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IRASCIBLE COMMENTS ON THE REVENUE LAWS

GEORGE F. JAMES*

SEPTEMBER 20 the President of the United States signed the Revenue Act of 1941, an act of which one damning thing may and should be said. It is an act drawn in the tradition of the last twenty years and giving no evidence of a genuine attack upon the basic fiscal problems of the nation. We have had a federal income tax since 1913 and a federal estate tax since 1916. In the early 1920's both of these crystallized into the form which they hold today. The basic estate tax act is still the act of 1926. The income tax law has been changed at almost every session of Congress since its original enactment but remains much the same. For almost twenty years the changes have been of a purely tinkering type. Rates for a time were lowered; since the depression they have been raised steadily and, to some, alarmingly. Exemptions have been reduced. Minor reforms and trivial changes have been all too frequent as treasury officials and congressional advisers attempted by strictly ad hoc legislation to meet with minimum ingenuity the tax avoidance devices evolved by private counsel.

Occasionally somewhat larger changes have been attempted, such as the short-lived undistributed profits tax against corporations.[†] Even these reforms, however, have been designed with far too great particularity. Where more sweeping alterations might have been largely successful, these small-scale efforts have sometimes failed entirely and been withdrawn, as was the undistributed profits tax, and sometimes succeeded in stopping one leak only to have other leaks spring up around the patch.

Now, in 1941, with a record-breaking national debt, a business structure subject to extraordinary and often incalculable stresses, and the heaviest fiscal demands in the history of the nation, Congress has been content again to apply its old panacea: exemptions have been lowered, rates raised, and new nuisance taxes enacted. Is it not time that the entire structure be reexamined to consider what major changes could be effected more equitably to distribute and effectively to raise the tremendous and growing levies which this present demands?

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† Revenue Act of 1936, at § 14, 49 Stat. 1655 (1936). The tax was not reenacted in the Revenue Act of 1938, 52 Stat. 447 (1938).

As we have noted, the 1941 act was perhaps unusual in that it effected no reforms whatsoever in the tax structure. However, attempts were made in the Senate Finance and House Ways and Means Committees to attack one of the more obvious shortcomings of the present law. In a consideration of possibly desirable changes, this may be a good place to start.

The Senate proposal was extremely modest, limited, and obvious. Under the bill reported by the Finance Committee, for the purpose of determining the income tax of any individual, income earned by each spouse (whether or not treated as community property under the state law) should be considered as the income of the earner, and income from property of a marital community should be considered the income of the spouse having its management and control under the state law.² This provision was aimed to accomplish one purpose: to equalize the tax burden of similarly situated couples living in and out of certain western states having community property laws. For this purpose the rule dealing with earned income was the important one. The significant advantage enjoyed by residents of the community property states lies in this—that whereas earned income in the non-community states cannot be assigned in advance so as to equalize the surtax brackets of husband and wife,³ under community property law all earned income is automatically credited half to each spouse. Since this rule is accepted as controlling under the federal income tax,⁴ the minimum bracketing is automatically obtained, where there is no other income.

Once income from investment becomes a significant or controlling factor, the tax advantage of community property tends to disappear. Unlike earned income, investment income can everywhere be assigned.⁵ It may or may not even be necessary to assign the corpus of the investment, and in any case assignment of income and corpus together will be effective to shift the tax burden of the income.⁶ Thus the investor in any state, having the option of returning his income jointly with his wife or severally, can adjust his affairs to result in the minimum tax on the income of the two, paying at most a moderate fee under the gift tax to obtain substantial income tax savings. The Senate draft would have equalized the present

² H.R. 5417, 77th Cong. 1st Sess. § 119 (1941), as reported out by the Senate Finance Committee.

³ *Lucas v. Earl*, 281 U.S. 111 (1930).

⁴ *Poe v. Seaborn*, 282 U.S. 101 (1930).

⁵ *Blair v. Com'r*, 300 U.S. 5 (1937).

⁶ Compare *Bing v. Bowers*, 22 F. (2d) 450 (D. C. N. Y. 1927), *Lowery v. Helvering*, 70 F. (2d) 713 (C.C.A. 2d 1934), and *Blair v. Com'r*, 300 U.S. 5 (1937).

inequality of tax on earned incomes between community and non-community property states—an inequality which Professor Griswold of Harvard recently characterized as one of the three great defects of the income tax laws.⁷ The hint of a filibuster by one of the gentlemen from Texas was enough to kill this obvious though relatively trivial improvement.

