ON AUGUST 28, 1894, Congress enacted what was then considered a drastic income tax statute. It carried a rate of 2%. The statute was regarded by many with horror. Mr. Joseph H. Choate, then a leader of the New York bar, called the act “communistic in its purposes and tendencies,” and confiscatory. Words momentarily failed even Mr. Choate before the Supreme Court, but he managed to label the principles upon which the tax was defended in that court as “communistic, socialistic—what shall I call them—populist as ever have been addressed to any political assembly in the world.”

No attempt was made to circumvent this outrageous “direct” tax upon property. None was ever necessary. A direct frontal attack was made in the famous *Pollock* case and was successful by the recently noteworthy margin of five to four. The decision, close as it was, “forcibly interred” the contested statute and the nineteenth century had a peaceful ending. Taxpayers were safe until orderly constitutional process made the sixteenth Amendment effective on February 25, 1913, and “direct” income taxation was possible without the impossible apportionment requirement. On this day the peace won by Mr. Choate proved merely a truce, and war was declared. In the beginning it was a quiet, good-natured conflict. It

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* Member of the New York bar.


3 *Id.* at 534.

4 Mr. Choate apparently stumbled at the climatic word “populistic.” Nowadays horror-stricken speakers would probably reverse the order of Mr. Choate’s vituperative adjectives, ending with “communistic.” But in 1894 there were plenty of populists and few communists.

5 *Id.* at 532.


has become recently a bitter struggle between the need of the government for revenue and a desire of taxpayers to save wealth for the family economic unit. In recent years the conflict has increased remarkably in intensity.

Mr. Choate was not mistaken in 1894 when he feared the worst, and said:

"There is protection now or never. If it goes out as the edict of this judicial tribunal that a combination of States, however numerous, however unanimous, can unite against the safeguards provided by the Constitution in imposing a tax which is to be paid by the people in four States or in three States or in two States, but of which the combination is to pay almost no part, while in the spending of it they are to have the whole control, it will be impossible to take any backward step. You cannot hereafter exercise any check if you now say that Congress is untrammeled and uncontrollable." [Italics supplied.]

The shelter erected by Mr. Choate collapsed before it had lived twenty years. The "communistic march" was halted only temporarily. The principles he abhorred are established today. The Act of August 28, 1894,


11 The Secretary of the Treasury has referred to the inequality of this conflict, stating it has only 2,000 government representatives to cope with 45,000 duly admitted tax attorneys. Statement of Secretary Morgenthau, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess., 10 (1937). The Secretary need not be too discouraged. How many of the 45,000 have been able to survive in what the Secretary has described as a highly competitive profession? Id. at 9 How many devote all their time to taxpayers, as do the 2,000? What is the relative expenditure of working hours? Mathematical averages are hard to compute. Mental and personal averages are incalculable, but a person who has had much experience with both Treasury and taxpayers' representatives might conclude that the Treasury representatives stacked up pretty well. Cf. Maguire and Zimet, Hobson's Choice and Similar Practices in Federal Taxation, 48 Harv. L. Rev. 1281, 1301 (1935).


14 Id. at 533. England also had its communistic tax march, much deplored by leaders of the English Bar. Mr. Dicey writing in 1913, the year of the adoption of the 16th Amendment to our Constitution, spoke of the principle that "taxation should be imposed solely for the purpose of raising revenue, and should be imposed with absolute equality, or as near equality as was possible, upon rich and poor alike." Mr. Dicey goes on to describe the ideal Chancellor of the Exchequer as a man who, after providing for the absolutely necessary expenditures of the state, "so framed his budget as to leave the largest amount possible of the national wealth to fructify," as the expression then went, "in the pockets of the people." "Dicey, Law and Opinion in England, Introduction to Second Edition, XXIX, XXX (1913). Mr. Dicey condemned the Finance Act of 1910, because it imposed "specially heavy taxes upon the rich," not merely for the purpose of raising needful revenue, but also "with the aim of promoting social or political objects." "Such taxation," Mr. Dicey said, "may easily become the instrument of tyranny." Id. at lii, see also lxxxvi.
was eight pages in length. The Revenue Act of 1936 contains 121 pages. The Revenue Act of 1936 contains 121 pages. The Revenue Act of 1936 contains 121 pages.

Governments must live and must have money to do so. The Revenue Act of 1936 contains 121 pages.

The 1894 Act imposed tax at a rate which we would call negligible in a day of 75% surtax brackets and 70% estate tax brackets. The income tax is today the largest revenue producer of the federal government. In an income tax case it has been said that taxes are the "life blood of government and their prompt and certain availability an imperious need." In an estate tax case the power of taxation has been referred to as a "fundamental and imperious necessity of all government." The institution of federal taxation is now a "giant in stature," if a "mere infant in age." No one seriously questions any longer a power to impose income tax without apportionment buttressed by the sixteenth Amendment and a power to impose various forms of excise tax founded upon many sweeping decisions of the Supreme Court.

No one questions the federal power to tax. But there are still many who seek to prevent the imposition of tax upon their income. Times have changed, but the underlying human reluctance to pay the price of living in an organized society remains in 1937 what it was in 1894; "tax ethics generally today are where business ethics and trade practices were in the

15 The Revenue Act is supplemented by other unrepealed provisions of prior acts, and by the Revised Statutes.


19 It produced in the 1937 fiscal year $2,149,000,000 out of a total of $4,653,000,000. The highest other revenue producer was the liquor tax with $594,000,000.

20 Bull. Ex'r. and Trustee, 295 U.S. 247, 259 (1935); see also Com't v. Stockholms Enskilda Bank, 293 U.S. 84, 89 (1934).


An anonymous wit once replied to this remark: "I think I have bought enough civilization for my life-time."
nineties.\textsuperscript{25} Frontal attacks being no longer availing, flank attacks became accepted strategy. New methods must be discovered. Taxpayers and their counsel\textsuperscript{26} have not been found wanting in mental fertility\textsuperscript{27} and subtlety.\textsuperscript{28} When the Constitution failed them, taxpayers graduated from

\textsuperscript{25} Testimony of Secretary Morgenthau, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 15 (1937).

\textsuperscript{26} Reference is frequently made in the tax avoidance investigation to the activities of lawyers. It has been said by Mr. Morgenthau that we have developed in this country a "group of ingenious lawyers and accountants who make their living by showing to people who can afford to employ them ways by which they may pay the least possible taxes." Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 9 (1937). The Secretary goes on to say:

"This may be a legitimate business. Nevertheless, by virtue of its highly competitive character, it brings about the following situation: The ordinary accepted standard by which many wealthy taxpayers judge the efficiency of the tax attorney is the amount that he can save in taxes. The most ingenious attorney, therefore, becomes the most successful and the most sought after. He feels that his sole duty is toward his client. If he is honest, he will not condone perjury, but he feels little moral or social responsibility to the Government. Therefore, if he can invent a new scheme for circumventing the intent of tax laws, which will be upheld by the courts, he is well within the ethics of his profession, regardless of the unfortunate effect that such a scheme will have upon the general application of such laws."

