945. It is contended that section 124A, applicable to the Korean war, is less effective than section 124, in that it contains no provision for shortening the 60-month amortization period in the event the emergency sooner terminates.

In conclusion, it is fair to state that, in every controversy over the rate of recovery of capital investment, the Government is always faced with the problem of some form of special relief.

H. R. 5634 would extend the amortization allowance to facilities, certified by the Secretary of Labor as a distressed area facility. The vice chairman of the Connecticut Development Commission urged accelerated depreciation and amortization as industrial inducements in areas subject to continuing economic decline. In any event, he recommended that code section 23 be amended to recognize the deductibility of rentals paid by a business concern to State-sponsored development corporations.

The Reynolds Metals Co. urged the amendment of code section 117 (g) by eliminating paragraph (3), which, in effect, treats the gain from sale of section 124A facilities as ordinary income.

Research and development expenditures

Historical note: The revenue authorities are not primarily responsible for the discontent over this subject. The original Regulations 45 recognized a liberal optional treatment of the cost of developing or protecting patents. (Art. 843 of Regulations 45.) This policy was upset by the former Board of Tax Appeals in *Goodell-Pratt Co.* (CCH Dec. 1025, 3 BTA 30 (1925)), and allied cases. In one of the most damaging blows ever struck at revenue administration, the Board held that, even though a taxpayer had expensed the development of patents, processes, etc., it could, nevertheless, restore them to surplus for invested capital purposes "upon a clear showing that they were in fact capital expenditures." Of course, development expenses would usually be capital expenditures under that view. In respect of the drilling and development costs of oil and gas wells, or the maintenance of a mine's regular output, the taxpayer influence was sufficiently great to make the optional treatment hold. (See *F. H. E. Oil Co.* v. *Commissioner*, (45-1 USTC par. 9200, 147 F. (2d) 238 (CCA-5)); *King Oil Co.* v. *Commissioner* (46-1 USTC Par 9178, 153 F (2d) 690 (CCA-5)); Concurrent Resolution 50, 79th Congress, first session, 1945 CB 545; Revenue ruling 170, 1953-18 IRB 6; T. D. 6023, 1953-15 IRB 10. Both the Bureau and the Tax Court have since relented voluntarily to some extent. (Mimeograph 6030, 1945-2 CB 45; J. H. Collingwood, CCH Dec. 17,878, 20 TC—, No. 132, (1953).)

Hearings July 28, 1953.—The National Association of Manufacturers believed that the taxpayer's consistent practice of expensing research and development costs should be accepted for tax purposes. The Federal Tax Forum urged substantially the same thing. They maintained that a clear statutory provision to that effect would encourage industry to make large expenditures for the research required by present conditions. The Western Union Telegraph Co. made a convincing presentation. They pointed out that, in many cases, the treatment of research and development expenditures is impracticable of determination. They recommended a specific provision in the code allowing the taxpayer, "in his sole discretion," not only to determine whether to expense or to capitalize an item but, also, to determine the rate of recovery of any balance of capitalized expenditures not previously written off. Such a code provision would undoubtedly eliminate considerable confusion and controversy, and would tend to encourage outlays for research and development work.

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A large delegation representing the farm bloc urged the enactment of bills which would authorize the expensing of amounts incurred in soil and water conservation. This includes the prevention of erosion, and similar things, rather than attempting segregation as to the expenses of contouring and crop plowing.

The American Federation of Labor considered that expenditures for research and development should be made as capital expenditures. They opposed the allowance as expenses of amounts designed to increase capacity, develop new products or material, or extend activities into new territories. Apparently labor is opposed to a tax policy which would reduce taxable net income of employers.

This writer is in complete accord with the taxpayer position on this topic, but does not think that the taxpayer should then be privileged to restore such expensed items to invested capital for excess-profits tax purposes, or excite sympathy on that account for special relief purposes. The taxpayer should keep his end of the bargain. (See *Guggenheim* v. *U. S.* (48-1 USTC, par. 9232, 77 F. Supp. 186 (Ct. Cls.), cert. den., 335 U. S. 908).)

Capital gains and losses and problems relating to basis

Historical note (capital gains and losses (sec. 117)): In *Merchants Loans & Trust Company* v. *Smietanka*[13] decided March 28, 1921, the Supreme Court upheld the taxation of capital gains under the sixteenth amendment. Beginning with Section 206 of the Revenue Act of 1921, capital gains were given special treatment involving the alternative computation device which, with few exceptions, has continued in effect. There, the maximum rate was 12½ percent. At that time, the justification for this action was based on the fact that gains accruing over a series of years were, under the law, taxed as a lump sum "and the amount of surtax excessively enhanced thereby." (1939-1 (pt. 2) CB 176 and 189.) Since that time, the statute has been repeatedly amended and the subject has become one of the most litigious in the entire Code. A good summary of the statutory law starts at page 84 of the Preliminary Digest, prepared by the staff of the Joint Committee on Internal Revenue Taxation. (See code sec. 117.)

Hearings, July 28-30, 1953: The National Association of Manufacturers submitted a statement condemning the taxation of capital gains as being harmful, particularly in that its principal impact is on venture or equity capital. Pending the ultimate elimination of the tax, the association recommended (1) that the rate be reduced, and (2) that the excess of capital losses over capital gains be deductible with the maximum tax benefit limited to the maximum rate applicable to long-run capital gains. They regard liberalization of the loss offset rule as of prime importance "as the first step toward ultimate elimination of the tax." tax."

Various suggestions were made to liberalize the treatment of capital losses. It will be recalled that the limitation on the deduction of capital losses in the 1932 and 1934 acts was occasioned largely by the stock-market crash of 1929. The offsetting of capital losses against ordinary income was having a serious effect upon the revenue yield from income taxation. (1939-1 (pt. 2) CB 465, 503, 540, 561, 594, and 632-633.)

The testimony of the Federal Tax Forum had more to do with recognition problems. The forum had three recommendations: (1) No gain or loss should be recognized on the sale of all the assets of a corporation, followed by the liquidation of the selling corporation within a reasonable period of time, if the sale is a step in the complete liquidation of the seller. This principle, from the standpoint of the buyer where it buys the stock of a corporation with a view to acquiring the assets, has been judicially recognized. (*Commissioner* v. *Ashland Oil & Refining Co.* (38-2 USTC, par. 9580, 99 F. (2d) 588 (CCA-6)); H. B. Snively (CCH Dec. 19,458, 19 TC —, No. 102 (1953), and citations).) (2) In determining deductibility under section 23 (g) (4), as an ordinary loss, of a loss from worthlessness of stock in a subsidiary, a corporation's "gross income" from sale of stock-in-trade shall be defined to mean its "gross receipts" from such sales. Of course, this definition of "gross income" from sales is contrary to *Doyle* v. *Mitchell Brothers Co.*, above and *Lela Sullenger* (CCH Dec. 16,735, 11 TC 1076 (1948)), and many subsequent decisions. (3) A transfer of substantially all the assets of a corporation to another corporation, receiving in exchange the voting stock of a parent company of the transferee corporation, should be regarded as a "reorganization" under section 112 (g) (1) (C). Admittedly, this would require an amendment to the code, as construed by the Treasury Department and the Supreme Court.

The president of the New York Stock Exchange recommended that the holding period for capital assets be reduced from 6 to 3 months; that the effective rate of tax on capital gains be cut in half; and that the amount of captal losses which may be offset against ordinary income should be increased to $5,000 annually, with the carryover period continued at 5 years. Many other stock and commodity exchanges and investment houses made substantially the same recommendations. Several argued for the immediate repeal of the capital gains tax.

A stock brokerage house suggested the amendment of code section 117 (e) in respect of so-called "puts," or options to sell securities at a fixed price, the acquisition of which is now defined as a short sale. This would except from the present definition such puts as are purchased on the same day as the securities, to which the puts relate, are purchased. It would tie together the securities purchased with the puts purchased. This would make it possible to purchase securities with the loss-protection feature of puts, and still avoid the abuses to which the present definition was aimed.

H. R. 5597 is designed to grant relief to the farmers who were "entrapped by the * * * Revenue's about-face" in respect to the taxation of gains from the sale of farms and orchards, with growing crops. (*Watson* v. *Commissioner* (53-1 USTC, par. 9391, 73 S. Ct. 848).) Section 323 of the Revenue Act of 1951 is applicable prospectively from January 1, 1951. The proponent of H. R. 5720 urged its passage; H. R. 5720 would make the 1951 amendment retroactive to 1942.

The representative of the Iron Ore Lessors Association, Inc., St. Paul, Minn., proposed the amendment of code section 117 (k) (2) to provide that the disposition of iron ore under lease for specified royalties per ton is the sale of a capital asset in installments. The amendment is incorporated in H. R. 604 and H. R. 2691. The disposition of timber and coal under cutting contracts and coal leases is now recognized as a capital transaction under section 117 (k) (2). The reduced tax rate on this activity would no doubt tend to stimulate the discovery and development of new deposits within the continental United States. It is probable that, in time, this treatment of timber and coal will be extended on as broad a scale as the percentage depletion. Support also developed to amend section 117 (j) to extend the advantage accorded livestock breeders to breeders of poultry and fur-bearing animals.

A number of witnesses in the construction business stated that the law should be clarified in respect to the classification of gains from certain housing and rental operations. The extent of present litigation on this subject warrants an attempt in that direction, although the rates as betwen ordinary income and capital gain will necessarily occasion serious controversy over any definition.

The tax benefit theory was invoked in the support of H. R. 5067 and H. R. 6572, which would adjust the basis for taxes and other carrying charges on unimproved and unproductive real property paid out in prior years and deducted without any tax benefit.

Historical note (problems relating to basis): One of the most unjust provisions of the code, at this time, limits a donee to the basis of the donor. This provision has existed since section 202 (a) (2) of the Revenue Act of 1921, irrespective of the varying fortunes of the gift tax. It was upheld constitutionally in *Taft* v. *Bowers*.[14] (Code sec. 113 (a) (2).) The provision is inconsistent with itself because where the donor's basis was greater than the fair market value of the property at the time of gift, such value becomes the basis for loss purposes. The appreciation in value involved in donated property, if it had been realized by the donor, would generally be subject to the capital gain rate of tax. The highest bracket in the gift tax is now 57¾ percent. (Code sec. 1001 (a).)

Hearings, July 28-30, 1953: An individual witness urged an amendment to code section 113 (a), which would make the basis of capital gain or loss on a sale by a donee the fair market value of the donated property at the time of its gift. As an alternative, he suggested an amendment which would credit against the tax on any gain based on cost to the doner the amount of any gift tax that has been paid, except to the extent that such credit has been given in computing the estate tax on the estate of a deceased donor. (Code sec. 813 (a).) The recommendation was made, in connection with the losses disallowed under section 24 (b), that the basic rules applicable in the case of gifts be applied to such transactions.

An analogous situation exists with respect to inter vivos transfers in trust or otherwise, which are included in the gross estate as being a transfer in contemplation of death or to take effect at or after death. An attorney urged that code section 113 (a) (5) be amended to enable the trustees or other transferees to use as their basis the values on which estate tax has been paid, instead of the decedent's basis. Such an amendment would apply only to inter vivos transfers which are included in the transferor's estate for estate tax purposes. This inequity was only partially remedied by section 203 of the 1953 Technical Changes Act. There remains a broad area where income and estate tax laws do not synchronize properly.

The American Bar Association had several recommendations respecting section 117, the basis provisions of section 113 (a) and the loss provisions of section 24 (b). For the most part, these were incorporated in the Reed-Camp bill. The Pennsylvania Bar Association and individual lawyers supported the same changes in several instances. One recommendation would provide that all property included in gross estate should have that tax-reported basis.

There were many carefully prepared and exhaustive statements or briefs submitted in connection with topic 22, which the student of economics and law would find of value.

Income taxes of lessor paid by lessee

Historical note: In *West End Street Railway Company* v. *Malley* (246 F. 625), decided by the first circuit court of appeals on December 10, 1917, it was held that payments made by the lessee under a long-term lease, direct to the stockholders of the lessor, constituted income to the lessor. Article 102 of regulation 33 (revised), promulgated January 2, 1918, expressed the same principle

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and applied it not only to payments to the lessor's stockholders but also to taxes, interest, insurance or other fixed charges under the lease indenture. Article 102 has been substantially embodied in all subsequent regulations. The regulations were fully upheld in *Old Colony Trust Company* v. *Commissioner* (1 USTC, par. 408, 279 U. S. 716 (1929)). Section 29.23 (a) (10) of regulation 111 provides that taxes paid by a tenant to or for a landlord for business property are additional rent to the landlord and a deductible expense to the tenant. In such a situation, the administrative practice has been to take the taxes into the lessor's income only once and not resort to an algebraic formula. However, in mimeograph 6779, 1952-1 CB 8, as supplemented by IR-mimeograph 51, 1952-2 CB 65, it was ruled that the lessor is deemed to have received as rental income not only the stipulated rental, but, in addition thereto, all Federal income taxes paid by the lessee to or for the account of the lessor. For Federal income tax purposes, the amount to be included in the gross income of the lessor, by reason of the Federal income taxes paid by the lessee, will be determined by reference to the construction given by the parties to the contract under which such taxes are paid. Since Federal income taxes are not a deductible item to the lessor, it is understandable that the parties might make an adjustment as between themselves carrying the matter beyond the first step of computation. Apparently, the Government now intends to carry the computation through as many steps as the parties do.

Hearings, July 31, 1953: The Western Union Telegraph Co., which has always held a very practical interest in this subject, submitted a statement explaining in some detail the necessity for legislation limiting tax pyramiding to the first step. It cited recent legislation enacted by the Dominion Parliament of Canada to provide prospective relief for taxpayers faced with tax pyramiding.

The Association of American Railroads suggested that the solution to the problem is, by statute, to exclude such taxes from the lessor's income and to deny the lessee the right to deduct as rental any taxes it pays for the lessor railroad. This is the treatment accorded long-term lessors and lessees for excess profits tax purposes. (Code sec. 433 (a) (1) (K) and (b) (11).)

Net operating loss

Historical note: The net operating loss is a crude but effective device for averaging incomes. It first appeared as section 204 of the Revenue Act of 1918, and, in that form, such net loss was allowed as a deduction from net income of the preceding taxable year, and then the succeeding taxable year. In the 1921 act, the net loss could be carried forward for the two succeeding taxable years. In the 1932 act, section 117 (b) curtailed the benefit to the succeeding taxable year. The net loss provisions were repealed as of January 1, 1933, by section 218 (a) of the National Industrial Recovery Act of June 16, 1933. It was restored by the Revenue Act of 1939 as section 23 (s) and 122 of the Code. (1939-2 CB 517.) The law has been amended frequently, the last time by section 205 of the Technical Changes Act of 1953. Under section 122, as amended, the net operating loss for any taxable year beginning after 1949 is now carried back for 1 year and carried forward for 5 years.

Hearings, July 31, 1953: The Federal tax forum pointed out that the evident tax purpose of carry-backs and carry-forwards is to spread an operating loss over a 7-year business cycle, or an aggregate of 84 months. However, section 122 is expressed in terms of "taxable years" and, where taxpayers have fiscal periods of less than 12 months, they do not benefit from a full 84-month spread. This discrimination is inequitable, says the forum, and should be corrected in such a way as to treat a predecessor or successor of the taxpayer in a tax-free reorganization as identical with or part of the taxpayer itself. The forum also took the position that in computing the net operating loss deduction there should be no economic adjustments or inclusion of exempt income.