The House plan was sounder, broader in scope and aimed at a more important objective. Under Section 111 (b) as reported out by the Ways and Means Committee, all married couples would have been required to file joint returns, lumping the income, credits and deductions of both to compute a single net taxable income. At the election of either spouse, liability for the tax would have been several, the tax being allocated between the two in proportion to their respective net incomes. One effect of such a provision would be to neutralize the advantages of community property and income. If husband and wife are required to compute and report their income jointly, it can make no difference how state law might distribute it between them. But the House bill would have done more than this, and more than the suggestion of the Senate Finance Committee. As pointed out above, in any common law state income from investments can be distributed between husband and wife so as to fall within minimum surtax brackets by a legally effective assignment of the investments from which the income is derived. For example, a married man having an earned income of \$12,000 a year and an income of another \$10,000 a year from investments of a fair market value of \$200,000, could reduce his income tax for 1941 by almost \$2,000 by transferring his investments to his wife, or to a trust for his wife's benefit. True, it would cost him about \$15,000 in gift tax to do it, but reducing the family capital by \$15,000 would cut income only \$750 a year, against a tax gain of \$2,000 a year. Nor would the capital loss be permanent. If the wife survive the husband, or if secondary beneficiaries be named under a trust in the event of the wife's predecease, the gift tax will be more than offset by avoidance of estate tax on the death of the husband. The example here outlined is a moderate one. Where really large incomes from investment are involved, the possible tax savings which can result by splitting income between husband and wife on separate returns are astonishing. Moreover, the election to file joint or separate returns is not even binding from year to year. If either spouse happens in some year to have deductions more than equal to his income, a joint return can be utilized to reduce the taxable income of the other spouse.

⁷ N.Y. Times, § 4, p. 8, col. 5 (Jan. 12, 1941).

Of course, a married couple whose income comes entirely or almost entirely from the earnings of the husband cannot thus distribute and reduce the tax, because of the non-recognition for income tax purposes of assignments of future earnings.⁸ At the same income level the present state of the law thus operates to discriminate in favor of income from investments and against earned incomes. This is the discrimination which the House committee's proposal was designed to eliminate.

The proposal was met by a most extraordinary array of arguments centering around the somewhat mystical notion that the combination of husband's and wife's incomes, even for the purpose of *computing* a tax (the proposed act providing not for joint but for several obligation to pay) was inconsistent with the spirit of married women's property acts. It was further argued that the tax would constitute a deterrent to marriage and a bonus for immorality. The latter argument seems more appropriate for the pages of *Punch* where it first appeared, advanced by the British humorist, A. P. Herbert, than it does for any serious discussion of legislative policy.⁹ But the opposition to the mandatory joint return was vigorous, its support from the administration somewhat pallid, and it was discarded upon the floor of the House of Representatives.

This ends the simple catalog of even attempted improvements in the revenue laws in the year 1941. The suggestion of the Senate Committee would have done something; the suggestion of the House Committee a little more. Both were apparently too revolutionary for the temper of Congress. But not even the preferable proposal advanced in the House would have more than scratched the surface of the more obvious inequalities in the personal income tax. For example, we have already pointed out that the present possibility of separate returns by husband and wife affords a great advantage to persons whose income is derived principally from investment. The technique which leads to tax savings by the division of a single family income into two parts with a consequent reduction in surtax rates is capable, where the size of the fortune justifies the exercise of ingenuity, of much more far-reaching application. Assume the case of a husband and wife with minor children and with a regular income greatly in excess of current requirements. Not only may this income be split between the parents; through the device of family trusts it is capable of almost indefinite division.¹⁰ Sections 161, 162, and 163 of the Internal

⁸ *Lucas v. Earl*, 281 U.S. 111 (1930).

⁹ *Herbert, Rex v. Pratt and Merry, The Tax on Virtue, in Uncommon Law* 397 (1936).

¹⁰ *United States Trust Co. v. Com'r*, 296 U.S. 481 (1936).

Revenue Code in Supplement E, dealing with estates and trusts, still follow the original theory of the income tax laws in treating each and every family trust as potentially a separate taxpayer, against which income tax is computed just as it is computed against an actual living person, and with the same rates of progression. It is true that to the extent that such a trust actually pays out or is required by its terms to pay out current income to named beneficiaries, the sums thus paid out constitute income to the beneficiary and are deductible from the taxable income of the trust. However, accumulated income is income of the trust and is not taxable to any beneficiary either at the time it accrues or, so long as it is not paid out currently, at any other time. It is taxable to the trust alone, at surtax rates determined by the net income of the trust and unaffected by the income of present or future beneficiaries. Thus anyone whose income is so largely in excess of his actual needs that he consistently saves a large part of it (practically all really high-bracket taxpayers come within this classification) can move his tax rates down theoretically as far as he wants, and practically to a very substantial degree, by establishing multiple trusts to accumulate income for his wife or descendants.¹¹ Of course, he has to do this correctly, and must be prepared to employ and pay competent counsel to guard him against technical slips. He must divorce himself from effective control. He would do well not to keep even the possibility of enjoying the income again himself at any future date. If he is really worried about eating regularly, he can, however, give the trustee discretion to pay part of the income to his wife if she should ever need it. If she is a fair-minded person, she would undoubtedly be willing, by an unrelated transaction and in some other taxable year, to make similar provision for her spouse. If we really wish to tax the rich at the tremendously high rates now called for by the income tax laws, it seems rather childish to permit this type of tax saving, subject as it is to tricky and somewhat dubious limitations but uncontested in principle.¹²