The Secretary has also referred to "expensive attorneys"; \textit{id.} at 15; Sen. La Follette to the "smart tax lawyers," \textit{id.} at 105; Prof. Fortas to "resourceful tax lawyers and consultants," \textit{id.} at 200; and Comm. Helvering to "quack tax avoidance experts," \textit{id.} at 195. The President in his letter of June 1, 1937 said:

"It is also a matter of deep regret to know that lawyers of high standing at the bar not only have advised and are advising their clients to utilize tax-avoidance devices, but are actively using these devices in their own personal affairs. We hear too often from lawyers, as well as from their clients, the sentiment, 'It is all right to do it if you can get away with it.'"

It must be remembered that a lawyer, when he is consulted, must render his best opinion upon the question he is asked, even if that opinion should be that the law has a loophole. He need not sell loopholes, but he must say that one exists if he thinks it does. But more important than this consideration is the fact that many lawyers of high standing have been for years advising against most of the devices enumerated in Secretary Morgenthau's letter. The salesmen of these devices have been laymen and institutions who hoped to profit in one way or another from the suggestions given. Many tax lawyers are wholly occupied with the problem of telling their clients what a complicated revenue act means, and representing taxpayers in genuine contests in particular cases.

\textsuperscript{27} Professor Maguire of Harvard Law School uses the term "infinity of intellectual ingenuity." Paul, Studies in Federal Taxation 30 (1937).

\textsuperscript{28} Paul, Studies in Federal Taxation 30; 76, n. 238 (1937). Things were simpler in the old days. For example, under the 1918 law one avoided tax on capital gains by transferring property to a wife, who took as her basis the value at the time of transfer immediately before the sale. Paul and Mertens, Law of Federal Income Taxation § 18.55 (1934). This practice was stopped by the 1921 Act. One secured a stepped-up basis under the 1921 Act by the easy expedient of exchanging the property tax-free for stock of a corporation. This practice was stopped by the 1924 Act. \textit{id.}, § 18.104. These methods were like taking candy from children. Nowadays the Treasury may comfort itself with the thought that tax-avoiding taxpayers at least have to think.
the old school of thought which believed that general propositions decide concrete cases. They learned the doctrine that the power to tax is not necessarily, as Chief Justice Marshall said, the power to destroy, while the Supreme Court sits; that distinctions in tax law, as in other fields of modern law, are distinctions of degree; that taxing statutes place cases on one side or the other of an arbitrary mathematical line; that taxpayers may go intentionally as close to this line as they can, if they do not pass it. The line may shift, and the taxpayer may, to his sorrow, misconceive its exact position, in which case he must pay the penalty. But the line is "hazy," and there is a fair gamble where the tax structure is complicated, where the question is one of degree upon which "reasonable men may differ widely as to the place where the line should fall," and where this difference of opinion is one of feelings rather than processes of articulate reason. Sometimes one wins, and sometimes one loses. The game is, in the opinion of many taxpayers, worth the candle.

One more item of background is necessary if one is to understand the

32 Holmes, J., ibid. See also remarks of Representative Vinson, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 122 (1937).
34 Superior Oil Co. v. Mississippi, 280 U.S. 390, 395, 396 (1930).
36 Secretary Morgenthau, Testimony at Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess., 10 (1937). See also Under Secretary Magill's testimony, id. at 17. This subject has been developed at length by the present author in Studies in Federal Taxation (1937).
37 We thus have a "sporting theory of tax administration." Secretary Morgenthau, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 10 (1937).
42 See Woolford Realty Co., Inc. v. Rose, 286 U.S. 319 (1932). See also testimony of Mr. Morgenthau, id. at 13.
recent congressional tax avoidance investigation and the elaborate provisions of the Revenue Act of 1937. Tax avoidance is not new.\textsuperscript{43} It was not suddenly discovered in 1937 that certain taxpayers were escaping their fair share of the tax burden. What interested the Treasury in this tax avoidance investigation was an increased prevalence and a new boldness on the part of taxpayers.\textsuperscript{44} Tax avoidance propaganda, supported sometimes by charges of unfairness on the part of the tax administration, was never so widespread as in the early part of 1937.\textsuperscript{45} The public had become more acutely tax conscious than it had ever been previously, and a substantial minority seemed more determined than ever to avoid taxes.\textsuperscript{46}

\textsuperscript{43} See Mr. Morgenthau’s letter of May 29, 1937; testimony of Under Secretary Magill, \textit{id.} at 26. See also Paul, \textit{Studies in Federal Taxation} 83, n. 283 (1937).

\textsuperscript{44} For example, the use of foreign personal holding companies greatly increased in the last few years. Ways and Means Committee Report No. 1546, 75th Cong., 1st Sess. 14 (1937). See also, Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess. 1 (1937); and see testimony of Under Secretary Magill, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess. 26, 64 (1937).

One wonders about the degree to which this new attitude may be rationalized by objections to the use of taxes by the government. There was much discussion in the hearings of making a Roman Holiday out of taxpayer persecution. Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess. 67, 330 (1937). The Treasury steadily maintained that the names mentioned were selected at random and without political significance; testimony of Under Secretary Magill, \textit{id.} at 416. This was undoubtedly true, but a deeper truth might be that any random selection would naturally hit those who were best able to convince themselves that unwise government expenditures justified an avoidance of contribution to the cost of government. In other words, does a tax investigation inevitably strike principally at political opponents, because it is political opponents who can most easily justify to themselves the failure to contribute to the cost of a government in which they are not participating? Whatever the answer to this question may be, it is a little unfitting for those who are not contributing to complain about the use to which contributions are put.


\textsuperscript{46} One must remember that most taxpayers move in a world that thinks of taxes without sympathy. The existing average standards of the taxpayer’s community sees nothing “reprehensible” or “illicit” or “mildly unethical” in tax avoidance. See Paul, \textit{Studies in Federal Taxation} 84–87 (1937), quoting the Russian proverb that “where all are stealing, none is a thief.” The story told by Judge Green in \textit{The Theory and Practice of Modern Taxation} 119 (1933), and repeated in Paul, \textit{op. cit.} 77 \textit{id.}, will bear retelling. Judge Green tells of how in England fellow club members refuse to shake the hand of a taxpayer suspected of fraud by the tax administrators, and compares with this attitude the French attitude as reported by Deputy Dumesnel in the French Chamber of Deputies. Deputy Dumesnel said, “I am not very sure but that in France in many circles one begins by asking such a person how he did it so that one may copy his method.” Deputy Tasso interposed with, “In France they make him honorary president of the club.”