The American Mining Congress and others also opposed the adjustments made in determining the deductible "net loss." They argued that a taxpayer with some years of losses and some of profit should not be taxed on more net income than is taxable to one with the same net income realized in a single year or over several years. This would change the theory of the relief from that of operating loss which has always dominated its computation. When the deduction was first granted by the 1918 act, it was described as a net loss resulting from "the operation of any business regularly carried on by the taxpayer." (See, also, 1939-1 (Part 2) CB 210, Amendments 71-76.) It retained that characteristic down through the 1932 act. Upon its restoration in 1939, section 122 was entitled "Net *Operating* Loss Deduction," (italics supplied), and the limitation on deductions is still measured, in part, by deductions attributable to the operation of a trade or business regularly carried on by the taxpayer.

Other witnesses argued for a lengthening of the spread from 7 to 10 years, with particular reference to a 3-year carryback. The discrimination in section 122 (d) (5) as between corporations and individuals was opposed. (See H. R. 4775.)

The statement of the Machinery and Allied Products Institute seemed very effective. It explained that, under the current corporate tax structure, a firm which is making an investment decision knows that the Government will take over one-half of its potential earnings. However, if the averaging period is long enough, the firm can be assured that the Government will also share to the same extent in its losses. Consequently, the risk of a new investment is more attractive the longer the period of averaging. Unfortunately for all taxpayers, the Government will take over one-half its budget and appropriations on that basis. It cannot wait a lifetime for revenue from the taxation of income. (*Burnet* v. *Sanford & Brooks Company* (2 U. S. T. C., par. 636, 282 U. S. 359 (1931)).)

Cancellation of indebtedness

Historical note: There was originally no specific legislation on this point. By statutory definition, gross income included income derived from any source whatever. The departmental regulations did the rest.[15] In *U. S.* v. *Kirby Lumber Company*,[16] the Supreme Court reversed the Court of Claims and upheld the regulations in respect of the accession to assets brought about when a corporation purchased its bonds at a price less than issuing price. The statutory development of this subject is set forth in the footnotes to *Commissioner* v. *Jacobson*.[17] (Code secs. 22 (b) (9) and (10) and 113 (a) (20) and (b) (3); regulations 111, sec. 29.22 (a)-13.)

Hearings, July 31, 1953: There were no requests for personal appearances on this topic, but certain material was submitted for the record.

The Association of American Railroads udged that code section 22 (b) (9) and (b) (10) be continued as a permanent part of the code. If any changes are to be made, the section should be liberalized. To that end, the association advocated the elimination of the requirement that the basis be reduced by the amount of gain realized upon acquisition by a corporation of its own bonds at a discount. The association als recommended that elimination of the time limitation in section 22 (b) (10).

Footnotes at end of speech.

The American Bar Association explained that code section 22 (b) (9) permits a corporation, in certain situations, to elect to exclude from gross income the income which would otherwise be taxable to it upon the cancellation of indebtedness, on condition that the basis of its property under section 113 be correspondingly reduced. This provision, in situations to which it applies, relieves hardship by deferring an additional tax burden upon a taxpayer already embarrassed financially. However, the provision does not apply to noncorporate taxpayers or unless the canceled debt was evidenced by a security. The association recommended an amendment which would make the statute applicable to all taxpayers and would eliminate the requirement that the debt be evidenced by a security. The American Institute of Accountants urged the same thing. A certified public accountant suggested that Congress define the conditions under which gain would be realized upon cancellation of indebtedness, because the courts have made a mess of their interpretation.

The American Federation of Labor would not favor any changes in the present law except such as would meet a definite need or correct a demonstrated inequity and would not result in the possibility of any tax evasion by any particular group of taxpayers.

Consolidated returns and intercorporate dividends

Historical note: Consolidated returns were authorized by section 240 of the Revenue Act of 1918, although certain parent-subsidiary relations had been recognized by Regulations 33 (revised), paragraphs 386, 394, 417, 614, and 617. After a decade of uncertainty, the use and legal effect of consolidated returns under the revenue acts was stabilized by sections 141 and 142 of the Revenue Act of 1928. In the 1932 act, the privilege to file consolidated returns was subjected to an increase in the tax rate. The privilege was entirely withdrawn by section 141 of the Revenue Act of 1934, except as to railroads. (1939-1 (pt. 2), CB 633, amendment No. 73.) Section 159 (a) of the 1942 act restored the privilege, in general, to its former extent, subjecting its exercise to an increase of 2 percent in the tax rate. Thus the matter stands today. (Code sec. 141.)

The tax on intercorporate dividends grows out of a dividend credit to corporations of only 85 percent of the amount received as dividends. (Code sec. 26 (b).)

Hearings, August 3, 1953: Many witnesses urged repeal of the 2-percent penalty tax, the elimination of the tax on intercorporate dividends and a provision for an annual election to file either a separate or a consolidated return. The 2-percent premium on filing consolidated returns does seem rough on public utilities which are required by State law to perform some of their services through local subsidiaries. The American Cotton Manufacturers Institute thought that, where the 2-percent penalty tax is eliminated, it should be accompanied by compulsory filing of a consolidated return in the case of 95 percent ownership. To avoid triple taxation of intercorporate dividends, the institute advanced an alternative solution of eliminating the credit to the receiving corporation and permitting the paying corporation to deduct from gross income the amount of all dividends paid.

The American Bar Association recommended the adoption of section 147 of the Reed-Camp bill relative to the exemption from tax on personal holding companies (code secs. 500 and following) of corporations joining in consolidated returns. Other witnesses recommended that intercompany items received by a corporation in a consolidated return should not constitute personal holding company income.

The Association of American Railroads and the Western Union Telegraph Co. sug-

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gested that code section 141 be amended to permit the inclusion in the consolidated return of lessor corporations regardless of stock ownership where the lessee corporation is obligated to pay the taxes of the lessor. The Bell Telephone System thought the 95 percent ownership test should be reduced to not more than 50 percent.

Corporate reorganizations and distributions

Historical note: When a taxpayer exchanges one item of property for another, or receives a distribution from a corporation of which he is a stockholder, there are two basic questions to be resolved: (a) whether income within the meaning of the 16th amendment has been realized, and (b) whether the income realized is to be recognized in computing taxable net income. The decision of the Supreme Court established early that exchanges of property were productive of income in the constitutional sense and that corporate distributions from profits were taxable income. The reorganization and dividends sections of the Code are generally relief provisions which either defer the taxation of the income presently realized from exchanges, or exclude from gross income certain corporate distributions which otherwise would be taxable income. The reorganization provisions in simplest form began with section 202 (b) of the Revenue Act of 1918. The deferment of tax on income realized in connection with reorganizations was expanded by the nonrecognition provisions of section 202 (c), (d), and (e), of the Revenue Act of 1921, and was fully developed in section 203 of the Revenue Acts of 1924 and 1926. The recognition of gain or loss from exchanges in general, and reorganizations, in particular, is presently governed by Code section 112. It is supplemented by the adjusted basis provisions of Code section 113.

After the 16th amendment, the first statutory definition of a dividend for income tax purposes occurred in section 2 (a) of the Revenue Act of 1916. The statutory definition has been continuously refined and enlarged in all subsequent revenue acts. The present statutory coverage of distributions by corporations is code section 115.

Hearings, August 3-4, 1953: This topic covers what is probably the most technical area of income taxation and a sharp interest was manifested. A statement submitted by a tax practitioner opened with the remark that code section 112 was in need of a complete legislative overhauling. Some of its provisions are stated to be inadequate, and the meaning of others has become confused as a result of legislation by the courts in an attempt to compensate for real or imagined inadequacies. Other witnesses agreed. The numerous changes recommended reveal the intricacies, the inconsistencies, and the interrelations of the income-tax structure. The amendments urged are roughly summarized:

1. Amend section 112, to substitute specific statutory standards for the vague court-made tests such as the business-purpose doctrine and the continuity-of-interest rule. (See *Gregory* v. *Helvering* (35-1 USTC, par. 9043, 293 U. S. 465); *Helvering* v. *Alabama Asphaltic Limestone Co.* (42-1 USTC, par. 9245, 315 U. S. 179).)

2. Clarify the meaning of the term "recapitalization." (*Bazley* v. *Commissioner* (47-1 USTC, par. 9288, 331 U. S. 737).)

3. In connection with a tax-free reorganization, the successor should stand in the "tax shoes" of the predecessor in all respects, with appropriate safeguards in the case of carrybacks. (*New Colonial Ice Cream Co., Inc.* v. *Helvering* (4 USTC, par. 1292, 292 U. S. 435 (1934).) Cf. *Helvering* v. *Metropolitan Edi-Co.* (39-1 USTC, par. 9432, 306 U. S. 522).) This recommendation would cover the allowance to the successor of such items as operating net losses; interest on deficiencies against predecessor; the tax benefit rules with respect to recoveries on bad debts, taxes and losses; expenses paid by successor on account of predecessor; pension contributions; credit carryovers; capital-loss carryovers; unused excess profits credit carrybacks and carryovers; inventory replacement (LIFO) in the case of involuntary liquidation; and amortization of emergency facilities. These changes were urged by several parties including the American Institute of Accountants, the Chamber of Commerce, the Western Union Telegraph Co., the National Coal Association and the Association of American Railroads. The railroad association would balance the proposition by including items of income reportable by the predecessor had it remained in existence. Here might be mentioned the recommendation of the American Institute of Accountants that where upon liquidation a cash-basis corporation is required to recognize accrued income (see code sec. 42 (a)), it should also be permitted to pick up deductible accrued expenses.

4. Define the word "securities" to include the types of corporate obligations commonly considered to be securities, excluding debts whose maturity is so short as to make them the practical equivalent of cash (*Bazley* v. *Commissioner*, above). The Chamber of Commerce joined in this change.

5. Define "a party to a reorganization" to include a corporation exchanging its stock and any subsidiary of such corporation which receives properties in exchange for such stock. (*Helvering* v. *Bashford* (38-1 USTC, par. 9019, 302 U. S. 454).) The accounting institute, the Chamber of Commerce and the American Bar Association urged the same thing.

6. Make section 112 (b) (7) a permanent provision of the code. Many organizations supported this idea. Under this heading came the suggestion that the period for exercising the election privilege be extended up to the time of the filing of the return for the taxable years.

7. Provide provisions similar to those in supplement R (secs. 371-373) and section 112 (m) for transactions resulting from antitrust decrees or orders of administrative agencies. The Chamber of Commerce supported this proposition.

8. The tax effect of a corporate liquidation followed by the sale of its assets, or vice versa, came in for considerable discussion. The existing uncertainty [18] both as to the buyer and the seller calls for statutory action. Many individuals and organizations supported such legislation. The recommendation would provide that gain to a corporation on the sale of its assets (other than sales of inventory to customers in the ordinary course of business) should not be recognized if the proceeds of the sale be promptly distributed in a taxable liquidation. Such a provision would make it immaterial whether the corporation first sold its assets and then liquidated, or liquidated and the stockholders made the sale.

9. Viewed from the standpoint of the buyer, the situation is equally disturbing. The buyer usually prefers to buy the assets direct so as unquestionably to benefit by its own cost basis, but, frequently, it is compelled to buy the stock in order to get the property. Where the buyer's objective was the acquisition of the assets, the courts have considered such to be the net effect of a purchase of stock with immediate liquidation in mind. (See *H. B. Snively*, above, and authorities cited; this view has not prevailed where consolidated returns were filed.) One witness roundly criticized this judge-made test as focusing attention solely upon the intent of the buyer in complete disregard of the equally material intentions of the seller who may have resolutely refused to sell the assets and insisted throughout upon a sale of the stock. The statute must be made certain.

Footnotes at end of speech.

Several different methods were suggested to accomplish this purpose, but, in effect, section 112 (b) (6) would be amended to provide that, after a purchase of stock in order to take over the assets of another corporation, the purchasing corporation may use, as the basis of the assets purchased, the cost so paid for the stock.

10. The special treatment accorded dividends, paid by public utilities upon their preferred stock issued prior to October 1942, is apparently too restrictive. It was recommended that the definition of a "public utility" under section 26 (h) (2) be extended to include under certain conditions the parent of 95-percent-owned public utility subsidiaries.

11. Several suggestions were made to extend the time limit under section 115 (g) (3) within which stock may be redeemed to pay estate taxes, without the risk of the redemption being treated as essentially equivalent to a taxable dividend. An excellent presentation was made on this subject. Several incidental modifications were urged: (a) to broaden the exemption of redemptions to include the amounts owed by an estate for debts and administration expenses; and (b) to remove the 35 percent limitation since the decedent may have held large blocks of stock in more than one closely held corporation.

12. The Commerce and Industry Association of New York, Inc., urged an amendment to section 27 (g) or (h) making it clear that the credit limitation on preferential dividends is not applicable to amounts paid in liquidation of stock interests. This change would overrule *May Hosiery Mills, Inc.* v. *Commissioner* (41-2 U. S. T. C., Par. 9571, 123 F. (2d) 858 (CCA-4), and preferential liquidations would form a dividends' paid credit for section 102 purposes and for the computation of undistributed subchapter A net income (sec. 504).

There were other significant changes recommended, such as: (a) Define in greater detail the content of "earnings and profits" for dividend purposes; (b) redefine the term "reorganization" to provide that the transfer of a portion of the assets of a corporation to another corporation constitutes a reorganization so long as the transferee corporation is controlled by either the transferor or by persons who are or were stockholders of the transferor; and, among others, amend section 112 (b) (5) to remove the rule of proportion.

Statute of limitations, assessment and collection of taxes and penalties

Historical note (statute of limitations): Beginning with the Corporation Excise Tax Act of 1909, there has always been a statute of limitations against both the Government and the taxpayer. It has never applied to fraudulent returns or where no return has been filed. It has varied from time to time both in length and extent. There have been two important departures from the orthodox conception of a statute of repose: (a) the extension of the regular 3-year period to 5 years where the taxpayer omits reporting 25 percent of his gross income (sec. 275 (c) of the Revenue Act of 1934); and (b) the mitigation provisions (first adopted by sec. 820 of the Revenue Act of 1938). The limitation statutes are now contained in code sections 275, 276, 311, 322, 3748, and 3801.

Historical note (assessment and collection): In respect of income, estate and gift taxation, the assessment and collection of deficiences therein stem from the statutory provisions in sections 273 and following of the 1924 and 1926 acts, adopted in connection with the newly created Board of Tax Appeals. As to miscellaneous taxes, the old statutory provisions still obtain, although the department has extended its internal appellate procedure to certain ones. The penalties, of course, vary and keep pace with the different kind of taxes, but their assertion and

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collection follow generally the requirements of the taxes to which they relate.

Hearings, August 4, 1953: The most colorful witness under topic 28 was a public accountant who came in at his own expense. The tenor of his testimony may be gathered from this extract:

"I fervently hope that it is not necessary to stress the enormities committed against defenseless taxpayers in order to prove the urgent need for remedies. It should be sufficient to point out that although the Bureau's enforcement personnel are all made in the image of God, they have not been endowed with His attributes."

As a former Bureau employee, I must admit he had something there. His main opposition was directed to the monthly production quotas of deputy collectors. As he said: "Rights without remedies are vain things." The expense which a low-income taxpayer must incur to protect himself against a Bureau 90-day wonder, destroys his procedural rights. He quoted Abraham Lincoln: "To consent by silence when they should protest makes cowards of men." This man really protested. He suggested the appointment of summary appeal agents on an honorary and volunteer basis somewhat in the manner of appeal agents appointed to check the decisions of draft boards under the Selective Service Act. As a matter of fact, this system obtains in England. Retired military and civil service employees are used for the purpose. As an alternative, if the power of decision is not to be vested in such summary appeal agents, then he suggested that it could be vested in an appointee for each administrative district, on a salary basis. The American Bar Association also has, in the past, made several recommendations concerning the handling of small deficiencies pending before the Tax Court. It is true from the standpoint of the little fellow that a prospective victim of the Bureau has got to be able to go to some person or board in their own locality. Has anyone given a moment's reflection as to how many persons or boards would be required to accomplish that state of administrative perfection?