In 1937 the United States Senate conducted an investigation of the tax-saving devices of the rich—"clever little schemes" which resulted in the capricious application or non-application of top rates. Various curious devices, such as the incorporated yacht or private estate, were in fact out-

¹¹ *Ibid.*

¹² For a relatively recent judicial limitation on the trust device, consider *Helvering v. Clifford*, 309 U.S. 331 (1940). While this case creates doubt as to the precise location of the line between trusts properly taxable as separate entities and trusts income from which should be taxed to the grantor, it contains only the barest hint of doubt as to the effectiveness of the trust device, correctly used.

lawed by the loophole-closing tax law of 1937. In the discussions then current and in the horrible examples paraded before the Senate investigatory committee, a very prominent place was given to multiple family trusts, yet the only attack on these trusts actually included in the bill was a reduction of the basic exemption of such trusts from \$1,000 to \$100.¹³ Of course this didn't affect the actual tax saving to any material extent. The tax saving results from the fact that one income of \$100,000 a year is taxed at a maximum rate of 64 per cent and an average rate of almost 50 per cent while five incomes of \$20,000 a year are each taxed at a maximum rate of 38 per cent and an average rate of less than 25 per cent. The loophole-closing act did not affect and did not purport to affect this saving.¹⁴ An income tax law really designed to eliminate tax advantages resulting from a formal separation of a single family income would provide not merely, as did the unsuccessful draft House bill of 1941, that husband and wife must file a joint return, but also that the income of the entire family unit and any income being accumulated for either spouse or for descendants be likewise included.

An even less drastic change would catch the bulk of the present tax leakage. If anyone is particularly worried about the constitutionality of treating family income as a unit, or by the problems of draftsmanship and of administration which would be raised, a much simpler device could largely accomplish the same purpose. This would be, without disturbing the present general structure of the taxation of trusts, to apply an extremely high tax rate to the undistributed income of the trust. No one has ever advanced any reason for taxing trusts at the same rate as individuals, and no serious constitutional question would be raised by taxing them at different rates. If the undistributed income of private trusts were taxed, let us say, at a basic rate of 80 per cent, the income of such trusts would be forced out and distributed to the beneficiaries. In a common type of trust, where the trustee has the option of distributing income to the grantor's spouse or accumulating it for descendants, this would crowd the income back again into a single fund where the higher rates would apply. Coupled with a mandatory joint return, it would en-

¹³ Consult Paul, *The Background of the Revenue Act of 1937*, 5 *Univ. Chi. L. Rev.* 41 (1937); G. F. James, Jr., *The Loophole-Closing Revenue Act of 1937*, 23 *A.B.A.J.* 759 (1937).

¹⁴ *Ibid.* A similarly narrow and ineffective change was made in 1938, when the exemption from gift tax of \$4,000 given to any one individual in any one year was made inapplicable to gifts in trust. *Revenue Act of 1938*, at § 505(a), 52 *Stat.* 565 (1938). Although apparently intended to discourage the use of trusts to minimize income and estate taxes, the change was too small to have any substantial effect.

tirely eliminate tax savings where husband or wife was the immediate beneficiary of distributed income. In other cases, of course, the trust might be so drawn that distributed income would actually go to children, where it would fall into lower surtax brackets than if it were paid to the grantor or the grantor's spouse. In such cases, however, the tax saving resulting from split incomes would be available only in the situation where the income actually was split and went immediately and irrevocably to some person other than the grantor or the grantor's spouse who was presently identified and able to receive it. While this solution would on the whole be less satisfactory than that of taxing the entire family as a single unit, it would go a long way toward accomplishing the supposed purposes of the 1937 law. Indeed, the suggestion is so simple and obvious that it is difficult to see why it was not adopted at that time if we are to assume that a serious effort was then made to equalize the impact of income taxes upon persons similarly situated and to obtain effective enforcement of the cumulative rates which the law purports to levy.

The discussion this far has been based upon one major assumption, more or less clearly expressed. This assumption is that the income tax law should be, to use the phrase of Professor Henry Simons, "a levy upon individuals according to their respective income circumstances,"¹⁵ and that it accomplishes its basic purpose only to the extent that it does tax individuals in accordance with their ability to pay, with the minimum of discrimination among tax payers similarly situated. Theoretically, we may assume that few persons would dissent from this statement of the objectives and practical test of the federal income tax. It is necessary to restate it, however, as a preface for discussion of that most curious anomaly under the Sixteenth Amendment, the corporate income tax.