Even a Supreme Court Justice may voice reservations. Assistant Attorney General Morris in \textit{The Work of the Tax Division of the Department of Justice}, 15 \textit{Tax Magazine} 526 (1937)
This determination reached the point of bitter defiance and recrimination\(^{47}\) so that taxpayers thought it the duty of the tax administration to ferret out\(^{48}\) taxpayers who took all possible advantages under a literal interpretation of the statute. Foreign editors spoke of the problem of the United States to "make its laws proof against evasion."\(^{49}\) Tax avoidance had developed into a fine art.\(^{50}\) Loopholes discovered by alert taxpayers had to be plugged or the governmental revenue would suffer alarmingly at a time when it was needed most.\(^{51}\) Something had to be done promptly to save morale, to prevent the income tax law from becoming a joke,\(^{52}\) and to offset the imitation-breeding example of successful tax dodging.\(^{53}\) Quick action was asked for by the Treasury to prevent the growth of vested interests in tax-avoidance devices.\(^{54}\) It was also thought that publicity might be almost as useful as legislation.\(^{55}\) There is something in this point; the tax avoiding propaganda on the other side was never so active.

tells a story of Chief Justice Chase of the Supreme Court who was asked, "I have a little property which brings me in a yearly rental but the tax gatherers have not spotted it. I do not know whether I ought to let the thing go that way or not. What would you do if you were in my place, Mr. Chase?," and who replied with a merry twinkle in his eyes, "I think it the duty of every man to live unspotted as long as he can."

To put things mildly, the mores of the American taxpayers' world do not call for the payment of taxes as a patriotic duty. Mr. Choate was able to attack the Act of August 28, 1894 on "patriotic" grounds. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 553 (1895). The taxpayers' world, as the Secretary of the Treasury has stated, is inhabited by rich people, but there are enough rich people in America to satisfy the natural taste of tax avoiders for gregariousness.


\(^{48}\) Secretary Morgenthau, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess. 12 (1937). See the statement attributed to Mr. J. P. Morgan: "If the Government doesn't know enough to collect its taxes, a man is a fool to pay them," \textit{Id.} at 189.

\(^{49}\) Testimony of Mr. Irey, \textit{Id.} at 41.

\(^{50}\) Perhaps the word "racket" should here be used.

\(^{51}\) Testimony of Mr. Morgenthau, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess. 14 (1937). See also testimony of Chairman Doughton and Under Secretary Magill, \textit{Id.} at 71.

\(^{52}\) "Clever little schemes" are not admirable when they undermine the foundations of society." Letter of President Roosevelt, June 1, 1937. See testimony of Secretary Morgenthau, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess. 15 (1937), also testimony of Under Secretary Magill, \textit{Id.} at 31, 90.

\(^{53}\) Letter of President Roosevelt, June 1, 1937, quoted in Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 1 (1937).

\(^{54}\) Testimony of Mr. Morgenthau, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 16 (1937).

\(^{55}\) Testimony of Under Secretary Magill, \textit{Id.} at 27.
TAX AVOIDING DEVICES

This was the situation which prompted the President’s letter of June 1, 1937, to Congress, asking for legislation making the “present tax structure evasion-proof.”¹⁵ In this letter of June 1, 1937, the President incorporated a letter from the Secretary of the Treasury, dated May 29, 1937, listing eight tax avoidance devices and three aspects of the law which in his opinion called for amendment. The devices listed by the Secretary of the Treasury were:²⁷

1. The evasion of taxes by setting up foreign personal holding corporations in the Bahamas, Panama, Newfoundland, and other places where taxes are low or non-existent and corporation laws lax;
2. The use of foreign insurance companies to procure fictitious interest deductions;
3. The insulation of income in domestic personal holding companies;
4. The incorporation of yachts and country estates;
5. The taking of artificial deductions;
6. The use of multiple trusts to split incomes and secure exemptions;
7. The splitting of incomes by putting wives and children in partnerships;
8. The employment of pension trusts to postpone the incidence of tax upon the high-bracket incomes of corporate executives.

One characteristic underlies several of these devices; the multiplication of the taxpayer’s personality. A taxpayer, in almost all the cases mentioned, starts with single individuality and subdivides himself by various mechanisms into a group of people. He subdivides himself into several people, some of whom are incorporated, and others of whom are not.²⁹ It is a common denominator of the several schemes that the income of a family economic unit shall be treated as if there were no such economic

¹⁵ Letter of President Roosevelt, June 1, 1937, quoted in Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 1 (1937).
²⁷ The Ways and Means Committee employed a different classification with respect to changes in law made by the Revenue Act of 1937. See Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 2 (1937), listing the following loopholes:

"I. Personal Holding Companies.
II. Foreign Personal Holding Companies.
III. Disallowed Deductions.
IV. Trusts.
V. Nonresident Aliens.
VI. Miscellaneous Provisions."

²⁸ The exception is the foreign insurance company device.
²⁹ Secretary Morgenthau, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 11 (1937).
unit. Another characteristic, applicable in the case of foreign personal holding companies, is the transfer of the source of income to a foreign jurisdiction beyond the reach of this country's taxing and administrative power. It will also be noted that the doctrine of corporate entity is often a staunch friend in need to tax-avoiding taxpayers. Corporations are people.

The three amendments to the law suggested by the President were:

1. The elimination of percentage depletion;
2. A change in respect to the taxation of husband and wife in the 8 community property states; and
3. Changes in the taxation of non-resident aliens.

In the hearings held before the Joint Committee on Tax Evasion and Avoidance extending from June 17, 1937, to July 28, 1937, the presentation of evidence followed generally the order of items contained in Mr. Morgenthau's letter of May 29, 1937. This order of treatment will serve as satisfactorily as any other for a further presentation of the subject, and we shall, therefore, in this article adopt this classification merely as a basis for presentation.

I. THE FOREIGN PERSONAL HOLDING COMPANY DEVICE

Foreign personal holding companies have been called one of the most flagrant loopholes for tax avoidance. Their use has reached serious proportions, as a conservative estimate showed the formation of 585 personal holding companies by Americans in the Bahama Islands, Panama, Newfoundland and Prince Edward Island. Apparently, taxpayers have even

60 Testimony of Secretary Morgenthau, id. at 13.
61 Testimony of Secretary Morgenthau ibid. See also text supported by notes 64–86.
62 See discussion by Mr. Kent of the case of Com'r v. Eldridge, 79 F. (2d) 629 (C.C.A. 9th 1935); Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 206 (1937). See also Lammot DuPont, 36 B.T.A. 223 (1937).
63 See letter of Mr. Morgenthau, quoted in Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess. 2 (1937). It will be realized that the classification of methods adopted by Mr. Morgenthau is not hard and fast. Methods overlap. See also testimony of Mr. Rogge, id. at 360.
64 Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 13 (1937).
65 Testimony of Mr. Irey, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 3 (1937) and see Exhibit 1; id. at 72, et seq. Under Secretary Magill has described one aspect of this situation with caustic wit id. at 28, as follows:

"As the Secretary has said, we do not know how prevalent this device is. The Bahama Islands are not a suitable place for the development of great corporate enterprises. The inhabitants are poverty stricken. There is a small trade in liquor. There are a few hotels for winter tourists. Yet suddenly long lists of impressive sounding corporations, financed by American capital, appear on the directories of the local office buildings. I understand there are
resorted to Liechtenstein, although information as to that jurisdiction is almost unobtainable. The point had been reached on March 11, 1937, when Nassau newspapers spoke of making the "seas safe for the property boom in the Bahamas," and of the islands themselves as the American "Promised Land," which Americans should help the British Empire to make safe for American immigration.