In connection with the supposed evil of monthly production quotas, Congressman KING (California) pointed out that there was anything but uniformity at some of the policy levels throughout the country.

A tax lawyer from Newark, N. J., made several interesting administrative recommendations: (1) That in all cases involving assessment of taxes, the procedure for miscellaneous taxes should parallel income tax procedure; (2) that jeopardy assessments should not be good for more than a limited period and be subject to some form of judicial or quasi-judicial review; (3) that the Tax Court judges be granted authority, in their good discretion, to extend the 90-day period within which a timely petition to that court could be filed; (4) that the underestimating penalties (sec. 294) (d) (2)) should be based on the prior year's return and not on the finally determined tax of the current year; (5) that the lien under code section 3672 (a) with respect to real estate should be adequate if filed in the office of the clerk of a United States district court once, rather than in the various county offices; (6) that the Government be granted statutory authority to subordinate its liens under section 3674; (7) that the right of transferee assessment be permitted with respect to all miscellaneous taxes; and (8) that the Federal Government have the right to levy for unpaid taxes against both Federal and State employees.

The Pennsylvania Bar Association recommended (1) that the 5-year limitations period under code section 275 (c) be eliminated where a reasonable disclosure was made on the return and (2) that, under code sections 3670, 3671, and 3672, the collateral of banks ahead of tax liens should be broadened to include accounts receivable and insurance policies, and that a bank's liabilities in respect of the lienee's deposits by clarified by statute.

Another witness recommended that the mitigation section (sec. 3801 (a) (3) be amended to add 100 percent affiliated corporations to the definition of related taxpayers. An official of a building and loan association suggested an absolute statute of limitations of 5 years in all cases; that the period of examining tax returns be reduced to 2 years; and several other propositions which are already officially recognized.

The American Bar Association recommended: (1) a 6-year statute of limitations where the failure to file an income return was due to innocence, and not to fraud; (2) that the Commissioner and the taxpayer should be granted authority to enter into an agreement extending the assessment period in respect of estate and gift taxes; and (3) that the limitation of 6 years in criminal fraud cases (sec. 3748 (a)) should not be suspended where the taxpayer resides in a district different from that where the return is filed.

Several witnesses supported one or more of the above propositions. One witness declared the operation of the limitations period on criminal prosecutions for tax fraud to be one of the most unfair statutes in existence today, and certainly should be corrected, or eliminated entirely. (See code section 3748.) The institute also objected to certain unreciprocal aspects of the interest provisions in respect of deficiencies and refunds.

The American Institute of Accountants, in addition to certain items before mentioned, also made several recommendations in respect of section 3801 (mitigation). It appears that the mitigation statute has worked much more smoothly than its critics first anticipated. Within its scope the honest mistake has virtually disappeared in revenue administration.

Partnerships

Historical note: Beginning with section II D of the 1913 act, the revenue statutes have contained provisions respecting the taxation of partners. Only in the year 1917 were partnerships as such subject to any form of income taxation. In that year, partnerships were subjected to an excess-profits tax. (Sec. 201 of the act of Oct. 3, 1917.) The partnership has always been an income-computing entity, but, except as above noted, it has not been the subject of income tax incidence. The individual partners have always been subject to tax on their respective shares of the partnership income, whether or not actually distributed to them. The present code provisions relating to partnerships are sections 113 (a) (13), 181–191 (Sup. F) and 3797 (a) (2).

Hearings, August 4, 1953: There is clearly a real need for comprehensive legislation on this subject. The most important contribution was made by the American Bar Association, which submitted an overall statute covering the income taxation of partnerships to supplant the few code sections that barely sketch the tax pattern. The representatives of the association explained that although partnership taxation is one of the most complex subjects in the code, everybody has been floundering for years in a sea of doubt. The Treasury Regulations have been inadequate, the courts have been inconsistent, and the Bureau has never succeeded in formulating a complete policy. The association's committee spent over 5 years on the work and they presented a set of rules which would add several pages to the code.

In general, the association recommended a statute which is based upon the present concepts of the code. The partnership would remain essentially as an information-reporting entity, with the tax imposed upon the individual partners for their respective distributive shares of the partnership income. In most areas of the partner-partnership relationship, the partners are treated as co-owners of the partnership property on the assumption that this approach most nearly conforms to the understandings of the parties in the usual small business. In the interest of flexibility and simplicity, however, there is provided a series of elections based upon an "entity" approach, which probably would be exercised by the larger and more complex partnerships. The recommended legislation was introduced with an accompanying explanatory report, to which all interested readers are respectfully referred. It covers many of the points made by other witnesses.

The American Institute of Accountants, as a partial solution to the whole problem of the double taxation of corporate dividends, recommended that a corporation be granted the option of being taxed as a partnership, provided (1) it had only common stock outstanding, and (2) at all times during the year, all of its outstanding stock is owned, directly or indirectly, by not more than 25 individuals. This is obviously for the benefit of the closely held corporations which, in fact, closely resemble partnerships.

A farmer submitted a plan whereby a sole proprietorship or partner should, at his election, be permitted to separate his income into two classifications: (a) the income obtained from his venture capital, by the direct operation of his business; and (b) the income he receives from investment capital in stocks, bonds, or other investment items.

Upon doing so, the proprietor or partner would pay corporate tax rates on the income from his business-venture capital and individual rates on the income from his investment or nonbusiness capital. The plan contemplates that venture capital should be permitted to flow in and out of the business as needed, without penalty, so as to avoid the lack of necessary capital to conduct the business or the accumulation of unnecessary capital.

The American Federation of Labor recommended that provisions in the 1951 act, under which minors may be admitted as partners, should be eliminated; but another witness recommended that they be given retroactive effect.

Income derived from foreign sources

Historical note: The Federal Government has always professed a sympathetic concern over our foreign trade. Of course, the Constitution itself forbids the taxing of articles exported from any State. The income-tax statutes, however, have gone much further. The allowance of a credit for income taxes paid to foreign countries began with sections 222 (a) and 238 (a) of the Revenue Act of 1918; the present provisions are in code section 131.

Section 262 of the Revenue Act of 1921 granted exemption under prescribed circumstances to income derived from sources within possessions of the United States. (1939-1 (pt. 2) CB 197 and 207.) That subject is now governed by code sections 251–252 (supp. J).

The China Trade Act, approved September 19, 1922, amended the 1921 act by adding thereto a new section 264. By this act, a special credit was granted to individual citizens of the United States, resident in China, with respect to special dividends paid to them by corporations organized under the China Trade Act. The subject of China Trade Act Corporations is now covered by code sections 261–265 (supp. K).

Section 213 (b) (14) of the Revenue Act of 1926 provided that, in the case of an individual citizen of the United States, a bona fide nonresident of the United States for more than 6 months during the taxable year, the amounts received from sources without the United States constituting earned in-

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come should be exempt from income taxation. This exclusion from gross income went through many corrective amendments, but became the subject of such abuse that section 204 of the Technical Changes Act of 1953 limited the amount of annual exclusion to $20,000. The present code provisions treating of this subject are in section 116 (a), as amended.

Section 141 of the Revenue Act of 1942 added a new code section 109, dealing with Western Hemisphere Trade Corporations. By sections 109 and 15 (b), exemption from surtax was granted certain domestic corporations deriving their income principally from the active conduct of trade or business within the Western Hemisphere, that is, within the Americas or adjacent areas. This had the effect of exempting a qualified corporation from surtax on its income derived from sources other than sources within the United States. A similar but much broader exemption was granted by code section 727 from World War II excess profits taxation. At this time, the relief granted by the code to Western Hemisphere Trade Corporations takes the form of a credit in respect of both normal and surtax. (Code secs. 13 (a) (2) (C), 15 (a) (3), 26 (i) and 109). Section 454 grants a similar exemption in respect of the excess profits tax presently imposed.

Hearings, August 4–5, 1953: A live interest was shown in this topic. The National Foreign Trade Council submitted a number of recommendations which revealed a profound study of the subject and covered most of the ideas developed at the hearings. They were:

1. Income derived through a foreign permanent establishment or from a foreign subsidiary should be taxable only where earned. The code should provide for the exemption of income derived by a United States citizen which is allocable under section 119 to a permanent establishment in a foreign country. (This might raise the question of the responsibility, if any, of the United States Government for their protection in the foreign country.)

2. As an alternative, the credit in respect of income from foreign branches or subsidiaries should equal the United States tax thereon, as if it had been the corporation's only income. This would produce substantially the same result as recommendation 1.

3. As a second alternative, an incentive rate should be granted income from permanent establishments abroad which would place the American-owned enterprises in a competitive position vis-a-vis foreign enterprises; extend the geographical limits of section 251.

4. The per-country limitation in code section 131 (b) should be repealed as an anachronism inserted in the revenue statute in a time of trade contraction. The overall limitation should be retained to prevent the reduction of the domestic tax on domestic income. If the per-country limitation is to be retained, taxpayers should be permitted to choose between it and the overall limitation on an annual elective basis.

5. Credit for foreign taxes paid in lieu of income taxes should be liberalized. (Code sec. 131 (h).)

6. Defer tax on foreign-branch income until it is remitted to the home office. (H. R. 611.)

7. Several minor amendments to the code providing: (a) relief for alien employees of foreign branches of American corporations who are presently at a disadvantage as contrasted with alien employees of foreign subsidiary corporations; (b) adopt war loss provisions esssentially similar to section 127, applicable to World War II losses; (c) extend the due dates of income tax returns of China Trade Act corporations (sec. 3805); (d) allow the filing of foreign tax credit refund claims without limitation as to time; and (e) amend section 109 (Western Hemisphere trade corporations) to permit purchases and incidental economic contacts with countries outside the Western Hemisphere.

The above recommendations were explained orally and by written statement. The American taxpayer is sitting on a mountaintop of taxation trying to do business in competition with companies that are on foothills or lowlands of taxation. Many witnesses and organizations urged one or more of the foregoing recommendations, using different arguments but arriving at the same place.

Several witnesses urged the amendment of section 109 to include an express definition of the "source of income" of export sales so as to avoid the "passage of title" test. Under section 109, to qualify as a Western Hemisphere Trade Corp., 95 percent or more of its grorss income must be derived from sources without the United States. In fixing the source of income from purchases within and sale without the United States under section 119, title must pass outside the United States in order to classify the gross income as having been derived without the United States. This necessitates the maintenance of a warehouse or branch office in the foreign country to which the property could be shipped and title transferred to the purchaser. The cost of that action is prohibitive to a smaller corportation, and, in addition, is contrary to the long-established trade practices to which the foreign purchaser is accustomed. An amendment, such as above suggested, is necessary to effectuate the legislative policy of section 109 concerning export trade.

Section 204 of the Technical Changes Act of 1953 corrected an abuse growing out of code section 116 (a) (2), by limiting the exemption accorded income earned abroad to $20,000. Even so, the American Mining Congress considers the present law fails to do full justice in the case of an individual citizen of the United States who is legitimately carrying on his business activities in a normal fashion in a foreign country by the rendition of services there, and whose earned income from foreign sources exceeds $20,000. It recommended that such income be fully exempted. The International Chamber of Commerce recommended increasing the $20,000 limitation to $30,000.

By section 332, the term "foreign personal holding company income" includes dividends, interest, royalties and annuities. This prevents a United States business from organizing an investing company in a favorable foreign country with a view to establishing subsidiary manufacturing corporations in other foreign countries. A witness recommended the amendment of section 332 (a) to exclude from foreign personal holding company income, dividends and similar income received from foreign manufacturing and operating companies not of a purely investment character.

Income tax treatment of estates and trusts

Historical note: The taxation of estates in process of administration, and of trusts, whether testamentary of inter vivos, is a tricky subject. This is one branch of law where the office lawyer can turn the meaning of words upside down.

Under the 1913 act, many operating trusts, particularly of the Massachusetts type, were taxed as "associations." Section 2 of the Revenue Act of 1916 expressly taxed the income of estates in process of administration, and of trusts, to the executor, administrator or trustee, as the case might be, except when the income was returned by the beneficiary. Section 219 of the 1918 act clearly established the status of estates and trusts as independent taxable entities. Their net incomes are determined pretty much as the net income of an individual, except that they are allowed another type of deduction referred to as distributions of income. The deduction for distributions which is available to estates and trusts is a distinctive attribute of these types of tax entities. This plan of having the tax follow the income has been used in modified form in other respects, such as the treatment of Supplement P income, but, generally speaking, the treatment of estates and trusts has been unique. The income taxation of estates and trusts is now determined by supplement E of the code (sections 161–172).

Hearings, August 6, 1953: A New York practitioner declared that what is supposed to be a code for the establishment of a system of Federal taxation has turned out in many of its parts to be a system of restrictions on the liberty of the American citizen or taxpayer to do the perfectly normal things that he has always done and is still allowed to do under the laws of every State in the United States. He objected to the present taxable position of revocable trusts and to the line of authorities illustrated by the Clifford doctrine. He recommended the outright repeal of code sections 166 and 167. Another New York practitioner recommended that section 115 (g) (3) be made applicable to the payment of all indebtedness of an estate in process of administration where other free assets are not available to meet the indebtedness. (This suggestion was more fully considered under topic 27 (b). He complained that, in the face of the language of section 29.115–9 of Regulations 111, the Commissioner declined to rule that the acquisition by a close corporation of all the decedent's holdings therein would not affect the distribution of a taxable dividend. He proposed that the law be amended "to make certain that such administrative interpretation is not possible."

Several witnesses from Boston urged support of H. R. 5418. This bill would provide for special taxation of real-estate trusts and associations with transferable shares or certificates of beneficial interest. Almost all such trusts are now classed as associations, taxable as corporations. The imposition of a corporate income tax on such trusts is especially unfair when it is considered that the purpose of such trusts is principally to provide unified management and that, usually, substantially all their income is distributed annually to the beneficiaries. In this respect, real-estate trusts are conduits of income, just as are stock investment trusts whose unique status has been specially recognized under the regulated investment company provisions of supplement Q (Code secs. 361–362). These witnesses argued their case well.

A representative of the United Cerebral Palsy Associations, Inc., proposed the amendment of code sections 812 and 162 to provide total exemption from both estate and income taxation of legacies or trusts set up for the upkeep of totally disabled persons, during their lifetime. In assessing such taxes, the Government is interfering with a natural and moral duty. He also proposed that an additional $600 income-tax exemption be granted to taxpayers supporting dependents who are permanently disabled from whatever cause.

A private witness made some very significant suggestions in respect of code section 162 (b), (c), and (d). Basically, what is involved is the taxing of A on account of what is really B's income. In general, an estate or trust is entitled to deduct from its gross income all amounts distributed or distributable as income to the beneficiaries. This witness contended that the only logical and equitable approach was to find out first how much could reasonably be charged to the income of each beneficiary, and then to allow the estate or trust to deduct the total of these amounts. This would always prevent charging one beneficiary with income that is, in fact, the income of another beneficiary.