From the very earliest days of the federal income tax, corporations have been treated as taxpayers distinct from their individual stockholders, the corporate entity being most meticulously respected. For the decade from 1918 to 1928, corporations paid a tax on their net incomes at non-progressive rates ranging from 12 to 13 per cent.¹⁶ During the same period individual tax rates at top surtax brackets ranged from 25 to 69 per cent.¹⁷

¹⁵ Simons, *Personal Income Taxation* 203 (1938).

¹⁶ Revenue Act of 1918, at § 230(a)(1), 40 Stat. 1075 (1919); Revenue Act of 1921, at § 230(b), 42 Stat. 252 (1921); Revenue Act of 1924, at § 230, 43 Stat. 282 (1924); Revenue Act of 1926, at § 230(a)(1), 44 Stat. 39 (1926); Revenue Act of 1928, at § 13(a), 45 Stat. 797 (1928).

¹⁷ Revenue Act of 1918, at § 211(a), 40 Stat. 1062 (1919); Revenue Act of 1921, at § 211(a)(1), 42 Stat. 233 (1921); Revenue Act of 1924, at § 211(a), 43 Stat. 265 (1924); Revenue Act of 1926, at § 211(a), 44 Stat. 21 (1926); Revenue Act of 1928, at § 12(a), 45 Stat. 796 (1928).

Money earned by a corporation would first be subject to the moderate corporate tax. If the corporate earnings were then paid out in dividends, each individual shareholder would pay surtax on his pro rata share at a rate determined by his own income for that year. It was immediately obvious that large investors would in many cases be far better off if their corporations refrained from declaring dividends. The shareholder's net worth would thus grow with his pro rata interest in the corporate surplus, free from progressive surtaxes as long as he kept his original investment unchanged. If the investor should realize his capital gain by selling a part of his stock, the law has contained since 1921 various provisions limiting the total tax he must pay. For a number of years the maximum rate on capital gains was $12\frac{1}{2}$ per cent.¹⁸ Today it is 15 per cent.¹⁹ Moreover, if the investor never sold his investment, so that it passed to his heirs or legatees on his death, the capital gain forever escaped taxation. This has been the law from the first (expressly so since 1921) and still is.²⁰

This state of the law offered a wide-open door for the reduction of effective surtax rates on large investors by the interposition of corporations to hold and accumulate income. To meet this defect the acts of 1916 and 1918 provided that the income of any corporation "formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders" should be treated as the income of its shareholders and taxed to them.²¹ In 1921 this particular device was abandoned (apparently because of constitutional doubts) and instead a special tax of 50 per cent was levied upon the net income of corporations "formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders."²² This penal tax, still to be found with a reduced rate in Section 102 of the Internal Revenue Code, may have discouraged the flagrant use of corporations to avoid surtax through the accumulation of income, but it has never been very widely or effectively enforced. Its test of purpose, even supported by various presumptions, robs it of much of its effect. A second abortive attempt to force corporate earnings out into the hands of shareholders where they will be subject to surtax was made in the un-

¹⁸ Revenue Act of 1921, at § 206(b), 42 Stat. 232 (1921); Revenue Act of 1924, at § 208(b), 43 Stat. 262 (1924); Revenue Act of 1926, at § 208(b), 44 Stat. 19 (1926); Revenue Act of 1928, at § 101(a), 45 Stat. 811 (1928).

¹⁹ Int. Rev. Code § 117(b) and (c)(1), 53 Stat. 51 (1939).

²⁰ Int. Rev. Code § 113(a) (5), 53 Stat. 41 (1939).

²¹ Revenue Act of 1916, at § 3, 39 Stat. 758 (1916); Revenue Act of 1918, at § 220, 40 Stat. 1072 (1919).

²² Revenue Act of 1921, at § 220, 42 Stat. 247 (1921).

distributed earnings tax of 1936.²³ The violent manner in which this device affected the internal management and financing of business, and its highly oppressive operation in certain situations, led to its repeal. Then the more obvious abuses were checked, or perhaps only forced to change form, by the personal holding company tax of 1937, still in the law as Chapter 2, Subchapter A of the code. Still, only the fringes of the problem have been touched.

In the meantime, there has been a dramatic change in corporate income tax rates. From 1918 to 1928 they varied from 10 to 13 per cent.²⁴ In 1941 the normal tax on corporations varies from 15 to 24 per cent.²⁵ On top of the normal tax is mounted a trivial corporate surtax,²⁶ the capital stock tax,²⁷ the declared value excess profits tax,²⁸ and a wartime excess profits tax ranging from 35 to 60 per cent.²⁹ Accurate estimates are not available, but it is certainly safe to suppose that most good-sized corporations will pay close to a half of their net incomes in federal income and excess profits taxes. In the case of many corporations having a fluctuating income and a relatively small invested capital, the federal income tax may come very close to swallowing all the profits which the stockholders might expect to receive. A small levy, justifiable as a tax on the privilege of doing business with corporate advantages, has become an important part of the income tax structure, in many cases the major imposition against corporate earnings, dwarfing in importance the eventual tax on corporate dividends (if any) in the hands of the shareholders.