The essential idea of the foreign personal holding company device is to siphon assets and income out of the United States into foreign countries where there are no income taxes, or where such taxes are low, by transferring property, usually securities, to a foreign corporation which serves as an "incorporated pocketbook" for the income from the property transferred, and insulates such income from United States tax upon the individual stockholder.

Tax saving was accomplished by the use of foreign corporations because:

(a) Dividends would not be distributed, and the American stockholder would thus avoid individual surtax on dividends which would have been inevitable if the dividends on the securities held by the foreign corporation had been received by him individually;

(b) If the property transferred to the foreign corporation had increased in value, the profit on any sale thereof would not be taxable to a foreign corporation if the sale was made outside the United States, and the profit would, therefore, be non-taxable income from sources without the United States.

Example: A taxpayer in 1936 owned Nassau Securities, Ltd., organized in 1935 under the laws of the Bahama Islands. He also controlled the General Investment Corporation, a corporation with a substantial business and many other stockholders. At his instance the General Investment Company agreed to buy its own stock from Nassau Securities, Ltd., at $102 per share, the transaction to be consummated in Montreal. At the time this agreement was made, Nassau Securities, Ltd. had no stock of the General Investment Corporation, and made an offer to all stockholders of General Investment Corporation to purchase their shares at $87.50 per share, any stock

two shacks on either side of the street down there—unfortunately I have not been to Nassau—with a long list down the side of these houses of these fine sounding corporations, which add up to have several hundred million dollars of capital."
so acquired to be deposited in escrow in Montreal on January 23, 1937, to be paid for January 25, 1937. These dates are important because they meant that Nassau Securities, Ltd., did not have to pay the individual stockholders of General Investment Corporation until after General Investment Corporation had paid it a larger sum per share. The net effect of the transaction was that Nassau Securities, Ltd. bought stock from the stockholders of General Investment Corporation, and sold the same stock to the General Investment Corporation at a profit of $14.50 per share. This profit was allocated to a Bahama corporation and the attempt was made to consummate the transaction in Montreal in order to avoid tax upon a profit the making of which violated fundamental rules of corporate fair dealing.72

(c) These foreign corporations were sometimes used in various ways to obtain deductions which would otherwise not be available to an individual taxpayer.

Example: A taxpayer organized two Canadian corporations. In 1930 he transferred to one of them assets in excess of $13,000,000. In 1932 the taxpayer obtained a loan from this corporation of $2,300,000,73 the interest upon which, $225,000, was sufficient to reduce his 1934 return to a non-taxable status. This operation was repeated in 1935 and 1936, with the result that little tax was paid in 1935 and no tax in 1936.74

(d) These foreign corporations might be used as vendees of securities to create a profit offsetting personally realized losses of securities, and thus step up the basis of the securities sold to the foreign corporation.

Example: A taxpayer used the Newfoundland corporation idea in a different way. Under the 1934 Act, losses on sales of capital assets were not deductible against ordinary income, except to the extent of $2,000. They could be applied, however, without any limitation against capital gains.75 He lost $130,000 in 1936 on sales of securities. Only $2,000 of these losses might be useful under ordinary circumstances.76 He therefore transferred other securities to his Newfoundland corporation, owned 78% by himself and 22% by a brother and a close friend. He thus created a capital gain of $130,000, against which he might apply his otherwise useless losses. This procedure increased the basis of the securities transferred to the Newfoundland corporation by $130,000, thus saving tax on a future sale of these securities.77

(e) Another use of these foreign corporations was to serve as corporate

72 See Kaspare Cohn Co. Ltd., 35 B.T.A. 646 (1937).
73 On the question whether this loan should be treated as an informal dividend see Roy J. Kinnear, 36 B.T.A. 153 (1937), and cases cited in Paul and Mertens, Law of Federal Income Taxation § 8.26 (1934).
74 Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 50 (1937).
77 Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 54 (1937).

It was not essential to this plan that a foreign corporation be used; a domestic corporation would have been equally available.
assignees of royalty income or income from personal services, making such
income taxable at a lower rate than would be applicable in the case of the
individual assignor.

Example: A taxpayer was the inventor of an electric razor manufactured in a plant
in Connecticut. In November, 1933 he formed a Nassau corporation to which he
transferred his royalty income—$120,000 in 1934—from the American operating
company. On December 18, 1935 he became a Canadian citizen. Five days later he
organized three further Nassau corporations. To these corporations he transferred
practically all the outstanding stock of the American manufacturing company.

Example: A taxpayer apparently acted as agent for the General Investment Com-
pany, an American corporation, in connection with the sale of a Buenos Aires subway.
He instructed the General Investment Company to pay $250,000 to a Bahama cor-
poration, organized by himself in the fall of 1936. He was admittedly an officer and
director of this corporation, but he would not admit in testimony before the Securities
and Exchange Commission that he was a stockholder, and stated that the stockhold-
ers constituted a group of his Argentinean, Paraguayan and English friends. The
$250,000 was paid on January 8, 1937, in the form of a check for $100,000 and cur-
rency in the amount of $150,000. According to his testimony, the check for $100,000
was taken to Buenos Aires and delivered to the corporation and deposited in the cor-
porate name. The $150,000 was also turned over to the corporation.

A special difficulty encountered by the Treasury in connection with
these corporations proceeded from its "lack of direct jurisdic-
tion," and the fact that the United States tax administration has no investigating
agents in foreign countries. Apparently, it is not possible for the United
States to sue for taxes in a foreign country.

Or his patents which produced this income. See Paul and Mertens, Law of Federal In-
come Taxation § 15.22 (1934).

Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st
Sess. 57 (1937).

Id. at 54.

See his testimony before Securities and Exchange Commission, May 7, 1937.

The taxpayer here was vague in his testimony and would not directly answer the ques-
tion whether this money was deposited in the bank.

The government claimed that the taxpayer owed $33,000, unpaid taxes and interest for
previous years. On January 7, 1937, he made a sworn statement in support of a compromise
of the $33,000 liability by the payment of $1,700 in installments. See Capone v. United States,

Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 14 (1937); Letter of
Chairman transmitting Report of the Joint Committee on Tax Evasion and Avoidance,

Testimony of Under Secretary Magill, Hearings before the Joint Committee on Tax
Evasion and Avoidance, 75th Cong., 1st Sess. 28, 65 (1937). See also testimony of Mr. Irey,
id. at 39, 61.