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A practicing lawyer recommended that code section 22 (a) be amended to prevent any possible application of it to the question of who is taxable on trust income. Supplement E should contain specific rules to the effect that trust income be taxed to the grantor only if (1) the trust is for a period which must end in less than 5 years, and the trust assets must revert to the grantor or his estate or must be disposed of as he directs, or (2) the grantor retains the power to determine who shall receive the trust income. (Cf. T. D. 5488, 1946–1 CB 19, amended by T. D. 5567, 1947–2 CB 9; *Commissioner* v. *Clark* (53–1 USTC, par. 9217, 202 F. (2d) 94 (CA–7); 1953–55 CCH Standard Federal Tax Reports, par. 8655).)

The chamber of commerce thinks that section 22 (a) should have no application to the taxation of estates and trusts. (See section 29.22 (a)–21 of Regulations 111; *Ruth S. Clark* (CCH Dec. 18,794, 17 TC 1357 (1952), aff'd 53–1 USTC, par. 9217, 202 F. (2d) 94, certiorari not authorized).) Also, there should be no Federal statutory concept of distributable income. Items which are not taxable in the hands of the fiduciary should not become taxable through distribution to the beneficiary. (*McCullough* v. *Commissioner* (46–1 USTC, par. 9140, 153 F. (2d) 345 (CCA–2).) The existing 65-day and 12-month rules under section 162 (d) (3) have proved to be administratively unworkable and should be eliminated. In connection with the Clifford problem, the chamber recommended that the grantor of a trust should not incur tax where he has divested himself for 5 years or more of ownership of the principal and income of the trust and of any power to control the beneficial enjoyment of such principal and income. The 5-year rule should also be applied to cases of irrevocable assignments of income in situations such as the *Blair* (37–1 USTC, par. 9083, 300 U. S. 5) and *Schaffner* (41–1 USTC, par 9355, 312 U. S. 579) cases. The chamber also recommended that a distinction be drawn between administrative powers over the trust under which the grantor may obtain economic benefit and administrative powers under which economic benefit for the grantor is not possible or is so incidental or intangible as to be disregarded. It also suggested that no attempt be made to define by relationship persons having certain powers who are sufficiently subservient to the grantor to give him, in effect, the power involved. Such subservience should be established by the facts and not by relationship to the possessor of the power.

The chamber further recommended that the credit against net income provided for trusts under section 163 (a) (1) be increased from $100 to $300. Section 153 requires that annual information be required from certain tax-exempt organizations under section 101 (6) and section 162 (a), and, also, in respect of employees' trusts under section 165. It was proposed that the ordinary statute of limitations against the assessment of deficiencies against such trusts and entities, commence with the filing of such information.

A representative of privately financed colleges recommended that code section 166 be amended to permit the creation of a revocable trust on a tax-free basis to the creator, provided the income is paid to a tax-exempt institution. This is a serious problem, because some colleges teach principles which necessitate high taxes.

Treatment of bad debts

Historical note: This topic embraces (a) bad-debt recoveries, (b) bad-debt reserves and (c) deduction of nonbusiness bad debts.

Article 110 of regulations 33 (revised) provided that bad debts, charged off as worthless and subsequently recovered, constitute income for the year in which recovered, regardless of the date of charge off. (Art. 52 of original regulations 45.) The Treasury Department, on its own volition, initiated the concept that a recovered bad debt should not be regarded as income unless the deduction had accomplished a reduction in tax liability. (G. C. M. 18525, 1937–1 CB 80; I. T. 3172, 1938–1 CB 150.) The tax benefit rule received statutory sanction in section 116 of the Revenue Act of 1942, entitled "Recovery of Bad Debts, Prior Taxes, and Delinquency Amounts," and added a new paragraph (12) to the exclusion provisions of code section 22 (b). The new statute provided for the exclusion from gross income of amounts, otherwise includible, which are attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent that the same did not operate to reduce the income tax liability of the taxpayer for any prior year.

The 1921 act first permitted the deduction for bad debts to take the form of a reasonable addition to a reserve for bad debts. (Secs. 214 (a) (7) and 234 (a) (5) of the Revenue Act of 1921.)

Section 124 of the 1942 act added a new provision for special treatment of nonbusiness debts in the case of a taxpayer other than a corporation. (Code sec. 23 (k) (4); 1942–2 CB 431 and 572.) The primary reason for this amendment was the abuse growing out of so-called loans to friends, relatives, and dependents where there were no reasonable grounds for or expectation of repayment. (1942–2 CB 426 and 565.)

Hearings, August 6, 1953: The regulations deny the tax benefit provisions of section 22 (b) (12) to reserve-basis taxpayers. (See sec. 29.22 (b) (12)–1 (a) (1) of Regulations 111; 1942–2 CB 427 and 566.) Accounting authorities seem to agree that this works a discrimination as between the reserve method and the specific charge-off method. The First National Bank of Chicago recommended that this discrimination be eliminated by striking from the regulations the objectionable sentence, and, if that is not feasible, amend the statute.

A national public accounting firm recommended the amendment of Code section 23 (k) (4) to exclude from the definition of nonbusiness bad debts, loans made to a business organization in which the taxpayer has a financial interest as an employee, stockholder, officer, or creditor. Such losses should be deductible as business bad debts, but they are now being classified by the Bureau and the courts as nonbusiness bad debts, deductible only as short-term capital losses. Other parties urged the same action.

The Commerce and Industry Association of New York objected to the Bureau's interpretation of section 23 (k) (4) to include among nonbusiness bad debts, debts which actually arose in the course of a taxpayer's trade or business but which, at the time of worthlessness, were not directly connected with a trade or business of the taxpayer suffering the loss. (Sec. 29.23 (k)–6 of Regulations 111.). The statute should be amended to provide that debts arising in the course of business should be treated as business debts regardless of circumstances at the time of worthlessness. The association also objected, where mortgaged property is bid in by the mortgagor, to dividing the transaction into two separate elements. (Sec. 29.23 (k) (3) of Regulations 111.) The American Institute of Accountants agreed that the splitting of that transaction into two parts should be changed.

Determination of taxable income inclusions and exclusions

Historical note: The title of this topic is something of a misnomer. Congress may not include in taxable income that which is not income. This subject deals, therefore, primarily with statutory exclusions from taxable income of items which Congress has full power to tax.

The expanding adventures of governments and authorities into proprietary functions, in direct competition with taxable free enterprises, have created a serious policy problem in national and local taxation. An utterly unfair discrimination grows out of the freedom from income tax of governmentally owned electric-power projects. The Government is actively competing on a tax-free basis with the taxpaying portions of the electric utility industry. Tax inequality between different lines of endeavor is bad enough, but tax inequality within a single field is indefensible. Since the South Carolina Dispensary case,[19] there is no doubt but that the Federal Government may tax the business activities of States and their subdivisions.[20] As a bookkeeping matter, the Federal Government could demand of its own instrumentalities the same accounting for taxes which it exacts of private parties. Although reciprocal immunity from taxation of the salaries of governmental employees has been destroyed as a principle of Federal constitutional law,[21] there is considerable doubt whether the reciprocal immunity in respect of interest on governmental obligations has been seriously weakened.[22]

An even more serious situation may be developing as a result of organizations, exempt under code section 101, entering fields of endeavor in competition with private business. Title III of the Revenue Act of 1950 coped with this tendency and made some progress in respect of organizations which come under section 101 (1), (6), (7), and (14), except churches. Section 101 (12) (cooperatives) was tightened up some by section 314 of the Revenue Act of 1951. However, Congress has not dealt with the entire problem, particularly social clubs and fraternal organizations. (Code sec. 101 (3) and (9).)

Hearings, August 6, 1953: The testimony and statements were very instructive. The representative of the Edison Electric Institute urged the removal of the tax exemption which Federal, State, and municipal bodies now enjoy in conducting proprietary business in competition with their own taxpayers. This includes the issuance of tax bonds to finance such enterprises, the recent trend to issue industrial development revenue bonds, and the REA electric cooperatives who are competing for business with the taxpaying utilities. The insitute urged amendments to sections 22 (b) (4), 101 (15) and 116 (d) to that end.

An accountant submitted a lengthy study and argued effectively for the taxability of industrial-development revenue bonds and authority bonds. He recommended the amendment of section 22 (b) (4) to subject to Federal income taxation without question the interest on industrial-development revenue bonds and the interest on the obligations of authorities which engage in proprietary ventures and which do not pledge the faith or credit or taxing power of their State or municipal governments. Along similar lines, the National Association of Real Estate Boards protested against the tax exemption granted to bonds sold to finance Government-owned housing projects, called public housing. These bonds take the form of a local public-housing bond issue, but they have the substance of tax-exempt Federal bonds issued by authority of the Public Housing Administration.

The representative of the American Hotel Association objected to exempt social clubs and fraternal organizations competing with taxable hotels by offering food, beverage and lodging to the public. There was inserted in the record a formidable list of tax-exempt establishments bidding for public patronage. (Sec. 101 (3), (7), (8), and (9) relate to privately operated and controlled organizations.) They are supposed to be powerful politically. They may ultimately weaken the taxpaying hotel and

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restaurant industry, but they are acting as a spearhead in furnishing certain services free from high taxes and without private profit.

The Coca-Cola Export Corp. made a thorough exposition of the discrimination which now exists against nonresident alien employees of United States corporations who visit the United States for business training or consultation. The ascertainment of income from sources within the United States is covered by code section 119, subsection (a) (3) of which provides that compensation not in excess of $3,000, received by a nonresident alien individual while temporarily in the United States, for the redition of services to an alien entity, shall not be deemed to be income from United States sources. Where the nonresident alien renders the services here to a United States corporation, he must pay the tax thereon. A statement was submitted containing a brief summary of some general provisions in income-tax conventions with respect to the exemption of temporary visitors to the United States from treaty countries. The witness stated that the most satisfactory solution to this problem would be to amend sections 211 (b) and 119 (a) (3) to exempt labor or services performed on behalf of a foreign branch of a United States corporation. It went further however, and urged that the present 90-day period be increased to 183 days, and that the limitation on the amount of exempt remuneration be increased from $3,000 to $10,000.

In behalf of the John Simon Guggenheim Memorial Foundation, a statement urged support of H. R. 3690, which would amend section 22 (b) (3) to treat as an exempt gift, amounts paid to an individual by a section 101 (6) organization to enable the recipient to improved or to complete his education or training or to engage in research or creative activity. An individual witness, purporting to speak for the owners of small corporations, recommended that the surtax exemption under section 15 (b) be increased from $25,000 to $50,000. This change was urged to keep with the corporation the tax savings with which to expand, instead of relegating the operators of small business to a permanent position of smallness.

Section 22 (b) (2) (A) provides, among other things, that, in the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance, endowment or annuity contract, or any interest therein, only the actual value of such consideration and the amount of the premiums and other sums subsequently paid by the transferee shall be exempt from taxation. If the policy is not transferred, the entire proceeds are exempt under section 22 (b) (1). The National Association of Life Underwriters thinks this result inflicts "great hardship," especially where the transferee has an insurable interest in the life of the insured. They strongly urge its change. The American Life Convention and the Life Insurance Association of America agreed with this contention, and, also, protested against the misapplication of the doctrine of constructive receipt to life insurance transactions.

Section 126 deals with income in respect of decedents. Subsection (a) (1) provides that, where gross income is not includible in the return for the period in which the decedent died, or a prior period, it shall be taken up (1) by the estate of the decedent, (2) by the person who acquired the right to receive the income, by reason of the death of the decedent, or (3) by the person who acquired from the decedent the right to receive the income by bequest, devise, or inheritance. Subsection (a) (2), however, provides that, where the right to receive income above described is sold or transferred, there must be included in the gross income of the transferor the fair market value of the right at the time of the transfer plus any consideration in excess thereof. This prevents the legatee widow of a life insurance agent from bequeathing the uncollected renewal account to their children without taking up its fair market value in her final return. The National Association of Life Underwriters urged the amendment of section 126 (a) (2) to place such a request on the same footing as obtains under subsection (a) (1).

A Washington practitioner recommended: (1) Provide specifically that treasury stock shall not be considered as an asset and that its sale shall not give rise to gain or loss; and (2) make section 128 applicable to the recovery of any taxes previously deducted under section 23 (c). Another practitioner supported a proposed amendment to the code which would give relief to certain banks required to issue preferred stock to the Reconstruction Finance Corporation in connection with mergers arranged by the Federal Deposit Insurance Corporation, by allowing them a deduction for amounts paid in retirement of said preferred stock.

Gift and estate tax problems

Historical note: Section 301 (b) of the Revenue Act of 1924 allowed a credit to Federal estate tax of the amount of any similar tax paid to any State in respect of property included in the gross estate. The credit was subject to a 25-percent limitation. The report of the Senate Finance Committee records the receipt of a letter from Secretary Mellon which says that inheritance taxes are properly sources of revenue for the States. The letter also declares that the far-reaching economic effect of high inheritance taxes is not properly understood. They siphon off capital for current operating expenses, the cumulative effect of which will prove harmful to the country. (1939-1 (pt. 2) CB 270, 289, and 308.) The limitation was increased to 80 percent by section 301 (b) of the Revenue Act of 1926. (1939-1 (pt. 2) CB 324, 338, and 376.) Section 401 of the Revenue Act of 1932 imposed an additional estate tax to which the aforementioned credit was specifically made inapplicable (sec. 402 (a)). At the same time, title III of the 1932 act restored the gift tax as a supplement to the estate tax. With technical refinements and ever-increasing rates in both estate and gift taxes, the matter stands today. At this time the basic estate tax has a maximum rate of 20 percent (code sec. 810). The additional estate tax has a maximum rate of 77 percent (code sec. 935). It is not difficult to see what happens to an estate when the two are added together. The maximum gift tax rate is 57¾ percent.

Hearings, August 10, 1953: Everyone except the American Federation of Labor seems to agree that the rates are too high. Even with the numerous alleviating provisions of the past 10 years, one must have strong leanings toward state capitalism to recommend lower exemptions and increased rates in these taxes. The chamber of commerce has this to say about the present estate and gift taxes:

"In any revision of the Federal tax structure there should be earnest attention to the consequences of the present estate and inheritance taxes, which are levied by the Federal and State Governments.

"The effects of present high rates, low exemptions, and inequitable provisions are damaging socially and economically. There is a serious impairment of incentive and discouragement of the natural desire to make family provision. Successful family enterprises are broken up and family ownership and control destroyed. There is dissipation of productive capital with all of the public detriment that follows. The consequences bear heavily upon small enterprises which must continue to have an important place in the business structure.

"The Federal Government should take the leadership in adjustments to avoid these destructive effects. It should remove itself from the whole field of estate and gift taxation.

"Meanwhile, the additional or supplementary estate tax should be repealed, leaving only the basic estate tax in effect with its 80 percent credit for death taxes paid the States and larger exemption. With such lowering of rates the need for a policing gift tax would disappear and it should be repealed or at least reduced to be consistent with the lower estate tax rates."

Several parties testified or submitted statements in support of that outlook. Most of the testimony, however, was directed to technical amendments designed to cure existing discrimination or imagined injustices.

The insurance business is considerably exercised over the taxation of the proceeds of life insurance. Under section 811 (g) (2), the estate of an insured is taxed if he owned the insurance policy or if he paid the premiums. The premium-payment test has the effect of including in the decedent's gross estate a policy to which he never had title or which has been irrevocably assigned by him, and in which neither he nor his estate has any interest. By contrast, the gift tax applies only to the cash value of an interest actually owned by the insured and donated by him. From many quarters, it was recommended that the premium-payment test be discarded, and that insurance proceeds received by beneficiaries, other than the executor, should be included in the decedent's gross estate only to the extent of the cash value, immediately prior to death, of the interest in the insurance actually owned by the decedent.