Viewed as a tax on individuals in proportion to their ability to pay, this is most extraordinary. Unless one indulges in the fiction of consider-

²³ Revenue Act of 1936, at § 14, 49 Stat. 1655 (1936).

²⁴ Revenue Act of 1918, at § 230(a)(1), 40 Stat. 1075 (1919); Revenue Act of 1921, at § 230(a), 42 Stat. 252 (1921); Revenue Act of 1926, at § 230(a)(1), 44 Stat. 39 (1926); Revenue Act of 1928, at § 13(a), 45 Stat. 797 (1928).

²⁵ Int. Rev. Code § 13, 53 Stat. 7 (1939), 26 U.S.C.A. § 13 (1940), amended by 54 Stat. 517 (1940), 26 U.S.C.A. § 13 (Supp. 1940) and by H.R. 5417, 77th Cong. 1st Sess. § 103 (Pub. L. No. 250, Sept. 20, 1941).

²⁶ H.R. 5417, 77th Cong. 1st Sess. § 104 (Pub. L. No. 250, Sept. 20, 1941).

²⁷ Int. Rev. Code § 1200, 53 Stat. 169 (1939), 26 U.S.C.A. § 1200 (1940), amended by 54 Stat. 521 (1940), 26 U.S.C.A. § 1200 (Supp. 1940), and by H.R. 5417, 77th Cong. 1st Sess. § 301 (Pub. L. No. 250, Sept. 20, 1941).

²⁸ Int. Rev. Code § 600, 53 Stat. 111 (1939), 26 U.S.C.A. § 600 (1940), amended by 54 Stat. 521 (1940), 26 U.S.C.A. § 600 (Supp. 1940), and by H.R. 5417, 77th Cong. 1st Sess. § 302 (Pub. L. No. 250, Sept. 20, 1941).

²⁹ Int. Rev. Code § 710, 54 Stat. 975 (1940), 26 U.S.C.A. § 710 (Cum. Pamphlet 1941), amended by H.R. 5417, 77th Cong. 1st Sess. § 201 (Pub. L. No. 250, Sept. 20, 1941).

ing General Motors as a retired army man with a simply tremendous income, he cannot help but observe that John Jones, a holder of ten shares of stock in that great corporation, is paying his share of the corporate income tax at the same rate as is Mr. Pierre DuPont. Thus the corporate income tax operates to defeat the basic principle of the personal income tax according to which each individual citizen contributes to the support of the government in accordance with his own capacity to pay.

This thoroughly anomalous result can be justified only by urging that the corporation must be taxed, if corporate accumulated or undistributed income is to be taxed at all, since the stockholder pays only upon that which he receives as dividends. Viewed in this light, the corporate income tax generally serves the same purpose as the present Section 102 tax on improper accumulation of surplus, the tax on personal holding companies, and the former tax on undistributed corporate income. This justification for corporate income taxes convinces only on the assumption that the result must be obtained in this manner and cannot be obtained in some other way, a way consistent with the basic notion of progressive equality. Surely the obvious suggestion would be to tax the stockholders of a corporation each on his proportionate part of the annual income of the corporation, whether or not that income be distributed in dividends. Such a tax, if it could be upheld against constitutional attack and successfully administered, would have many advantages over the present system. In the first place, it would eliminate the entire problem of the accumulation of corporate surpluses to avoid surtax on the individual stockholders. The always unsatisfactory Section 102 and the highly controversial tax on undistributed earnings would be simply unnecessary. Corporate officers could plan expansion or retrenchment, reinvestment or distribution, on the basis of the economic requirements of the business, unaffected by the extraneous fiscal policies of the United States or their own efforts to circumvent these policies. By permitting the stockholder to add undistributed corporate earnings, on which he must pay tax, to the basis attributable to his stock on a future conversion of the capital asset itself, the inherent difficulties surrounding the taxation of capital gains would be very considerably minimized, a point to which further reference will be made. Most important, the basic principle of ability to pay as a criterion in the application of the tax laws, would be served. If the change resulted in reducing revenue (and it is by no means certain that it would), this problem could be directly attacked by changes in the rates of individual tax.