Testimony of Under Secretary Magill, id. at 64, 85. There seem to be no American cases
squarely on this point, though see dicta in such cases as Wisconsin v. Pelican Insurance Co.,
127 U.S. 265 (1885); and no foreign decisions involving our own government. But in certain
Sometimes taxpayers skipped around among foreign countries "like a bug," thus rendering detection difficult. One taxpayer reported first from New Brunswick, then from British Columbia, and then from Jamaica.  

**Change Made by Revenue Act of 1937.** To prevent repetition of the practices described, the Revenue Act of 1937 adds a new supplement P to the Revenue Act of 1936, effective generally as of August 26, 1937. This supplement proposes to tax the income of foreign personal holding companies to the United States shareholders, thus disregarding the entity of such corporations. This method of taxation will no doubt be attacked on constitutional grounds. The broad necessity of saving the revenue will probably repel any such attack. Each United States shareholder must include in his gross income as a dividend for the taxable year with which or in which the taxable year of the company ends, the amount he would have received as a dividend if on such last day there had been distributed by the company, and received by the shareholder, an amount bearing the same ratio to the undistributed Supplement P net income of the company for the taxable year as the portion of such taxable year up to and including such last day, bears to the entire taxable year. Foreign personal holding companies are defined as any foreign corporation if—

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English cases where other governments attempted such extraterritorial collection, the English courts not only threw the foreign state out of court but subjected it to the additional indignity of paying costs for the attempt. See Municipal Council of Sydney v. Bull, [1909] 1 K.B. 7; H.M. The Queen of Holland v. Drukker, [1928] 1 Ch. 877; see also Dicey, Conflict of Laws 224 (4th ed. 1927); Beale, Conflict of Laws 1633-1638 (1935).

86 Testimony of Under Secretary Magill, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 69 (1937).

87 See Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 13 (1937). References below are to this report. See also Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 6 (1937).


89 Revenue Act of 1937, § 202; see Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 23 (1937). The provisions of Supplement P are really retroactive to a considerable extent, applying to taxable years, either of a shareholder or a corporation, so long as the tax year ends after August 26, 1937.


91 Revenue Act of 1937, § 337(b); Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 19 (1937). Space does not permit elaboration of the provisions as to credit for obligations of the United States and its instrumentalities (§ 337(c), id. at 21); information in the return (§ 337(d), id. at 21); the effect on the capital account of the foreign personal holding company (§ 337(e), id. at 21); the adjusted basis of stock in the hands of shareholders (§ 203, id. at 22, 24); and the basis of stock in case of death (§ 204, id. at 24).

(1) at least 60% of the income is foreign personal holding income—meaning
(a) dividends, interest, royalties, annuities, (b) (except in the case of regular dealers) gains from the sale of securities, (c) (with certain exceptions) gains from future transactions, (d) distributable income from estates and trusts and gains from the disposition of any interest in an estate or trust, (e) amounts received under contracts of the type described in the statute under which the corporation is to furnish personal services, (f) amounts received as compensation for the use of or right to use property of the corporation in any case where, at any time during the taxable year, 25% or more in value of the outstanding stock of the corporation, is owned directly or indirectly, by or for the individual entitled to the use of the property; whether such right is obtained directly from the corporation, or by means of a sub-lease or other arrangement, and (g) rents, unless constituting more than 50% of the gross income, and

(2) at any time during the taxable year, more than 50% in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individual citizens or residents (called the "United States group").

It was not deemed necessary to include exempt corporations in the term "foreign personal holding company" to prevent avoidance. The statute contains elaborate provisions as to constructive ownership and convertible securities. The gross income of foreign personal holding companies is computed as if they were domestic corporations, except that to prevent double decker arrangements or chain arrangements, there is to

94 Revenue Act of 1936, § 332(c), added by Revenue Act of 1937 § 201.
95 Revenue Act of 1936, § 332(e), added by Revenue Act of 1937, § 201. See discussion, at p. 80 of incorporated talent cases.
96 Revenue Act of 1936, § 331(b), added by Revenue Act of 1937, § 201.
98 Revenue Act of 1936, § 333(a), added by Revenue Act of 1937, § 201.
99 Revenue Act of 1936 § 334(b), (c) as changed by Revenue Act of 1937 § 1. This method of insulation is simple enough, involving the use of two or more companies instead of one. An individual with substantial income could transfer assets to one foreign personal holding company which would accumulate and retain the profits. The stock of this corporation would be held by a second corporation, the stock of which would in turn be held by the original individual owner of the property. In such a situation the domestic resident might escape the tax on his share of the accumulated profits by interposing the defense that he did not personally own any of the stock in the company which actually received and collected the income. The statutory insertion marks the death-knell of this stratagem by piercing the veil of any number in a chain of corporations and attributing the income of the various successive companies to the
be added as a dividend, in the gross income of the first company for the taxable year in which or with which the taxable year of the second company ends, the amount the first company would have received as a dividend if on such last day there had been distributed by the second company and received by the shareholders an amount which bears the same ratio to the undistributed Supplement P net income of the second company for its taxable year, as the portion of such taxable year up to and including such last day bears to the entire taxable year.

"Supplement P Net Income" means net income with an additional allowance for federal income, war-profits and excess profits taxes paid or allowed during the taxable year to the extent not allowed in computing net income and an alternative allowance for contributions or gifts, but no allowance is to be made for taxes of a shareholder paid by the corporation, for the extraordinary pension trust contribution deduction, or for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company in excess of the rent or other compensation received for the use or right to use the property, unless the Commissioner approves such excess. The "Undistributed Supplement P Net Income," which is what is taxed to the United States shareholder, is the "Supplement P Net Income" minus a credit for dividends paid, computed without the benefit of the dividend carry-over provision.