As a measure of simplicity, one witness declared that every gift should be taxed when it is made, regardless of whether it is direct or indirect, whether it is revocable or irrevocable, and that there should be no further question concerning the corpus of the gift or trust. The statement seems to be an oversimplification. For example, what is the fair market value of the gift involved in a revocable trust? How would the donee's conditional liability be measured in case the donor later exercised his right of revocation? [23]

A practicing attorney pointed out that, under certain circumstances, the relief intended by the optional valuation of estates under section 811 (j) is nullified and converted into a hardship. These situations arise in audit after the election has been made to use the optional date. Items difficult of valuation, or unexpectedly included in the gross estate, may be valued by the examining agent at a figure higher than that provable value at date of death. An amendment to the code was recommended which, upon such an increase in the value of the gross estate, would provide that the executor of the estate should have a new election.

Section 22 defines gross income. There are really two definitions or conceptions contained in section 22. Subdivision (a) is more like the constitutional concept of income. Its language is very broad and general, even though not as terse as the 16th amendment. The entire section 22, however, gives the statutory definition of income. It is detailed and covers a multitude of items. The Ways and Means Committee hopes it can come up with a better general definition of income, and we wish them luck. A research engineer who appeared before the committee urged that no inanimate entity, such as a business, be regarded as having taxable income. His conception of taxable income is that "which is received by natural persons as ultimate consumers; it includes wages, salaries, dividends, legacies, and gifts." He paid his respects to Karl Marx by saying that commu-

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nism in the Internal Revenue Code is the source of all our tax problems.

Section 1003 (b) (3), in arriving at net gifts, provides a $3,000 annual, per donee exclusion. This was designed to permit a donor to make small gifts without being required to file a gift-tax return. However, gifts of future interests are expressly excepted from this exclusion. There has arisen a great deal of confusion in the case of gifts in trust. It is difficult to determine in a particular case whether a gift in trust for a minor child will be entitled to the $3,000 exclusion or regarded as the gift of a future interest. One witness pleaded that, in such a situation, in order to retain the benefit of his annual exclusion, a father must abandon the reins over his infant. One recommendation would allow a donor to make annual gifts up to $3,000 (or $6,000 with spouse's consent) to minor donees without considering such gifts as applying against the specific lifetime exemption of $30,000 provided by section 1004 (a) (1). Another proposal would allow each donor an annual $3,000 exclusion for all his gifts of future interests.

A Washington practitioner suggested that section 812 be amended to allow a deduction for the amount of the estate tax. It was explained that, mathematically, the amount of such a deduction would be computed in a manner similar to the computation of the charitable deduction where there is a specific bequest with the residue, after estate taxes, going to charity.

A private citizen suggested the complete elimination of the baffling reference to property that is subject to claims but not to general claims in section 812 (c) and, also, the elimination of the tracing rule which denies any allowance for property acquired unless it can be identified as having been acquired in exchange for the property previously taxed. If there is going to be an allowance in one case, there should be a similar allowance in the other case, even if there is no direct connection between the property included in the first estate and that left by the second decedent. These two simplification measures cannot be accomplished without the substitution of a tax credit for a deduction from the gross estate. The suggestion was also made that, in lieu of the present allowance of a full deduction if the second decedent dies 4 years and 364 days after the first, there be provided a sliding scale by which the credit or deduction would range from, say, 20 percent to 100 percent according to the number of years intervening—for example, less than 2 years, 100 percent; 2 to 4 years, 80 percent, etc., up to 20 percent from 8 to 10 years.

This was an actively considered topic. The record contains significant proposals.

Excise tax problems

Historical note: Excise taxes are among the oldest forms of internal taxation used in this country. The first internal revenue statute laid duties upon spirits distilled within the United States. (Act of March 3, 1791, 1 Statutes 199, 202.) It is not surprising that the taxation of liquor and tobacco is regulated today by statutes drawn to fit a bygone age. Excise taxation was widely used during the Civil War period, and, to a considerable degree, in World War I. Its present extensive use dates primarily from the Revenue Act of 1932 and the requirements of recent wars. (See code sec. 1650.)

Hearings, August 10-11, 1953: The excise tax problems relating to rates, to new taxes, or to the removal of existing taxes, are not treated at this point but all such are gathered together under topic 40.

The tax representative of the Western Union Telegraph Co. presented four inequities or discriminations imbedded in the code, as construed by the Bureau, which are harmful to his company and create customer resentment: (1) and (2) The amounts paid for the installation of instruments, wires, poles, switchboards, apparatus, and equipment are expressly exempted from the 15 percent tax on local telephone service (code section 3465 (a) (3); the installation charges of the telegraph company, including the salaries of operators, should likewise be exempt. (3) By section 3465 (b), common carriers are exempt from the tax on leased wire, teletypewriter, or talking circuit special service utilized in the conduct of their business; this exemption does not apply to the taxes on telegraph and telephone messages imposed by subsection (a) (1), and the telephone companies have a competitive advantage in respect of their teletypewriter service. (4) The competitive disadvantage under which Western Union's Intrafax operates as against other intercommunication and interior systems, located within a local exchange area, should be removed.

The recommendations urged by the Associated Tobacco Manufacturers were unique in that they asked for no cut in the tax rates. Their representative also believed that his recommendations were entirely noncontroversial. He proposed three principal administrative changes and a list of minor adjustments which may be found in the record. The three principal ones were: a stamp method of procollecting tobacco taxes; a simple statement to take the place of the multiplicity of requirements in respect of statements, registration, bonding, certificates, and so forth; and a modernization of the recordkeeping requirements. Counsel for the Cigar Manufacturers Association, Inc., offered a complete recodification of the archaic statutes relating to the collection of excise taxes on cigars.

The R. J. Reynolds Tobacco Co. urged the removal of the present requirement of prepayment of cigarette and tobacco taxes, since the financing of its stamp purchases was becoming a hardship. A proposed amendment of sections 2001 (a) and 4047 was submitted. The American Tobacco Co. suggested a similar change. The freezing of capital in the form of excise tax payments was further exemplified by a witness representing the National Association of Independent Tire Dealers. The tax on tires and innertubes is high and, where the manufacturer has a company-owned retail outlet, the competition is serious to the independent dealer.

The importers of alcoholic beverages think they have a perfect case for tax revision. In the first place, the applicable statutes are antiquated and need modernizing. Section 2800 (a) (1) taxes distilled spirits at the rate of $10.50 on each proof gallon, "or wine gallon when below proof." The quoted phrase works a discrimination against imported distilled spirits. It grew up like Topsy and the history of it is explained. Various amendments to section 2800 are proposed.

The manufacturer's excise tax on radio receiving sets and accessories was first imposed by section 607 of the Revenue Act of 1932. The tax on television receiving sets was first imposed by section 605 of the Revenue Act of 1950. These taxes are now imposed under Code section 3404. The Radio-Electronics-Television Manufacturers Association urged passage of H. R. 6314, which would remove from the tax all electronic devices used for commercial and technical purposes. In addition, it would remove the tax for all components, except tubes. While H. R. 6314 would solve the administrative tax difficulties peculiar to this industry, there remain problems which are general to all manufacturer's excise taxpayers. They were all listed in a prepared statement. One of them dealt with the lack of adequate review in this field of taxation. It was suggested that the Tax Court be given jurisdiction to determine deficiencies in excise taxes and to review the departmental rulings on the subject.

Section 617 of the Revenue Act of 1932 laid a producer's excise tax on gasoline. Section 603 (c) of the 1934 act broadened the definition of gasoline to include naphtha. (Code sec. 3412 (c) (2).) Because the generic word naphtha is contained in the definition of gasoline, a large number of specialized petroleum products must be meticulously accounted for, gallon for gallon, all the way from the refiner through intermediate distributors down to the manufacturers who use them as raw materials. The American Mineral Spirits Co., Chicago, asked to be relieved of the enormous burden of accounting involved, by eliminating the word naphtha from the definition of gasoline. H. R. 5989 and S. 2238 would accomplish the purpose. These bills were also supported by the American Petroleum Industries Committee.

Recognizing the need for a restatement of basic principles of sound excise tax administration, whether selective or uniform, the National Association of Manufacturers established a subcommittee on manufacturer's excise tax administration comprised of experts in this field drawn from the major industries now subject to such taxation. They made a fine oral presentation and submitted an excellent brief, which are highly commended. A specialist in income, estate, and gift taxation has no conception of the administrative burdens connected with excise taxes. The association suggested many reforms, one of them being an internal appellate procedure which has already been adopted in part by the Bureau.

The Sheaffer Pen Co. protested the discrimination in respect of the lack of a termination date for the excise tax on writing instruments. (See code sec. 3408.) They requested that an April 1, 1954, termination date be put on the tax on writing instruments. With some force, the company contended that writing instruments are in much greater use by school children than wrestling head harnesses, push balls and water polo equipment. The Fountain Pen & Mechanical Pencil Manufacturer's Association objected to the taxation of an ornamented mechanical writing instrument as a luxury item, and urged the immediate termination of the tax on pens and pencils.

The automotive industry formed an industry-wide committee which urged the elimination of the discriminatory automotive excise tax. In regard to section 3403, they protested, especially, the tax on parts required to keep cars in repair. The Treasury holds that repairing, rebuilding or reconditioning of used automotive parts is the manfacture of automotive parts, and is taxable under section 3403 (c). The reconditioning of some automotive parts is taxable, not so others. The enforcement is not uniform. A lengthy brief was submitted in behalf of the various associations, which stated bluntly that the Treasury Department has not kept its promises to correct its errors by administrative regulations and that further promises cannot be relied upon. In the name of justice and equality, Congress was earnestly beseeched (1) to amend section 3403 (c) by adding the words "other than repaired, reconditioned or rebuilt parts or units when sold as such, or (2) to repeal section 3403 so as to eliminate the tax on automobiles, trucks, parts and accessories. Several members of the industry-wide committee spoke in support of the brief. One of them said: "These people are hopelessly lost on a sea of uncertainty."

The Royal Typewriter Co., Inc., directed attention to a discrimination in the tax as applied to rented typewriters. (Code section 3406 (a) (6).) There is a 10-percent tax on the sale of a new machine, but, where a machine is rented and then sold as secondhand,

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the Bureau invokes section 3441 (c) to apply the 10 percent rate to both the rental payments and the secondhand prices. The witness proposed that section 3441 (c) be amended to make it clear that the total tax payable with respect to any article, even though payable in installments as rental payments, should not exceed the tax measured by the manufacturer's wholesale price, thus putting all transactions on the same basis.

Two individuals prominent in the trailer rental business urged legislative clarification of the manufacturer's excise tax on the lease of utility automobile trailers. (Code secs. 3403 and 3440.) Their testimony was convincing. It elicited from Chairman REED the observation that one point is fundamental in all tax bills: "There shall be certainty in taxation." This is particularly true in excise taxation, where the tax must be collected when the transaction takes place. Short-term trailer rentals are not the equivalent of sales and could very well be eliminated from the type of leases mentioned in sections 3440 and 3441.

The Participating Sports Association of America protested vigorously against the 20-percent admissions tax on privately operated enterprises, in competition with similar facilities operated by States or political subdivisions. The witness pointed out that recreation involving physical exercise is taxed in the same manner as any luxury entertainment or spectator sport. He urged passage of H. R. 3421. The representative of the National Screw Machine Products Association submitted a problem involving the application of section 3413 to a group of oils known commercially as cutting oils. H. R. 5606 would specifically eliminate cutting oils, used in manufacturing processes, from the general category of lubricating oils. The representative of manufacturers of ticket games sought relief from the taxes on wagers and substitution therefor of a stamp tax as on playing cards.

A large number of statements, full of meaty suggestions, were submitted for the record by parties who made no personal appearance.

Retirement funds for self-employed and others not covered by existing pension plans

Historical note: The Social Security Act provides for a governmental system of basic pension benefits. First, there are the grants-in-aid to the States to help them pay old-age pensions to needy elderly persons. Second, under the old-age and survivors insurance program, which covers most employed persons, the employers and employees are required through Federal payroll taxes on each jointly to pay the cost of retirement benefits for such employees and their survivors. (Code secs. 1400–1432 (Federal Insurance Contributions Act).)

The maximum benefits, under this program, for an individual are $85 per month, and, for a husband and wife who are both over 65 years of age, the maximum is $127.50. If a person earns more than $75 a month, he is disqualified for the benefits. Third, in addition to their coverage under the Federal old-age and survivors insurance program, some 8 million employed persons receive supplemental pension benefits under approximately 17,000 tax-favored pension plans set up by employers for their employees, either voluntarily or as a result of bargaining with labor unions. These private pension plans constitute a second layer of pensions built on top of the Federal old-age and survivors insurance program. (Code secs. 23 (p) and 165.) If a pension plan is approved under the cited code provisions, the employer obtains a deduction in the current year for his contribution to the fund, but the employee is not taxed currently on what the employer pays into the fund in his behalf, even though such payment is in the nature of additional compensation for services. The employee is taxed only when he gets the money at retirement, as and when it is received. This tax deferment is also extended to the accretions of the employer's contribution resulting from the investment of the trusteed funds or the purchase of deferred annuity contracts from an insurance company.

This preferential tax treatment for private pension plans, some of which antedate the entire Federal social-security setup, has now become an established national policy. However, it is presently restricted to employee pension plans. The self-employed persons in the country, such as farmers, professional people, shopkeepers, etc., cannot come under these tax-favored pension plans since technically they are not employees. Therein lies the discrimination. In the same predicament with the self-employed persons are millions of employed persons whose employers have not set up private pension plans. It is obvious that if such persons had the same right of tax deferment on a portion of their income as millions of employed persons have under section 165, they would be in a similar position to provide for their old age. In all fairness, they are entitled to that much. Self-employed persons would ask nothing from the Government or anybody else.

Hearings, August 12, 1953: Several bills are pending to relieve this discrimination. The purpose of the Jenkins-Keogh-Camp bills is to encourage the establishment of voluntary pension plans by individuals. These bills would accomplish the purpose by permitting such persons a postponement of income tax with respect to a limited portion of earned income (as distinguished from investment income), paid into a restricted retirement trust fund or to an insurance company as premiums for a restricted retirement-annuity contract. The limited amount so excluded, plus each participant's share of the interest on his fund, would be taxed in later years, when drawn down as retirement benefits. Such is the essence of the plan, and those seeking details of the proposed legislation are referred to the record of the hearings.

The Associated Actors & Artistes of America, the American Bar Association, and other local bars, the American Medical Association, the American Institute of Accountants, the Authors League of America, the American Veterinary Medical Association, the New York Stock Exchange, the American Farm Bureau Federation, the insurance industry, and many others, urged its passage and submitted formidable supporting data. This legislation is very necessary at least as a starting point. One witness, although agreeing on principle with its general objectives, disagreed with the plan of the pending bills and submitted his own alternative solution. The representative of the National Association of Investment Companies thought the pending bills too restrictive in providing that the trustee of restricted retirement funds of an individual must be a bank. The representative of the Investment Counsel Association of America agreed with the principle of self-employed retirement funds, but would grant the trustees of such funds much broader investment powers.

Although not directly pertinent, at the beginning of the hearings on topic 36, the committee welcomed Judge Herbert F. Goodrich of the United States Court of Appeals for the Third Circuit. Judge Goodrich explained in considerable detail the good work being done by the American Law Institute. The Maurice and Laura Falk Foundation made a grant to the institute to undertake a study of the income-tax laws. The main object of the institute's income tax project is an improvement of the technical provisions of the present statutes. They disavow any attempt to write a complete income tax code. A clarification of definitions is one of their objectives. The accurate definition of terms either prevents or puts an end to unnecessary disputes.