There are two possible objections to this proposal. The first is a con-

stitutional objection based on *Eisner v. Macomber*³⁰ and the subsequent cases which have rung the changes on the theory of corporate personality. It would require undue digression here to work out in detail the constitutional arguments on each side. They will be sufficiently obvious to any student of this field. We do not hesitate to assert that few competent authorities could honestly believe, in view of the present personnel of the United States Supreme Court and the trend of modern decisions, that an act taxing corporate stockholders pro rata on the undistributed profits of the corporation would be held invalid as an income tax under the Sixteenth Amendment. The court today should be ready to accept the practical wisdom of Mr. Justice Holmes' dissent in *Eisner v. Macomber*. "The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest."³¹ Once they understood the issues, it can hardly be doubted that most persons not lawyers would regard the suggested tax on corporate shareholders as falling much more fairly within the purposes of the Sixteenth Amendment than does the present corporate income tax.

The other possible objection to taxing corporate shareholders on the undistributed profits of the corporation is the one advanced by Professor Simons, "that it would involve serious administrative difficulties. . . ."³² The problem about which Professor Simons was primarily concerned was the difficulty of allocating undistributed earnings among different classes of owners in view of the many types of preferred and semi-preferred, common and semi-common stocks, which may be issued under the varying corporation laws of our forty-eight states. While no one would deny that in many cases allocation might present serious problems, they should not prove insuperable. The obvious rule of thumb would be to allocate each year's earnings to those security holders to whom they would be payable if the directors of the corporation had elected to pay out that entire year's earnings in dividends. Normally this would require payment first against current interest and accumulated interest, if any, then against arrearages on cumulative preferred stocks, if any, and to current preferred dividends, and finally to common or other fully participating stocks. Professor Simons has pointed out that any substantial increase in corporate earnings will be reflected marketwise in an increase in the value of all se-

³⁰ 252 U.S. 189 (1920).

³¹ *Ibid.*, at 220.

³² Simons, *Personal Income Taxation* 190 (1938).

curities currently selling below par, even though arrearages may be such that no part of current earnings could be distributed to junior claims. But this is hardly the point. If a common stock increases on the market because prior claims have been reduced, some owners will sell and others will not. Those who sell will be taxed to the extent that they realize a capital gain. As for those who do not sell, it is hard to see why they should be taxed on such a highly speculative paper profit until either they do realize it by a sale or the corporation reaches the stage of having free earnings distributable, whether or not actually distributed, to their stock holdings.³³

Undoubtedly there would be some cases of corporate structures so complicated or securities so ambiguous and unusual that real difficulties of allocation would be encountered. In such cases the Treasury Department might very properly exercise pressure, through its regulations, toward simplification and standardization, as it has done to a considerable extent in corporate accounting. It is worth noting that the present pressure of the corporate income tax is toward increased fixed debt and away from equity financing, because interest paid is deductible in computing taxable corporate net income, while dividends paid are not. This incidental effect of the present law is highly important at the present corporate tax rates and, to say the least, doubtful as an item of public policy.

Finally, while it need not be supposed that treasury regulations and administrative determinations could achieve perfect justice in the application of an undistributed profits tax to all classes of corporate shareholders with their diversity, it is not clear why such an ideal standard should be set. The present system of taxing the corporation itself on its income has no merit other than an apparent simplicity. It does not achieve even substantial justice among shareholders because it doesn't attempt to. Any system not utterly unworkable, which taxed the shareholders upon the corporate earnings, would be an improvement on the present law.

Moreover, as suggested before, the taxation of undistributed corporate income to the shareholders would minimize the extremely difficult problem of capital gains taxation. This problem is an aspect, and ordinarily the most severe aspect, of the larger problem of fluctuating income and the annual determination of tax. Despite our general aim at uniformity, two men otherwise similarly situated, each of whom earned \$100,000 over

³³ Whenever shares of stock were sold, an apparent difficulty would arise in apportioning the tax between buyer and seller in the year in which the sale took place. The convenient method would be to tax annual undistributed earnings to stockholders on the last day of the year. The market should operate to adjust the tax burden fairly between buyer and seller.

a ten-year period, would be taxed very differently if one of them earned his at a uniform rate of \$10,000 a year and the other earned \$3,000 in an average year and \$73,000 in one extraordinarily good year. While this result might follow from an extraordinary legal fee or a group of tremendous commissions, it would most commonly follow from the sale of capital assets, the value of which had appreciated over a period of years and was realized in the year of sale. It is at least in part to minimize such unfairness that the law has always treated capital gains differently from ordinary income, applying to them a maximum tax rate very substantially less than that applicable to ordinary income in the top surtax brackets. On the other hand, this generous treatment of capital gains has in turn compelled the adoption of largely ineffective measures to prevent the accumulation of corporate income, to avoid surtax on stockholders.