The statute includes administrative provisions as to information re-
turns by officers and directors,\textsuperscript{108} and by shareholders,\textsuperscript{109} and as to the formation of foreign corporations,\textsuperscript{110} and a general penalty provision.\textsuperscript{111} It places a premium on liquidation before January 1, 1938, by a provision to the effect that profit on any liquidation will be taxable income in its entirety, instead of to a limited amount, depending on the period of holding of the stock of a foreign personal holding company, unless liquidation is completed before January 1, 1938, or unless it is established that liquidation is impossible before that date because of the laws of the foreign country, in which event the liquidation must be completed before a date set by the Commissioner, but not later than June 30, 1938,\textsuperscript{112} and extends the Statute of Limitations upon additional assessments to seven years in case of omissions from gross income.\textsuperscript{113}

2. THE DEVICE OF FOREIGN INSURANCE COMPANIES\textsuperscript{114}

The use of this device was not widespread, but the gullible vendees of the device attempted considerable tax saving. The mechanism has been variously labeled as "pure fiction,"\textsuperscript{115} "financial romance,"\textsuperscript{116} a "hollow shell,"\textsuperscript{117} a "phoney life insurance device,"\textsuperscript{118} a "labyrinth of artificiality,"\textsuperscript{119} and from another viewpoint, as "stern reality."\textsuperscript{120} It consisted of an elaborate attempt to secure what was alleged to be interest deduction on what purported to be indebtedness represented by a so-called loan from a company which masqueraded as an insurance company.\textsuperscript{121} The taxpayers

\textsuperscript{111} Revenue Act of 1936, § 341, added by Revenue Act of 1937, § 201. See Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 22 (1937).
\textsuperscript{112} Revenue Act of 1937, § 205. See Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 25 (1937).
\textsuperscript{114} The very fact that a taxpayer used a foreign insurance company instead of a domestic insurance company was in itself significant; testimony of Under Secretary Magill, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 127 (1937).
\textsuperscript{115} Testimony of Mr. Leming, \textit{id.} at 100.
\textsuperscript{116} Statement of Mr. Vinson, \textit{id.} at 100.
\textsuperscript{117} Testimony of Under Secretary Magill, \textit{id.} at 105–138.
\textsuperscript{118} Statement of Senator La Follette, \textit{id.} at 105.
\textsuperscript{119} Testimony of Mr. Leming, \textit{id.} at 141.
\textsuperscript{120} Statement of Mr. Crowther, \textit{id.} at 141.
\textsuperscript{121} Testimony of Under Secretary Magill, \textit{id.} at 29.
THE BACKGROUND OF THE REVENUE ACT

went through elaborate motions of acquiring a single premium participating life insurance policy in a substantial sum from this hollow insurance company, and of borrowing simultaneously from the same corporate entity a sum, the interest on which was sufficient virtually to wipe out the taxpayer's gross income from such sources as personal services rendered. The "insurance company," which in one case issued a policy in the sum of $4,000,000, was organized under the laws of the Bahama Islands. But it had no paid-up capital stock, kept none of the records usually kept by insurance companies, had no appreciable bank balance or other assets, and made no attempt to carry reserves in the manner customary in the insurance business as that business is done in the United States. The technical entity was nothing more than a shell, yet it purported to issue policies nominally running into millions of dollars. With equal audacity it pretended to make loans likewise running into millions.

The policy issued by this corporate entity to taxpayers buying this plan contained many unusual features, among which was a clause stating that the policy should not lapse at the end of any given policy year, even though the taxpayer took no steps to comply with its provisions. The policy carried a significant lien, or first charge, in favor of the issuing corporate entity against the principal sum in any settlement at death in excess of 25%, this lien being nominally in exchange for a waiver of medical examination. Thus, the so-called "insurance" was really not insurance at all. In the typical "policy" employed in connection with this device the taxpayer was expected to obtain a loan on the so-called reserve value of the policy at the end of the first policy year. Thus, the "policy" holder paid a single premium of $2,793,720, and at the same time borrowed $2,832,540.

This foreign insurance company device was sold by a New York partnership. Under a contract with the taxpayer which provided that this firm should receive "for services rendered," 25% of the estimated saving of federal and New York state taxes, through the deduction of interest on the so-called policy loan, a small amount was payable immediately and the balance was payable when the income tax returns should be finally closed. A further fee was payable on subsequent interest payments on the loans supposed to have been made. That these handsome payments to advisors were well earned is shown by the profitable results which the

122 Thus the estate of the so-called insured got "zero in money"; statement of Mr. Vinson, id. at 127. Apparently the estate of one "insured" under this scheme, had owed to it $158 on a policy of $400,000. See statement of Mr. Cooper, id. at 139; statement of Senator Harrison, id. at 140.

123 Id. at 143.
taxpayer reaped from this collaboration in the following years. The $2,832,540 received from the company in 1932 was employed, in part, to pay the year's interest on the so-called loan, and also to discharge a bank loan which the taxpayer has obtained at a Canadian bank for $8,361, for the purpose of paying the original premium. Thereupon, one taxpayer deducted as "interest paid" for 1932 an amount of $141,628—thereby effecting a remarkable return from a net cash investment of $8,361.

The same series of maneuvers was repeated with some carelessness in subsequent years; the company issued annual dividends and also checks representing increases in the amount of the loan on the policy. The taxpayer graciously returned both checks to pay the interest on the loan, without even having the checks deposited or put through the usual bank channels.

Change Made by Revenue Act of 1937. The Joint Committee on Tax Evasion and Avoidance believed existing law adequate to reach these pretended insurance cases, and suggested no amendments to plug a loophole that did not exist. The Committee seems justified in this position, and it would seem that the Treasury agrees. These cases were, no doubt, presented for their publicity value as a deterrent. The whole device was a house of cards. To respect it would have been, in the language of the Supreme Court, to respect "an elaborate and devious form . . . . masquerading" as outstanding insurance and indebtedness thereon, and "to exalt artifice above reality."

3. DOMESTIC PERSONAL HOLDING COMPANY DEVICE

Domestic personal holding companies were a popular and exceedingly effective device for avoiding income tax. The principal purpose of such

124 Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 7 (1937); Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 2 (1937). See remarks of Senator George, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 30 (1937); and statement of Senator Walsh, id. at 133.


126 Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 27 (1937).


128 It was argued in favor of some personal holding companies that they were organized before 1934 when the personal holding company provision first appeared in the law. This argument, of course, is irrelevant if a personal holding company already in existence was employed to take advantage of the benefits conferred by the Revenue Act of 1936 § 351, 49 Stat. 1732 (1936), 26 U.S.C.A. § 351 (1929). See Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 220 (1937).
companies was to hold income-producing property (usually securities) and to withhold distribution to the shareholder or shareholders of the income therefrom. Such companies were also used to obtain deductions which would not otherwise be available.

Example: A taxpayer,\textsuperscript{129} owned several personal holding companies, some directly and some through a holding company which was not a personal holding company, because it received more than 20% of its income from operating a farm.

This elaborate corporate set-up involved two ideas. The holding company and one personal holding company, both had stock in, and received substantial income from, Christiana Securities Corporation. The dividends from the Christiana stock were taxed only at the personal holding company brackets, lower than the brackets of the individual stockholder, and in addition, such dividends were reduced by the expenses, losses and depreciation of the farm estate and the corporation operating the farm.

Example: A taxpayer and his friend,\textsuperscript{130} New York bankers, owned twelve personal holding companies and two realty companies, the taxpayer owning one and his friend the other of the two realty companies.\textsuperscript{131} These twelve personal holding companies in 1935 claimed losses aggregating $522,987.86, resulting from sales of securities between the various corporations. These losses, of course, offset income from securities. These sales were from one company owned by the taxpayer and his friend to another company owned by both the taxpayer and his friend; there were sales from one company belonging to one individual's group to a company belonging to the other individual's group; there were sales within a group; and finally, there were sales that completed the circuit, that is, securities were sold by a company owned by one of these individuals to a company owned by the other, and then a like number of shares in the same securities were sold back by the two other controlling companies, "the result being each group of companies was back to where it had started, and losses were claimed on both sales."