Exclusion of pension and retirement income for specific types of employees

Hearings, August 13, 1953: Old-age pensions received under the Social Security Act or under the Railroad Retirement Act, and also pensions received under any act relating to disabled war veterans, are entirely exempt. All other pensions and annuities received for past services are taxable. The exemption of retirement income should apply to all types of retirement income and thus eliminate the present discrimination. H. R. 5180 would go a long way toward equalizing the tax treatment of retired people.

Many educational groups and various associations of Government employees, retired officers, and retired Government employees testified in support of H. R. 5180. Under this bill the first $1,500 received as retirement income would be excluded from gross income in the case of all taxpayers who are at least 65 years of age and retired, or who are retired under a public or private retirement plan regardless of age. However, the $1,500 exclusion is to be reduced in proportion to the taxpayer's current earnings, if he works after retirement and earns more than $900 a year. This reduction is on a sliding scale similar to old-age and survivors insurance (OASI) provisions. The ceiling is $125 per month and any pension that a person would get (except service-connected disability) would be counted with OASI payments and railroad retirement in computing whether the ceiling is reached. The philosophy of the bill is to treat everybody's retirement income the same, whether it is derived from a pension plan, a privately purchased insurance annuity, or from investments. The National Education Association testified in support of the bill and submitted a brief technical analysis of its provisions.

Some organizations went much further. For example, the policemen contended for a lower retirement age and more liberal provisions respecting the work clause or supplementation of retirement income in the case of enforcement officers. Others went the whole distance and urged the complete exemption of all retirement income. The strong interest taken in this subject may lead to some degree of general relief from income taxation in respect of retired persons.

Depletion and exploration expenditures

Historical note: The Corporation Excise Tax Act of 1909 permitted the deduction of "a reasonable allowance for depreciation of property," but made no reference to depletion. (Sec. 38 Second (second).) The Supreme Court construed the 1909 act as denying any deduction for depletion of the mineral content of a mine, but, notwithstanding such interpretation, the Court upheld the constitutionality of the act.[24] The act of October 3, 1913, which is the first income tax act under the power of the 16th amendment, granted individuals a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, "not to exceed, in the case of mines, 5 percent of the gross value at the mine of the output for the year" (sec. II B (sixth)). As to corporations, the 1913 act granted, in the case of mines, "a reasonable allowance for depletion of ores and all other natural deposits, not to exceed 5 percent of the gross value at the time of the output for the year" (sec. II G (b) (second)). The constitutionality of the 5-percent limitation was upheld by the Supreme Court.[25] Although not specifically mentioned as such, oil and gas properties were allowed depletion under the 1913 act. The Revenue Act of 1916 was the first to make specific reference to the depletion of oil and gas wells (sec. 5 (a) eighth (a)). The deducation was based on "actual reduction in flow and pro-

Footnotes at end of speech.

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duction." In the case of mines the 1916 act substituted for the 5-percent limitation a depletion allowance not to exceed the market value in the mine of the product thereof, which had been mined and sold during the year (sec. 5 (a) eighth (b)). The statute expressly said that where the depreciation or depletion allowances shall equal "the capital originally invested" (or the fair market value on March 1, 1913), then "no further allowance shall be made." It is thus seen that the 1916 act had practically arrived at the point of full depletion allowances for the year, without limitation, although the statute used cumbersome yardsticks.

The Revenue Act of 1918 improved the language of the allowance by including within its scope other natural deposits and timber, and based the deduction according to the peculiar conditions in each case, all under Treasury regulations. The 1918 act, however, went much further. It contained the first breach in the principle that cost (or March 1, 1913, value) constitutes the limit of capital value recoveries by way of annual allowances. It introduced a new basis for the measure of capital to be recovered in the case of a discovery, on or after March 1, 1913, of mines, oil and gas wells. (Secs. 214 (a) (10) and 234 (a) (9).) The unlimited use of discovery value was found to cancel profits from unrelated sources, so the 1921 act limited the depletion on that score to an amount not in excess of the net income from the particular property. (Secs. 214 (a) (10) and 234 (a) (9); 1939-1 (pt. 2) CB 191.) And, in the 1924 act, the limitation was still further restricted to an amount not in excess of 50 percent of the net income from the discovered property. (Sec. 204 (c); 1939-1 (pt. 2) CB 254 and 280.) The discovery value basis was replaced in the 1926 act, so far as oil and gas were concerned, by a flat allowance of 27½ percent of the gross income from the property, limited further to an amount not in excess of 50 percent of the net income from the property. (Sec. 204 (c) (2).) An enlarged definition of discovery was retained as one of the depletion bases for mines. (Sec. 204 (c) (1).)

In the Revenue Act of 1932, the benefits of percentage depletion were extended to coal, metal mines and sulfur, and the discovery value basis was withdrawn as to them. (Sec. 114 (b) (2) and (4).) Since that time, percentage depletion has been extended no slower than might be expected, and consistent with precedent. The present provisions concerning depletion are found in code sections 23 (m) and 114.

Hearings, August 14, 1953: The testimony and statements submitted under topic 38 make good reading. Mining and prospecting for natural resources is an inspiring subject in itself, aside from problems of taxation. From the nature of the testimony, the writer gained an impression that, for some reason, the mining industry was fearful lest all or part of their depletion benefits would be taken from them. On the basis of past experience, they need have no fear and nothing presently imminent need cause alarm. This writer favors the levelling out of the percentage allowances to eliminate rank discriminations, and the extention of the unique theory into the field of all capital investments which are destroyed by use and obsolescence.

There were but few dissenting voices in the long parade of witnesses and statements urging retention and/or extension of the principle of percentage depletion. Those opposed to this form of tax exemption were the American Farm Bureau Federation, the American Federation of Labor and the Counsel for the National Oil Marketers Association.

Chairman REED explained that section 130, relating to "hobby" losses, seriously interferes with oil and gas and mineral exploration and development, as well as farms in drought areas. Such losses arise from physical conditions not within the control of the taxpayer. He instructed the staff of the joint committee to prepare a bill to remedy the situation, which was done.

The American Mining Congress made several points regarding depletion and exploration expenditures, which they considered to be essential allowances for the mining industry. In the first place, the term "net income from the property" for purposes of the 50 percent limitation is not satisfactorily defined. The Congress suggested that, in arriving at that concept, deduction should be made only for those expenses directly connected with the production of income from the property and for such indirect or overhead expenses as definitely contributed to the production of income from such property. It is the contention of the Congress that the deductions in computing net income from the property should not be increased by expenses applicable to other property, by interest paid on indebtedness, or by taxes or other charges which are not formal costs of producing net income from a particular property. A code amendment was submitted which would add a new subparagraph (C) to section 114 (b) (4), and would limit the deduction to those items which have a direct bearing upon the production of income from the particular property.

The American Mining Congress also considers that the definition of "mining property" is in need of clarification and simplification. Section 29.23 (m)-1 (i) of regulations 111 leaves much to be desired. Many different situations are encountered as to mining property. An amendment at the end of code section 114 (b) (4) was suggested, which apparently would leave this matter largely within the taxpayer's discretion.

Under topic 17, we observed the various devices by which it was sought to alleviate the double taxation of dividends. The mining industry has a unique problem in connection with corporate distributions. Since percentage depletion allowances are not taxable to the corporation, the Congress considers that distributions therefrom should not be taxable to the stockholders. (Cf. sec. 29.115-6 of regulations 111.)

In connection with code section 23 (ff), the American Mining Congress recommends that both the $75,000 annual limitation and the 4-year limitation be removed. Expenditures for exploration should not receive less favorable treatment than is now accorded those for intangible development expenses. The Congress also recommended that following the example of Canada, new mines be allowed a 36-month exemption from income taxation. The idea is a good one and should apply to all new business.

The slate industry made a good case for increasing their rate of percentage depletion from 5 percent to 15 percent. They based their plea largely upon the rate already allowed for competing products.

The chairman of the Texas Railroad Commission, speaking as a citizen-soldier in the cause of national defense, urged the committee not to change the 27½ percent depletion allowance to oil and gas, nor to reduce it in any way. He stated that the system is working; it is producing the oil; and it means national security. His oral testimony was quite lengthy and well documented by tables, charts, and supporting statements, including a letter dated May 22, 1953, from the Secretary of the Navy, which estimated the current United States daily production of crude oil, distillates, and gas liquids, with restrictions removed, at 8,159,000 barrels per day, and which then stated that "This figure is not sufficient to meet the United States and allied requirements in time of a national emergency." The substance of the witness' testimony was that this country needs all the oil it can get and the percentage depletion deduction should not be withdrawn or reduced.

Another witness discussed the stripper-well segment of the oil industry and explained the water-flood method of secondary recovery. All oil wells eventually become stripper wells. He stated that the percentage depletion deduction is a real help to the secondary recovery operator and absolutely essential to the small operator if he is to expand his business. He urged the retention of the present incentive provisions in the code and the rejection of any proposal to reduce the oil depletion allowance.

A representative of the talc industry made an indignant presentation about the obstinate refusal of the Treasury Department to give full effect to the percentage depletion deduction of that industry. The feeling seems to grow out of the decision of the Tax Court, favorable to the taxpayer's position, in *International Talc Company, Inc.* (CCH Dec. 18,016, 15 TC 981 (1950) (NA)), which the Treasury Department seeks to curtail by regulation. (T. D. 6031, 1953-16 IRB 6.) Apparently the Department sought to apply the 15 percent rate for talc on the basis of a hypothetical sales price for the chemically pure content of the talc ore at the head of the mine. The Department, by T. D. 6031, now seeks to exclude "fine pulverization" from the statutory definition of "ordinary treatment processes."

The salt industry made a very interesting and effective presentation. The Salt Producers Association brought in a five-man team to appear before the committee, and, of all things, one of them was assistant to the chairman of the organizing committee, District 50, United Mine Workers of America. He spoke for the employee's point of view and backed up management's plea for an increase in the percentage depletion allowance for salt from 5 percent to 23 percent, as in the case of sulfur. (Code sec. 114 (b) (4) (A).) A second witness directed his remarks primarily to the effect which the percentage allowance has on the smaller producers. He made this observation: "In the long run, the way to keep our salt industry strong and healthy is to permit it to retain a greater portion of its earnings to plow back into exploration, development, plant expansion, and modernization." But, in every case, the way to keep any worthwhile activity strong is not to tax it to death. The witnesses for the salt industry made out a good case of discrimination in view of the allowances made to other minerals. They dispelled the idea that salt is as common as sand or as easy to get. They also set the average reader straight on the fact that 90 percent of this country's salt production goes to industry, particularly our giant chemical industry, and only a small part ever gets into the saltshakers on the dining table.

The representative of the Gypsum Association pointed out that gypsum (calcium sulphate) is the only important nonmetallic mineral that is not specifically accorded percentage depletion under section 114 of the code. There have been no discoveries of commercial deposits of gypsum in many years with the exception of one in southern Indiana, which is a relatively small deposit. The gypsum industry, particularly in the eastern part of the country, exists in its present volume because of substantial importations of gypsum rock from Canada and Mexico. The industry asks for a 15 percent depletion allowance, and, on a competitive basis, seems entitled to it.

The Refractories Institute declared that section 319 of the Revenue Act of 1951, which extended the percentage depletion allowance to refractory and fire clays and quartzite, had contributed substantial benefits to the national economy. They urged retention of the allowance. The Lake Superior Iron Ore Association stated that it is of national importance that the re-

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serves and production facilities of the Lake Superior area be built up and maintained. They recommended the removal of the $75,000 annual and the 4-year limitation on exploration expenditures. (Code section 23 (ff).) The kyanite industry urged the extension of the 15 percent depletion rate to kyanite, which is one of the aluminum-silicate minerals. They averred that, to the best of their knowledge, every mineral that is used along with, and in competition with, kyanite receives the 15-percent allowance. Many other interested parties submitted material for the record, without oral appearance: industries, such as slate, timber, sand and gravel, oil and gas, clay pipe, crushed stone, bituminous coal, etc.

Improper accumulation of corporate surplus (sec. 102)

Historical note: Under the Internal Revenue Code, as well as all the prior enabling acts under the 16th amendment, the plan of taxing corporate income to the corporation and dividend distributions to the stockholders has been employed. It is sometimes alluded to as double taxation, that is, the same dollar of profit is taxed first to the legal entity which earns it and, when anything left over is distributed to the stockholders, the latter become subject to the tax on taxable dividends. By comparison, where the business is conducted as a partnership, it is not liable for income tax, as such, but the owners are liable only in their individual capacity. (Code sec. 181.) In computing the net income of each partner, his distributive share of the partnership net income is included, whether or not distribution thereof is actually made to him. (Code sec. 182.)

With low corporate rates, the corporation-stockholder plan of taxation would offer a lawful means for deferring indefinitely, or escaping entirely, the dividend tax to the stockholders on earned surplus. Congress, therefore, placed in the act of October 3, 1913, a provision designed to discourage corporations from accumulating a surplus beyond the reasonable needs of the business, and a similar provision, in various forms, has obtained in all subsequent income-tax legislation. By section II A, subdivision 2, of the 1913 act, it was provided that for the purpose of the additional tax, or surtax, the taxable income of any individual should embrace the share to which he would be entitled, whether distributed or not, of the profits of every corporation, formed or fraudulently availed of for the purpose of preventing the imposition of the surtax through the medium of permitting such profits to accumulate instead of being distributed. The income-tax rates imposed by the 1913 act were insignificant compared with present exactions. The corporate rate was 1 percent; the individual normal tax rate was 1 percent; and the individual surtax brackets ranged from 1 to 6 percent. The improper accumulation section as a whole has passed through several mutations over the years, and today it is in the form of a tax on the corporation measured by 27½ percent of the first $100,000 of undistributed section 102 net income, and 38½ percent of all such net income over $100,000. (Code sec. 102; see, also, Otto, "Sec. 102: The Tax on a Corporation's Psyche," Taxes—the Tax Magazine, June 1953, p. 432.)

An excellent statement of the original and continuing purpose of the legislation is found in the decision in *Helvering* v. *Chicago Stock Yards Company* (43-1 USTC, par. 9379, 63 S. Ct. 843):

"As the theory of the revenue acts has been to tax corporate profits to the corporation, and their receipt only when distributed to the stockholders, the purpose of the legislation is to compel the company to distribute any profits not needed for the conduct of its busines so that, when so distributed, individual stockholders will become liable not only for normal but for surtax on the dividends received" (p. 846).

Although this statute has been on the books continuously since 1913, only two cases thereunder have been decided by the United States Supreme Court. They are: *Helvering* v. *National Grocery Company*, (38-2 USTC, par. 9312, 304 U. S. 282), which arose under the comparatively low rates of the Revenue Act of 1928, and *Helvering* v. *Chicago Stock Yards Company*, above, which arose under the Revenue Acts of 1928 and 1932. Under those acts, the corporate rates of tax were 12 and 13¾ percent, respectively. At that time, it is evident that the lion's share of corporate profits could escape surtax on the stockholders in the absence of some gimmick to compel distribution.

It has been said that the "punitive force" of such a provision is less where the surtaxes are higher. The writer prefers to say that, the higher the taxes on corporate income, the less need or justification there is for such a provision. For example, suppose that corporate taxes alone, including excess profits taxes, take 60 percent of the earnings of the corporation. The undistributed section 102 net income, then, could not exceed 40 percent of the corporate earnings for the year. This practical turn in both the theory and effect of section 102 is important. One of the gravest aspects of the application of section 102 has always been the need of the corporation for new capital, especially for expansion purposes. In the National Grocery Company case, above, the Supreme Court answered this difficulty in the following language:

"Since Kohl was the sole owner of the corporation, the business would have been as well protected against unexpected demands for capital, and assured of capital for the purpose of any possible expansion, by his personal ownership of the securities as by the corporation's owning them" (p. 938).