The suggestion that capital gains be taxed precisely like any other income would prevent the use of the present capital gains provision to minimize taxation. However, we should be caught on the other horn of the dilemma; the law would operate unfairly against the taxpayer who in any taxable year was forced to liquidate large blocks of securities which had greatly appreciated in value over a long period of time. If we should go further, in line with Professor Simons' suggestion,³⁴ and treat any disposition of capital assets whether by sale, by gift, or by the death of the owner as an occasion for realization, this unfairness would be aggravated. However, 85 per cent of all the capital gains which are reported and go into taxable income are derived from the sale of securities,³⁵ and very largely from the sale of equity securities rather than bonds. If all holders of stock were required to pay tax on their pro rata share of corporate income as it accrues to the corporation, and were permitted to add undistributed corporate income on which they had been taxed to their basis for gain or loss on subsequent disposition of the security, the heart would be cut out of the capital gains problem. It would then be generally satisfactory to tax such gain as ordinary income in the year of its realization, treating any transfer, whether by sale, exchange, gift, devise, or inheritance, as a realization by the transferor for this purpose and using fair market value at the date of transfer as the measure of realization where nothing of monetary value is received in exchange. This treatment of transfers by gift, will or descent as resulting in realization of gain by the transferor, as advocated by Simons, would plug a huge hole in the present law, by which unrealized gain in assets passing on death forever escapes the income tax.

³⁴ Simons, *Personal Income Taxation* c. vii (1938).

³⁵ *Ibid.*, at 137 n. 4.

There would still be some cases in which income would be grossly distorted by the sale in one year of assets which had appreciated over a considerable period of time. This might be particularly true of real estate and of businesses which had expanded greatly in gross operations without yielding any net income in their earlier years. In order to protect such taxpayers, the law should provide for the periodic appraisal of investment assets and the reporting of gain (but not loss) thereon for income tax purposes, at the option of the taxpayer. While this would permit the taxpayer to level out his income in such a way as to produce the minimum tax, such a power can hardly be criticized. On the other hand there should be little reason for sympathizing with someone who, having the right to pay a tax periodically on the unrealized value of his estate, failed to exercise this right in his lifetime, thereby subjecting his estate to heavy income taxation.

The question of the income taxation, in the estate of a decedent, of the previously unrealized value of his assets, leads naturally to the related question of gift, inheritance, and estate taxation. One peculiarity of estate tax laws, such as the federal act, is that they, unlike inheritance taxes, are calculated on the wealth, and hence presumable ability to pay, not of the heir but of the decedent. In any practical sense and regardless of form, the tax is obviously on the man who succeeds to the property, not on the man whose enjoyment is permanently terminated by his own death. It is therefore a little difficult to see why a single system of taxation under the Internal Revenue Code should contain the income tax, based at least in theory on the ability to pay of the actual taxpayer, and the estate tax, based upon the ability to pay of the actual taxpayer's predecessor in interest. A serious attempt to redesign our federal tax structure into a coherent and understandable whole based upon an avowed philosophy should include a change back from the estate to the inheritance tax system.

However, this change has many times been advocated and on occasion seriously urged in Congress, but has not been accepted. Assuming a continuance of the present estate tax, supplemented by a gift tax, there are rather evident anomalies in the present structure. The oddest of these is the complete separation of the gift and estate taxes. Every owner of property may give away \$40,000 worth (plus considerably more) in his lifetime without paying any tax upon it,³⁶ and then start paying his tax at a rate of 2½ per cent on the first \$5,000 in excess of all exemptions. This

³⁶ Int. Rev. Code § 1004(a)(1), 53 Stat. 147 (1939), 26 U.S.C.A. § 1004(a)(1) (1940).

can be run up to \$250,000 with a maximum rate of less than 25 per cent.³⁷ Then at the death of this property holder a second \$40,000 exemption is applicable to his estate,³⁸ and after this the rate runs from 3 per cent on the first \$5,000 to a maximum rate of 30 per cent on \$250,000.³⁹ The rate of tax paid on the decedent's estate is in no wise affected by the amount of property which he may have given away in his lifetime. In other words, the gift and estate taxes have cumulative rates but the latter does not cumulate upon the former. Hence, if two persons each had a million dollars and one of them gave away about 60 per cent of it in his lifetime and let the balance pass in his estate at his death to the same donees, and the other let the entire million dollars pass at his death, the total tax paid in the two cases would be very different. Roughly, the man who gave away \$600,000 in his lifetime would pay a little over \$225,000 in gift and estate taxes together, while the man who let the entire million pass at his death would pay around \$310,000. There is presumably no strong public policy in favor of wealthy persons getting rid of their property during their lifetime and transferring it into the hands of their putative heirs. The great discrepancy in tax in these two situations results not from an attempt to obtain any desired governmental end but merely echoes the history of the adoption of the two taxes. Its practical effect is greatly to reduce the apparently high brackets applicable to some but not all persons of great wealth, the favored group being those who obtain timely and reliable legal advice and are willing to act upon it. Since the gift tax already provides the structure for cumulative rates by which the rate applicable to gifts in later years is determined in part by the amount previously given,⁴⁰ it would be administratively a simple enough matter to extend the same principle to the estate tax as well, materially increasing the revenue and eliminating another arbitrary inequality in the operation of the law.⁴¹ Incidentally, it may be added

³⁷ Int. Rev. Code § 1001(a)(2), 53 Stat. 144 (1939), 26 U.S.C.A. § 1001(a)(2) (1940), amended by 54 Stat. 521, 26 U.S.C.A. § 1001 (Supp. 1940), and by H.R. 5417, 77th Cong. 1st Sess. § 402 (Pub. L. No. 250, Sept. 20, 1941).