The personal holding company provision of the statute,\textsuperscript{132} in a sense, legitimatized personal holding companies\textsuperscript{133} by imposing a penalty tax upon their undistributed adjusted\textsuperscript{134} net income. The domestic personal

\textsuperscript{129} Id. at 212.
\textsuperscript{129} Id. at 216.
\textsuperscript{130} The rental income of these two realty companies was enough under Acts previous to the 1937 Act to take them out of the definition of personal holding companies which required that 80% of the gross income be from sources other than rent. Revenue Act of 1936 § 351 (b)(1), 49 Stat. 1732 (1936), 26 U.S.C.A. § 351 (1929).
\textsuperscript{131} This section was first inserted in the Revenue Act of 1934 in response to an admitted failure of the penalty tax upon corporations accumulating surplus to avoid the imposition of surtax upon shareholders. See Paul and Mertens, Law of Federal Income Taxation § 48.38 (1934). See also statement of Mr. Vinson, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 173 (1937).
\textsuperscript{132} Testimony of Under Secretary Magill, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 30 (1937). Cf. testimony of Mr. Magill, id. at 161.
\textsuperscript{133} These tax rates commenced under the Revenue Act of 1936 at 8% and reached 48%.
\textsuperscript{134} The Ways and Means Committee believed these rates sufficiently low "to permit individuals
holding company was an "incorporated pocketbook" in the same manner as a foreign personal holding company; its advantage was, however, not dubious absence from jurisdiction, but an effective rate of tax lower than the individual surtax brackets of its stockholders. A domestic personal holding corporation did not conceal; it revealed and paid the statutory price.\textsuperscript{135}

The illusory quality of the personal holding company tax rates is definitely proved by the experience of the Treasury in the years 1934, 1935, and 1936. Notwithstanding nominal rates of 8% to 48%, the preliminary report on 1935 returns showed the collection of less than $2,000,000 on personal holding company income of approximately $115,000,000.\textsuperscript{136}

Companies filing 4,457 returns under the 1934 Act showed an aggregate net income of over $53,000,000. Only 374 of these companies, or less than 9%, showed income subject to the personal holding surtax imposed by section 351. These companies showed taxable income of only $5,000,000, or less than 10% of the total net income of the group. They paid a personal holding company surtax of only $1,695,000, or about 3% of their aggregate net income. The remaining 4,083 companies in the group paid no surtax under section 351. They were subject only to the ordinary tax on corporate income, which is, of course, less than the tax on individuals in the higher brackets. The highest bracket of the normal tax on corporations under the 1934 law was 13-3/4%, whereas the individual surtax bracket (not including normal tax of 4%) reached 59%. The individuals who owned these corporations were, therefore, taxed on the income from assets held by these companies "as if they were bona fide operating corporations, instead of merely ephemeral subdivisions of the personalities of the individual owner and creator."\textsuperscript{137}

Data was presented to the Committee on Tax Evasion and Avoidance showing what happened with respect to seventeen personal holding company cases which were pending in the Conference Division of the Bureau of Internal Revenue at the time of the investigation. Of these 17 companies only three paid surtaxes under section 351. Two of these surtaxes

\textsuperscript{135}Some personal holding companies were none too anxious to reveal the entire situation, as is proved by the way in which the returns of companies and stockholders were filed in widely separate districts, making a difficult problem of assembly. See, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 171 (1937).

\textsuperscript{136}Id. at 149.

\textsuperscript{137}Id. at 150.
were inconsequential. The remaining fourteen companies paid no surtax under section 351. The total net income of the fourteen companies before any deductions under section 351 was $4,862,824.87. This group of corporations paid ordinary corporate tax under section 13 of only $18,668.07. The entire group paid a total surtax under section 351 of $25,905.28. The total corporate taxes paid by the seventeen companies was $43,973.35. It was estimated on a conservative basis that the individual owners of these seventeen personal holding companies would have had to pay a tax of $1,638,023 if no personal holding company had been organized.138

The personal holding company rates were delusive because of the over-generous deduction provisions contained in the statute.139 These provisions may be summarized as follows:

(1) Personal holding companies might deduct 20% of their adjusted net income less dividends received from other personal holding companies.140

(2) Personal holding companies might deduct reasonable amounts used or set aside to retire indebtedness incurred prior to January 1, 1934.141

(3) Personal holding companies, to arrive at adjusted net income, might deduct losses on the sale or exchange of capital assets, without limitation.142 If such losses were incurred by an individual, they were allowable only to the extent of $2,000, plus gains from such sales or exchanges.143

Analyses were presented by the Treasury to the Joint Committee on Tax Evasion and Avoidance of 1,300 returns filed under the 1936 Act. Of these 1,300 cases, 278 claimed the above mentioned 20% deduction. Fifty-six claimed the deduction for amounts used to retire indebtedness, and forty-six claimed deductions for capital losses. The 278 corporations claiming the 20% exemption took a deduction of $4,878,471, accomplishing a tax reduction thereby of $929,831. The fifty-six companies claiming a deduction for debt retirement deducted $5,606,444, accomplishing a tax saving of $982,967. The forty-six companies claiming loss deductions listed capital losses of $11,251,535.60, accomplishing a tax saving of $725,509.07.144

138 Id. at 162; see also table, id. at 166.
139 Id. at 149.
141 Revenue Act of 1936, § 351(b) (2) (B). 49 Stat. 1732 (1936), 26 U.S.C.A. § 331 (1929). This deduction has been retained in the Revenue Act of 1937. See text supported by notes 147–49.
143 In other words, an individual was less favored than a personal holding company.
It must be admitted that this personal holding company device constituted in most cases a successful tax avoidance mechanism. There will, no doubt, be cases which will show that what is claimed to have been done in connection with personal holding companies was not done, but where much of the income tax law rests upon the base of corporate entity, and where there is a genuine transfer to a personal holding company, and the law imposes a penalty tax on the personal holding company on the theory that it is a separate corporation, the only thing left is to repair by an amendment damage suffered from statutory over-generosity.

*Change Made by Revenue Act of 1937.* A death sentence is pronounced against the use of these holding companies as a tax avoiding device by the provisions of the 1937 Act, which completely rewrite Title IA of the Revenue Act of 1936. These sections are distinguishable from the provisions dealing with foreign personal holding companies chiefly in that they make no attempt to tax the undistributed corporate income directly to the stockholders, since in the case of domestic corporations there is not the same possibility that otherwise, if the income is left in the corporate treasury, it may escape taxation altogether. The most significant changes which have been made are three-fold: (1) a drastic increase in the surtax rates upon such corporations, now varying from 65% on the first $2,000 of undistributed adjusted net income to 75% on all income over that amount; (2) a tightening up of the specifications which classify a corporation as a domestic personal holding company; and (3) a denial of certain deductions formerly allowable in "undistributed adjusted net income."