The same answer was given by the same court in the Chicago Stock Yards case (p. 847). Such answer was plausible and defensible within bounds under the moderate rates of the Revenue Acts of 1928 and 1932. Under present rates, however, the conclusion is contrary to fact. It is a good illustration of how changed conditions alter the validity of one's prior approach to a problem.

It is plain that the reasoning adopted by the Supreme Court in the National Grocery and Chicago Stock Yards cases, in regard to the anticipated or unexpected corporate need for additional working capital, has lost its validity, under current income taxation. Under low rates of income taxation, the Court's reasoning is roughly correct; but, under existing rates today, it is dead wrong. Furthermore, with the free use of its own income, remaining after taxes, the corporation would probably pay, because of increased earnings, as much more tax as the stockholders would pay thereon had it been distributed. It is hard to see how section 102 serves any useful purpose at this time. The revenue which the Government hoped to get as surtax on dividends is now being gathered in directly by heavy taxes against the corporation. When the Federal Government alone takes over half of a company's profits in income taxes there is no occasion to invoke section 102. The only apparent justification for its retention is in respect of corporations which have a substantial exemption from tax, such as percentage depletion.

Hearings, August 14, 1953: The Pennsylvania State Chamber of Commerce, in cooperation with the Council of State Chambers of Commerce, recommended certain amendments to section 102. They feel that the intent of section 102 should be retained. However, section 102 should be revised so that:

(a) The tax will apply only to that portion of the undistributed section 102 net income which was unreasonably accumulated. The incidence of this tax is upon "the undistributed section 102 net income," which is determined without regard to the degree of unreasonable accumulation. This clearly establishes the penal character of the tax. In this respect, it is like the 50-percent civil fraud penalty which is imposed upon the total deficiency, irrespective of the portion thereof to which the fraudulent intent is ascribed. (Code sec. 293 (b).)

(b) The burden of proof will be upon the Commissioner with respect to both the fact and the amount of the unreasonable accumulation of surplus. The burden of proof is now upon the Commissioner in respect of the civil frand penalty and the transferee liability. (Code secs. 1112 and 1119 (a). Cf. Code sec. 700 (i) (unjust enrichment) and Code sec. 811 (l) (rebuttable presumption in estate tax).)

(c) Dividends paid within 75 days of the close of the taxable year may, at the taxpayer's election, be deducted in computing section 102 net income for such year. This is a very important administrative remedy, and the chambers of commerce were entirely too timid in their suggestion. In the case of personal holding companies, provision is made, after the event, for a deficiency dividends credit against an unpaid deficiency. (Code sec. 506 (a).) There remains a 10-percent differential in tax on the undistributed subchapter A net income of the personal holding company, but the brutal impact of the deficiency is mitigated. It seems that, when the Government is attacking the judgment and state of mind of a businessman, the taxpayer should be privileged to make a contested distribution, demanded by the Bureau or decreed by the courts, without any section 102 liability, after the manner of the deficiency dividends credit.

The chamber of commerce of Charlotte, N. C., urged the reforms above suggested and also recommended that deficiency dividends be allowed as corrective measures similar to those provided in Code section 506, mentioned above. No brief is held for the surtax dodger, but the present section 102 poses a constant threat to a businessman who is thrifty and prudent. The American Mining Congress urged the repeal of section 102, but, in the alternative, suggested that, in the event of imposition of surtax under section 102, the corporation should be permitted to relieve itself of such tax by a deficiency dividend similar to section 506 or by filing consent dividend papers as provided in section 28.

The Machinery and Allied Products Institute pointed out that section 102 represents a psychological barrier to sound business policy. It has perverse cyclical effects because it prevents companies from establishing a cushion against booms and depressions. They objected particularly to the immediacy doctrine whereby an examining agent with benefit of hindsight is in position to condemn accumulations for indefinite but real business needs. They have no faith in the efficacy of changes in administrative policy, citing the 70-percent rule. When the Government takes over half of a corporation's income in taxes, the 70-percent rule is entirely too severe. In addition to the oral testimony of its representative, the institute submitted a carefully reasoned statement on the whole subject.

The American Institute of Accountants said that, under our present system of taxing dividends, the principle of section 102 is undoubtedly necessary, but that assurance of a wise and sympathetic administration of the section is equally necessary. They also recommend placing the burden of proof upon the Commissioner, and allowing the taxpayer to meet the liability by deficiency dividends or by filing consent dividend papers.

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The Georgia State Chamber of Commerce filed a comprehensive statement which went into the matter in considerable detail. It must be read to be appreciated. They submitted a series of proposed amendments which would require that surtax avoidance be a substantial factor in inducing the accumulation and would greatly expand the concept of assets reasonably needed in the business.

A Washington practitioner recommended an amendment to provide that the reasonable needs of the business shall not exclude investment in a new or different enterprise so long as it is represented by 100 percent ownership of the operating assets or 95 percent of the voting stock. He also made the novel suggestion that there should be a temporary moratorium on section 102 to permit small businesses to build up reserves against bad business conditions. In violent contrast, the American Federation of Labor made the amazing statement that "The penalty rates under section 102 are notoriously low."

Excise tax rates

Hearings, July 28–31 and August 3–12, 1953: Topic 40 was covered by evening sessions of the committee. Since there are scores of excise taxes in addition to the old standbys of liquor and tobacco, there will be no historical treatment of them.

The American Home Laundry Manufacturers' Association stated that the home laundry equipment industry is a sick business, closing down plants and laying off people. It may be triggering the explosion which could rock the whole appliance field. The witness ascribed the predicament of the industry to the 10 percent excise tax on ironers and dryers which he insisted forced the manufacturer to price the product out of the consumer's market. (Code sec. 3406 (a) (3).) He also stated that former Secretary of the Treasury Andrew Mellon proved conclusively that you can get more revenue by lower tax rates than by rates that are too high. He urged passage of H. R. 2963 which would repeal the excise tax on household ironers and clothes dryers. On interrogation, the witness explained that this is a young industry whose products have not reached the public saturation point. The 10 percent tax adds about $25 to the retail price and has a critical impact on the market in moderate income homes.

An official of a concern which developed and manufactures household gas and electric dryers, noted that there was no excise tax on farm machines which ease the work of the men in the fields. Nor is an excise tax put on machine tolls which make the job easier for the men in the factories. Neither should there be an excise tax on household appliances which ease the work of the homemaker. He stated that "We've run into a stone wall of consumer resistance." From the most careful consumer analyses, he ascribed the foundation for the consumers' reluctance to buy to extra cost imposed by the excise tax. He urged Congress for relief, and despaired of any help from the Treasury. Several other witnesses appeared in behalf of this industry. They were pretty blunt and plain spoken. The mechanics of manufacturers' excise taxation was explained. A manufacturer's excise tax inflates the price on each transaction at every stage of distribution. The tax must be financed and it increases the cost of financing inventory. In the end, it usually comes out of the consumer although, in a falling market, distributors stand their share. The British have reduced their purchase tax on appliances and other consumer goods. Another interesting angle is that, where the people think there is a possibility of the excise tax being removed, they stop buying and wait it out. The housewives sit on their pocketbooks. The Government, including the executive branch, should act fast whenever it encourages the people to think tax relief is in sight.

The Institute of Cooking and Heating Appliance Manufacturers urged the repeal of the 10-percent excise on electric, gas, and oil ranges, and water heaters. (Code sec. 3406 (a) (3); H. R. 4843.) The tax on certain household appliances was defended during war conditions as discouraging production of nonmilitary articles, thus conserving men, critical raw materials and machines for the war effort. Such thinking seems out of place at this time. The present excise tax system has piled discrimination upon discrimination over the past 20 years and, as Chairman REED says, it cannot be corrected overnight. Among the household items not taxed are washing machines, vacuum cleaners, draperies, floor coverings, sinks, sewing machines, and most consumer soft goods. Yet the kitchen contains a concentration of taxable items. The witness said that when Canada eliminated its 25 percent tax, its cooking business on gas and electric ranges spiraled to an all-time high. He further explained that, when an excise tax is levied at the manufacturer's level, the cost of financing the tax by the dealer takes the form of a customary markup of 75 percent. In other words, by the time it reaches the consumer, this 10-percent excise is 17 or 18 percent of the retail dollar. This point was developed by several witnesses. A dollar of cost is the same whether it represents raw materials, wages, or taxes. It must be financed until the machine is sold to the consumer. A manufacturer of electric food-waste disposers also urged relief from the 10-percent tax under code section 3406 (a) (3). This business is solving the garbage disposal problem in urban areas. A representative of the retail appliances dealers made a picturesque witness. He asked the question: "Who is in favor of these excise taxes anyhow?" Nobody; but the Treasury. "Forgive them their trespasses, for they do not have to run for reelection in 1954." Coming to the business community, he said the only group that appears to love a manufacturer's excise is our old friend, the National Association of Manufacturers.

The representative of the Gas Appliance Manufacturers Association made the best social argument against discriminatory excise taxation: It makes possible discriminatory regulation by the Government of the industries affected; it reserves to the Government the power to determine whether a young or small business shall be permitted to grow to the full position it might achieve in a free competitive system; it substitutes political control and political penalties for the judgment of the consumer. The witness also commented on some strange inconsistencies. We are on a horse riding in all directions at the same time. The Federal Government aids low-cost housing projects; the same Government increases the cost of such housing by taxing items which are a necessity to completed housing units. The Federal Government supports prices in aid of agricultural production of food; in the same breath, it taxes the preservation and preparation of food. The witness agreed, however, if you have to have the revenue, an excise over all production activities, except food and medicine, would be more equitable.

The Association of American Railroads urges the elimination of the 15 percent transportation tax on persons. (Code sec. 3469.) The tax is definitely discriminatory in that it applies to transportation by common carrier. Private carriage escapes the tax. The rail passenger transportation is a depressed industry. This tax drives intercity travel from common carriers to private carriage. This tax was an important part of the plan during World War II to discourage civilian common-carrier travel, and it is still helping to accomplish that purpose. The witness believes that every railroad in the United States is showing a deficit in net railway operating income from their passenger service operations. The railroads are doing everything they can, and the governmental brakes on their efforts should be removed. Another representative of the association urges the immediate repeal of the excise tax on the transportation of property. (This came in under sec. 620 (a) of the Revenue Act of 1942; code sec. 3475.) In general, it is a 3-percent tax. It discriminates between long and short hauls and between public and private carriage. It is readily avoided at the expense of the railroads and other public carriers by operating a truck on one's own account. The tax is not justified in time of peace and the present competitive situation. There is also a considerable markup in respect of this tax. A lengthy statement discussed the need for more transportation facilities to take care of wartime conditions.

The president of the American Retail Federation submitted a statement which was summarized by a witness in his behalf. He made an argument unanswerable on principle, except that the Government needs the money. The economics of his argument were sound. He argued that the wartime excise taxes, both retail and manufacturing, are barriers to an expanding economy; and that the adverse effect of the discriminatory retail excises on sales of taxed items is clearly shown where we compare such tax collections with other economic data. He made another statement which commands attention: Retailers believe that our American economy and standard of living are hung upon the successful production and sale of the categories of goods which our people are not compelled to buy, and that the difference between full employment and serious unemployment depends upon the efficient distribution of goods and services beyond the necessities of life. The witness opposed the campaign of the National Association of Manufacturers for a national manufacturer's sales tax on the end products of all manufacturers, excepting only food.

The clock manufacturers urge the repeal of the retailer's excise taxes on their products. (Code secs. 2400 and 1650.) They claim that clocks and ulitarian watches are not luxuries, but are necessities in both peace and war. The witness pointed out that their products are sold through a wide variety of outlets such as drugstores, specialty shops, and newsstands and the necessity of keeping records and accounting for collections causes the retailer to discontinue that line of stock. The association urged the discontinuance of excises on clocks and low-priced watches.

The Lawn Mower Institute, Inc., Washington, D. C., protested the tax on power lawnmowers. (Code sec. 3406 (a) (3).) They claim it is causing a serious reduction in sales and loss of employment. Besides, it was tacked on to the code by section 485 of the Revenue Act of 1951 without consultation with industry and without due regard to the economic factors involved in this industry. This is one instance where the manufacturers absorbed part of the tax. The Institute urged fvorable action on H. R. 4900 which would have repealed the tax.

The witness for the Rubber Manufacturers Association recognized the accepted principle of taxation that luxuries are fair tax targets, and observed that, today, tires and tubes are not a luxury but rank along with the basic necessities of food, clothing, and shelter. This tax is based upon weight and not upon selling price. (Code sec. 3400 (a).) When translated into terms of an ad valorem tax, it is considerably higher than the 8-percent excise on automobile parts and accessories. It was recommended that the rates be reduced to the pre-1941 level of 2½ cents per pound for tires and 4½ cents per pound for inner tubes, with provision for credit on floor stocks.

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Probably the most unique suggestion to come from the hearings was made by the counsel for the Cigarette Lighter Manufacturers Association, Inc., New York City. It grows out of the markup by jobbers and retailers, because of the manufacturer's excise tax on mechanical cigar and cigarette lighters imposed by section 3408 (a). Apparently, in this industry, there is a general markup from manufacturing to retail level of slightly more than 100 percent. The association suggests shifting the existing 15-percent manufacturer's excise tax on lighters to the retail level at a reduced rate of 7½ percent. The tax would be paid by the retail customer on the sale to him. Since there is no tax financing cost to the retail merchant, the article can be sold at a reduced price. Therefore, the customer pays less for the commodity and the Government gets the same amount of tax, maybe more, should sales increase as a result of the price reduction. H. R. 5733 was introduced to make the lighter industry a pilot case for the application of the plan. One of the large labor unions, the International Association of Machinists, supported the proposal. H. R. 5733 fell by the wayside, as did most other revenue bills, in the closing days of the last session. It is recognized that the retail merchants might object to the extra paperwork. In the case of lighters, however, most retailers already handle other items subject to the retailer's tax, so that it would only require a little more of the same kind of records. Also, the Treasury would have to await the retail sale for the tax. The association was highly commended on its presentation because of the public spirit in which they tried to solve the tax situation.

The National Association of Manufacturers, New York, N. Y., made a logical but unpopular presentation. They start from the historically sound proposition that the Federal Government must always make use of excise taxation. With almost confiscatory rates of income taxation in the upper brackets, the Government has still been compelled to resort to excise taxes. There is no logical basis for the selection of most of the goods and services now taxed, nor for the range of tax rates imposed. Our excise system is a mass of discriminations and inequities. The next fundamental position taken by the association is that equity in taxation is achieved through broad bases, uniformity of tax treatment, and low or moderate rates according to revenue requirements, rather than the narrow bases, selectivity and crushing rates that characterize the existing structure. To this end, they recommend that the present Federal excises, except those on alcoholic beverages and tobacco, be replaced by a flat-rate tax (suggested at 4½ to 5 percent) on all end products of manufacture, except food and food products. They prefer the levy of this flat-rate tax at the manufacturer's level but do not foreclose support of the tax at the retail level if it should prove more feasible of enactment. They defend the flat-rate tax at the manufacturer's level on the grounds (1) it would be fair to everyone and eliminate the existing discriminations, (2) it would be substantially less than nearly all the present excise rates because of the broad base of incidence, (3) it is far easier and cheaper to administer the tax, because less than 300,000 manufacturers would be involved as compared with up to 3 million retail and service outlets, and (4) it would not compete directly with State use of retail taxes which are now used in 33 States.