³⁸ Int. Rev. Code § 935(c), 53 Stat. 141 (1939), 26 U.S.C.A. § 935(c) (1940).

³⁹ Int. Rev. Code § 935(b), 53 Stat. 141 (1939), 26 U.S.C.A. § 935(b) (1940), amended by H.R. 5417, 77th Cong. 1st Sess. § 401 (Pub. L. No. 250, Sept. 20, 1941).

⁴⁰ Int. Rev. Code § 1001(a)(1), 53 Stat. 144 (1939), 26 U.S.C.A. § 1001(a)(1) (1940).

⁴¹ Since this manuscript was prepared, William C. Warren has considered the whole problem of correlation of gift and estate taxes. Warren, *Correlation of Gift and Estate Taxes*, 55 Harv. L. Rev. 1 (1941). In his conclusion, after mentioning the possibility of integrating the two taxes with a single cumulative rate structure, he suggests an analysis by which all transfers of capital which leave the taxable income in the grantor are subject to estate (but not gift) taxes, and all transfers which take the taxable income out of the grantor are subject to

that the \$40,000 exemption now contained in the estate tax law in favor of insurance payable to beneficiaries other than the estate of the decedent⁴² appears to have no justification whatsoever. While undoubtedly life insurance is a good thing for many purposes and in many situations and should be encouraged, it seems ridiculous to encourage it by a tax reduction which has no operation at all in case of estates of \$40,000 or less and is not significant in amount except in substantially larger estates. The widowed and orphaned beneficiaries of estates in the large tax brackets are not the persons whose need for the proceeds of life insurance can be a major concern of public policy. The special exemption of life insurance proceeds was probably a compromise adopted when the estate tax law was first extended specifically to cover insurance proceeds paid to named beneficiaries other than the estate of the decedent. Operating as it does to produce a variation in tax unrelated to the financial status of the taxpayer, it tends, although not to a major extent, to distort the equitable operation of the system and should be eliminated.

The biggest hole in our present tax system not yet discussed is the income tax exemption in favor of interest paid on the securities of state and local governmental units. So much has been written on this subject that it should be unnecessary to pursue it further.⁴³ It is unsound in law, viciously unsound in economics, and has been supported in recent years only by the advocates of special interests which would be, or fear that they might be, injured by its abolition. The Attorney General reported years ago in a well-documented opinion that the Constitution of the United States does not require its continuance.⁴⁴ Its presence in the law today can be explained only by the lethargy or political timidity of our public officials.

Much that has been said in this paper is so nearly self-evident as to be almost trite. Certain suggestions on the other hand may have some merit of novelty and on examination may commend themselves. Still other portions, such as the discussion of taxing corporate profits, raise much

gift (but not estate) taxes. Apparently a single cumulative rate structure is not contemplated. It is hard to see why this suggestion, preserving the inequality resulting from the double rate standard, should be said to be "unlike integration, not based on expediency but on the fundamental legal principles underlying the three federal taxes and on a sense of innate fairness."

⁴² Int. Rev. Code § 811(g), 53 Stat. 120 (1939), 26 U.S.C.A. § 811(g) (1940).

⁴³ Consult Simons, *Personal Income Taxation* c. VIII (1938). The literature is collected in Mertens, *The Law of Federal Income Taxation* § 6.69 (Cum. Supp. 1939).

⁴⁴ *Taxation of Government Bondholders and Employees: The Immunity Rule and the Sixteenth Amendment* (U.S. Dept. of Justice 1938).

more basic and serious problems, and strong objections may be urged to them. But no one can hope to devise a perfect system of taxation in the compass of a short article or from the ivory tower of the academic. This paper will have achieved its purpose if it satisfies the reader that there are many basic changes in the law which might be made, that certain of these are rather obviously sound, and that others are constitutionally possible and have much to recommend them. In the meantime the Treasury Department and the Congress go on tinkering with the minor details of a basically faulty system. Is it not time for the appointment of a commission to consider the complete reconstruction of our internal revenue code, with an ideal system in mind and without undue concern for political sacred cows or for the apparent but illusory inevitability which arises from familiarity over a score of years with the present structure of the law? If a code so designed were never put into effect, it could still afford the blueprints of a better system and, simply by stirring dissatisfaction, lead to greater reforms than the history of the last few years permits us to expect.