With respect to coverage, the plan would subject to the excise all end products of manufacture (other than food), thus securing the maximum coverage and lowest rate. A good case can always be made for various tax exemptions, but once the door is opened to any exemption beyond food, the door would never be closed. We would then approach the selective system now on the books, that is, tax discrimination by exemption instead of by direct selection. (This writer doesn't believe that even food should be exempted under either the manufacturer's or the retail plan.)

There are many criticisms that will be made of the association's proposal: (1) It would extend the list of taxable articles. The clear answer is that, short of repeal of all excise taxation, the cure for arbitrary discrimination is to level it off by a flat rate on all commodities. (2) Excise taxation reduces total purchasing power. The association denies this on the specious ground that the process of taxing and public spending is basically one of transfer of purchasing power from private to public hands: The private citizen spends less because he has less, but the Government spends more. That answer is like the claim of the radical economists that it makes no difference how big the national debt is. The country is no poorer, we merely owe it to ourselves. Exactly so, but the holders of Government bonds will gradually lose their savings in that process. High progressive taxation is also a method of redistributing the country's wealth and current earning power. This writer prefers to do his own spending and not have the Government do it for him. It seems to me that the advocates of high income taxes and no sales taxes are very illogical. All taxation reduces the purchasing power of those taxed, be it income tax or sales tax. What they are really talking about is a social philosophy which encourages the voting majority to hide behind an arbitrary minimum standard of living, to support alluring governmental projects, and throw the tax burden on the minority who are assumed to be better able to pay. (3) Excise taxes are regressive. This argument goes to the abolition of most excise taxation, which the Treasury probably cannot afford at this time, if ever. (4) The manufacturer's excise tax is included in inventory and is pyramided by the time it reaches the retail consumer. That is true of all taxes wherever the Government wants its revenue as soon as possible. As for pyramiding, it is like any other element of cost which the retailer must finance. (5) It is a hidden tax. A retail sales tax paid as such at the counter is brought home more forcibly to the buyer, but a flat-rate tax would soon become known to everyone and would usually be smaller than a retail excise on a selected article.

The flat rate manufacturer's excise deserves serious study before it is rejected. Those who oppose excise taxation should inquire more deeply into the causes of our perennial emergencies. Is the United States doomed to a permanent status of emergency and high taxes? If that is the new normalcy, then it appears inescapable that excise taxation must be retained. Under those conditions, the suggestion of the National Association of Manufacturers is the easiest to administer. The spokesman pointed out that, 21 years ago, the Ways and Means Committee reported out a uniform manufacturer's excise tax bill, but it was beaten on the floor.

The photographic manufacturers called attention to the excessively high rates on photographic equipment and sensitized material. They urged partial relief now and as quickly as conditions permit to eliminate entirely the excise tax on photographic products. (Code sec. 3406 (a) (4).) Upon interrogation by the committee, the witness heartily endorsed the general manufacturer's excise tax at a uniform rate.

The National Association of Railroad and Utilities Commissioners recommended the repeal or reduction of the excise taxes on transportation and communication services. (Ch. 30 of the Internal Revenue Code.) The Western Union Telegraph Co. objected to the disadvantage suffered by the Nation's telegraph system in competition with the tax-free and Government-subsidized airmail service. The airmail has made heavy inroads on long-haul message service. While other regulated public-utility services like gas, electricity, and water are free from excise taxes, the telegraph service bears a 15-percent Federal tax. (Code sec. 3465.) Western Union made a good statement of its case.

The luggage and leather goods industry had a field day at the hearings. The various trade associations and several manufacturers in this industry urged repeal of the 20-percent tax on luggage, handbags, and leather goods imposed by code sections 1651 and 3406 (a).

Cigars, milk, safety deposit boxes, copra, coconut oil, vegetable oils and fats, soap, synthetic detergents, automotive vehicles, gasoline, truck trailers, electric, gas and oil ranges, water heaters, athletic goods, bowling alleys, skating rinks, swimming pools, amusement parks and beaches, theaters, museums, actors, musical artists, mechanical amusement devices, jewelry, furs, cosmetics, beauty parlors, and many others—each came in for its share of attention in the presentation of its particular excise tax problem. They all ran along the same lines.

The producers of things and services object to the Government classifying them as luxuries with the consequent excise tax results. In fact, many items regarded as luxuries a few decades ago are now generally accepted as necessities of modern living. Owing to the haphazard way by which the crazy-quilt pattern of excise taxation has been developed, there are many unjustifiable and discriminating situations. The high individual rates necessitated by the selective procedure also set up a customer sales resistance which affects adversely the volume of production and employment. The most prtisan member of union labor can see that; whereas he thinks the near confiscatory rates of income, estate, and gift taxation merely put a beneficent government in funds with which to create prosperity. It would seem that, in the field of excise taxation, labor and mangement have some chance of constructive teamwork.

CONCLUDING REMARKS

The committee hearings were completed on August 14, 1953. In that vast, bewildering jungle which is the Government of the United States, the area of taxation is surely one of the most important. These hearings gave everybody the opportunity to say what they thought about the entire Federal tax structure. More than 600 witnesses were heard. The complete repeal or overhauling was urged as to many sections of the Internal Revenue Code. As Chairman Reed said, their testimony stands as "a shocking indictement of the unfairness and confusion of our antiquated revenue system." One witness described it as "an utterly chaotic condition." To those of us who have known it all along, this result came as no surprise.

The committee received many compliments on the systematic way in which the matter of revenue revision was approached, as well as on the procedure adopted whereby insofar as practicable, individual topics were discussed one at a time. The topic-by-topic presentation was very helpful to the members of the committee and the staff of the joint committee, although inconvenient to many witnesses who desired to testify on more than one topic. It is apparent that some of the testimony and submitted statements were examples of pleading for special interests, but the majority of those who appeared entered into the spirit of the occasion and endeavored to point out the many discriminatory and confusing provisions of the code.

Some of the witnesses made colorful presentations. This was characteristic of those

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who testified on the subject of excises (topic 40). They came up swinging and laid it right on the line. One witness had the courage to say that a lot of barnacles have accumulated upon the hull of the Federal tax ship, by reason of previous congressional action or inaction.

Chairman REED stated that the revelations of the committee's hearings called for a comprehensive tax revision [26] and that such a bill would be the first order of business for the Ways and Means Committee at the next session. Some tentative decisions regarding such revision have already been made, including two which were publicly announced by Mr. REED. They concern:

1. An amendment to allow children, including those attending college, to earn over $600 a year without a resulting loss of the dependency credit to the parent (topic 1).

2. Amendments to improve the present system of filing declarations of estimated tax which will remove some of the present penalties and will relieve about a million taxpayers of the necessity of filing such returns (topic 11).

Aside from the provisions of the Constitution which grant the legislative branch control over taxation, it is my opinion that general tax revision and recodification should be accomplished by Congress. The secrecy surrounding the executive branch renders it unfit to manage the job. The system of open hearings before their elected representatives would seem preferable from the standpoint of the public at large. (The People's Right To Know, by Harold L. Cross, ch. XVII (the Statutes and the Regulations); Next Steps in Congressional Reform, by George B. Galloway.) If Congress is unable to initiate, finish, and control the direction of revenue revision, and recodification, then, as one commentator said:

"Congress is simply forfeiting to the better organized executive branch its proper participation in moulding public opinion and making national decisions" (Columbia Law Review, June 1953, pp. 889–890.)

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[1] The historical notes and annotations with respect to published editions of the Internal Revenue Code generally began with its original content when adopted in 1939.

[2] For those interested in a broader but concise statement of existing law, a dependable summarization may be found in Master Tax Guide for 1953, published by Commerce Clearing House, Inc.

[3] M. D. Harrison, CCH Dec. 19,036, 18 TC 540 (1952) (foster children).

[4] See Mildred A. O'Connor (CCH Dec. 15,004, 6 TC 323 (1946). Cf. Katherine K. Thurston (CCH Dec. 18,505 (M), 10 TCM 809 (1951)); Eugene W. Lorenz (CCH Dec. 17,155 (M), 8 TCM 720 (1949)).

[5] Estate of Jacob Hentz, Jr. (CCH Dec. 19,564 (M), 12 TCM 368 (1953) (nonprofessional attendant at home)); Frances Hoffman (CCH Dec. 18,805, 17 TC 1380 (1952)); Samuel Ochs (CCH Dec. 18,452, 17 TC 130 (1951), affirmed 52-1 USTC, par. 9271, 195 F. (2d) 692 (C. A. 2), cert. den. 344 U. S. 327).

[6] *Anderson* v. *Forty-two Broadway Company* (239 U. S. 69, 36 S. Ct. 17 (1915)); *Tyee Realty Company* v. *Anderson* (1 USTC, par. 15, 240 U. S. 115 (1916)); *Brushaber* v. *Union Pacific Railroad Company* (1 USTC, par. 4 240 U. S. 1 (1916)).

[7] Report of Ways and Means Committee on revenue bill of 1924, 1939-1 (pt. 2), CB 245.

[8] 1939-1 (pt. 2) CB 558; sec. 25 (a) of the Revenue Act of 1934.

[9] See code secs. 143 and 144; Montgomery, Federal Taxes, Vol. II, pp. 603–614.

[10] *Commissioner* v. *Smith* (45-1 USTC, par. 9253, 324 U. S. 177, rehearing den. 324 U. S. 695).

[11] 1 U. S. T. C., par. 45, 255 U. S. 527 (1921); 1939-1 (pt. 2) CB 187 and 191.

[12] *Doyle* v. *Mitchell Brothers Company* (1 U. S. T. C., par. 17, 247 U. S. 179 (1918)); see, also, *Gambrinus Brewery Company* v. *Anderson* (2 U. S. T. C., par. 675, 272 U. S. 638 (1931)).

[13] 1 U. S. T. C., par. 42, 255 U. S. 509 (1921).

[14] 1 U. S. T. C., par. 368, 278 U. S. 470 (1929).

[15] Regs. 45, art. 51, and all subsequent regulations.

[16] 2 U. S. T. C., par. 814, 284 U. S. 1 (1931).

[17] 49-1 U. S. T. C., par. 9133, 336 U. S. 28.

[18] Compare *Commissioner* v. *Court Holding Company* (45-1 U. S. T. C., par. 9215, 324 U. S. 331) with *U. S.* v. *Cumberland Public Service Company* (50-1 U. S. T. C., par. 9129, 338 U. S. 451).

[19] *South Carolina* v. *U. S.* (199 U. S. 437, 26 S. Ct. 110 (1905)).

[20] See, also, *New York* v. *U. S.* (46-1 U. S. T. C., par. 9138, 326 U. S. 572) (Saratoga Springs mineral water).

[21] *Graves* v. *O'Keefe* (39-1 U. S. T. C., par. 9411, 306 U. S. 466).

[22] *Commissioner* v. *Shamberg's Estate* (44-2 USTC, par. 9446, 144 F. (2d) 998 (CCA-2) (Port of New York Authority bonds), cert. den. 323 U. S. 792).

[23] *Nasquin* v. *Humphreys* (39-2 USTC, par. 9237, 308 U. S. 54). Cf. *Sanford's Estate* v. *Commissioner* (39-2 USTC, par. 9745, 308 U. S. 39).

[24] *Von Baumbach* v. *Sargent Land Company* (1 USTC, par. 10, 242 U. S. 503 (1917)) and cases cited.

[25] *Stanton* v. *Baltic Mining Company* (1 USTC, par. 8, 240 U. S. 103 (1916)). For its effect on subsequent years, see *Burnet* v. *Thompson Oil & Gas Company* (2 USTC, par. 707, 283 U. S. 301 (1931)).

[26] See committee reports on the Internal Revenue Code, 1939-1 (pt. 2), CB 532–533.

Twenty-fifth Anniversary of Yeshiva University—Address by Hon. Charles H. Silver

EXTENSION OF REMARKS

OF

HON. JACOB K. JAVITS

OF NEW YORK

IN THE HOUSE OF REPRESENTATIVES

Wednesday, January 6, 1954

Mr. JAVITS. Mr. Speaker, 25 years in the annals of an American university or college is still a mark of youth. But the quarter century mark can also be an indication of vigor, vitality, and the potential for more and greater service to the country and the community which the university serves. Such is the case with Yeshiva University, one of America's younger and expanding institutions of higher learning, located in the district which I represent. Appended is the address by Hon. Charles H. Silver, a distinguished New Yorker one of the founders, at Yeshiva University's 25th anniversary dinner held at the Hotel Waldorf-Astoria in New York City on Sunday, December 13, 1953:

I am especially honored to preside at this dinner because it marks an important milestone in the history of Yeshiva University. In a broad sense we are here to pay tribute to an ideal which began as a vision and hope and became a living reality.

It was 25 years ago that a group of men called on me and asked me to join with them in a movement to create the first American University under Jewish auspices. Among them was Dr. Bernard Revel, whose very being was dominated by a wonderful spirit of zeal and courage that inspired all of those with whom he came in contact. He was accompanied on this visit to me by three other distinguished American Jews—Judge Otto Rosalsky, Harry Fishel, and Samuel Levy. They spoke with strong conviction and confidence in the ultimate attainment of their goal.

These men, my friends, are not with us this evening. All of them have passed to their eternal reward. Tonight we celebrate the 25th anniversary of Yeshiva College, which they helped to found, and this event must be linked with their names and their achievements, for they shall always be a part of this institution.

It is with a feeling of deep personal satisfaction that I am privileged to raise my voice in praice of Dr. Revel, for I knew him well and I shared with thousands of others a high regard and sincere affection for him. It could not be otherwise. He was that rare individual who was completely wrapped up in a cause that was projected with a high and noble ideal. We American Jews may well be proud that in him we had one of our faith who was respected by men and women of all creeds, for his humanity was as broad as the horizon of life itself.

We are indeed fortunate that his successor is recognized as a great scholar and able administrator. We all know what Dr. Samuel Belkin has done as president of Yeshiva University, for it was under his guidance that Yeshiva College expanded into a full-fledged university, and I want to publicly congratulate Dr. Belkin on his magnificent achievement. We American Jews, and indeed all Americans, owe him a debt of gratitude for his work in the field of education.

It is well to recall at this time that Yeshiva University really began as a theological seminary on the lower East Side in 1879. In this respect Yeshiva's history runs apparel with other great American universities such as Princeton, Yale, and Harvard which also started as theological seminaries and through the years broadened their scope of educational activities.

And as you know, in the recent past, ground was broken for the Albert Einstein School of Medicine, the first under Jewish auspices in this country, but one which will admit students of every race and strain with the single provision that only merit will be the condition for admission.

We are entering our second quarter of a century. The past has been for Yeshiva a series of joys and sorrows, a period of hard planning and solid accomplishments. I wish that I could read the names of those able and courageous individuals who have followed the banner that was raised by Bernard Revel and is now being held aloft by Dr. Belkin. The men and women in the ranks have been the powerful components which fused all those elements of strength and vitality and understanding that were so essential to the progress of Yeshiva University. In this hour of our rejoicing that we have brought Yeshiva to maturity, we must not permit our feeling of deserved satisfaction to overshadow the problems of the future. We look to our educators to mold the basic ideas and characters of the young men who are emerging into a world that is torn by strife and confusion. It is a world that is being slowly but inexorably being remade by the tide of events that must ultimately be resolved so that the new values which are being created shall yield up the greatest good to the greatest number.

As American Jews we have a solemn duty and responsibility to the land of our birth or adoption, but I am sure that we are opposed to those who would create a climate of suspicion and fear among the educational institutions of our country. It is the philosophy to our people, the tradition which we have inherited that no man shall be accused unless there is valid and certain ground for accusation. There has been too much loose talk about subversion in our schools and colleges. We Jews hate the very

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