Under earlier law, only such non-exempt companies as derived at least 80% of their gross income from royalties, dividends, interest, annuities, and gains from the sale of stock or securities (except in the case of regular dealers), and which were owned to the extent of at least 50% of their stock by or for not more than five individuals during the last half of the taxable year, were classified as personal holding companies. The latter element

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145 *Cf.* opinion of Member Arundell, Kaspare Cohn Co., Ltd., 35 B.T.A. 646 (1937).
146 See text supported by notes 132-35.
147 In fact, domestic shareholders under the present act cannot even save themselves by voluntarily choosing to report their pro rata shares of the undistributed net income; actual distribution of the earnings is the only avenue of escape from the new surtax.
148 Revenue Act of 1936, § 351, as changed by Revenue Act 1937 § 1.
149 The new act with respect to domestic personal holding companies is made applicable only to taxable years beginning after December 31, 1936. Revenue Act of 1937, § 3. Corporations operating on the basis of a fiscal year ending before 1938 will thus have an opportunity to escape impending doom by changing their status during the year 1937.
remains unchanged in the new definition. And even under the new act the proportion of income from the specified sources must total 80% of the entire yearly income, and the stock ownership test must be satisfied, before a corporation is to be treated as a holding company. But once a company has attained that uncomfortable status, it will now remain shackled to that classification until the percentage falls below 70% for three consecutive years or until there has been a change in the stock ownership. This provision, intended to check deliberate changes in the company’s income to take it out of the statutory definition, has aroused impassioned objections on the ground that it creates a pit into which some operating companies may fall in years of subnormal business activity; but it is not likely to constitute a serious threat to legitimate business corporations in any great number of instances.

A considerable florescence is apparent in the items which go to make up “personal holding company income.” The definition of this phrase bears an almost exact resemblance to that contained in the provisions dealing with foreign personal holding companies. Rents, for example, are similarly included unless they constitute 50% or more of the gross income. The props are removed from the device of incorporated talents and the incorporation of private yachts, residences, or other property by similar provisions including the receipts from such sources in holding company income. However, the present section affords special protection to gas and oil royalties by excluding them from holding company income if they constitute 50% or more of the total gross income and if the deductible business expenses of the corporation constitute at least 15% of its gross income. This practical compromise was the outcome of vigorous objections raised by certain domestic interests against the original sweeping inclusion of such royalties.

The elaborate provisions for determining whether 50% in value of the outstanding stock is owned directly or indirectly by or for not more than five individuals at any time during the last half of the taxable year harmonize with the corresponding provisions regarding foreign holding com-

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150 Revenue Act of 1936, § 352(a) (2) as changed by Revenue Act of 1937 § 1.
151 Revenue Act of 1936, § 352(a) (1), as changed by Revenue Act of 1937 § 1.
152 Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 3 (1937).
153 Revenue Act of 1937, § 353(g); Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 6 (1937); see also pages 53-54, supra.
154 Revenue Act of 1936, § 353(f), as changed by Revenue Act of 1937 § 1.
155 Revenue Act of 1936, § 353(h) as changed by Revenue Act of 1937 § 1. This alteration was inserted by the Senate; see Finance Committee Report No. 1242, 75th Cong. 1st Sess. 1 (1937).
panies. As heretofore, stock which is owned directly or indirectly by or for a corporation, partnership, estate or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. Thus a robust disregard for the separate existence of corporations and other legal entities is displayed to some extent even in the case of domestic holding companies. An individual is regarded as representing the stock holdings of other members of his family, and this principle has now been expanded to cover stock owned directly or indirectly by or for a partner.

An option to acquire stock, or any of an endless chain of options to acquire such an option, is considered to confer actual ownership. To prevent frustration of the law by the use of securities convertible into stock, the identical provisions of constructive ownership are made applicable to such securities if the effect would be to make the corporation a holding company or to make certain receipts includible as holding company income.

Finally, the deductions allowed to domestic personal holding companies under earlier law have been thoroughly and severely overhauled. The new Act disallows such corporations any deduction for taxes previously imposed but paid during the taxable year under the section penalizing unreasonable accumulations of surplus. Deductions for charitable contributions are now limited to 15% of the net corporate income, unlike the earlier privilege of unlimited deductions. Losses from sales or exchanges are now allowable only to the extent of $2,000 plus capital gains, thus placing domestic holding companies on the same plane as individuals. To seal the fate of incorporated yachts or estates, deductions for operating expenses and depreciation of corporate property are disallowed if they exceed the rent or other compensation received for the use or right to use

156 Revenue Act of 1936, § 354(a) (x) as changed by Revenue Act of 1937 § 1.

157 The scope of the word "family" is the same as that embodied in § 351 of the older law; see, Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 7 (1937).

158 Revenue Act of 1936, § 354(a) (2) as changed by Revenue Act of 1937 § 1. The closeness of the business relationship incident to a partnership was deemed sufficient justification for this broadening.

159 Id. at (3); see also Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 8 (1937).

160 Revenue Act of 1936, § 356(a) (1).

161 Revenue Act of 1936, § 354(b) as changed by Revenue Act of 1937 § 1.

162 Revenue Act of 1936, § 356(a) (2) as changed by Revenue Act of 1937 § 1. The various types of donees to which such gifts are permissible are enumerated in § 23(q) of the Revenue Act of 1936, 49 Stat. 1658 (1936), 26 U.S.C.A. § 23 (1929). It is noteworthy that this deduction is calculated without subtracting the amounts disallowed as deductions under § 356(b). See Revenue Act of 1936, § 356(a) (2) as changed by Revenue Act of 1937 § 1.
the property.\textsuperscript{163} The new act also denies the deduction of 20\% of the excess of the adjusted net income over the amount of dividends received from other personal holding companies.\textsuperscript{164} However, the deduction of amounts used or irrevocably set aside to retire indebtedness of any kind incurred before January 1, 1934, continues to be permitted.\textsuperscript{165}

4. DEVICE OF INCORPORATING YACHTS AND COUNTRY ESTATES

The simplicity of the idea of incorporating yachts and country estates has the earmarks of genius. One can but wonder why it was not resorted to long before it appears in the record as a condemned avoidance mechanism. As almost every taxpayer must know, the deduction of personal expenses is expressly prohibited by the statute.\textsuperscript{166} A taxpayer owning a yacht individually can hardly plead with much chance of success that expenses of his yacht are \textit{business}, as distinguished from \textit{personal}, expenses.\textsuperscript{167} The same is true in a lesser degree\textsuperscript{168} where farms, racing stables, and other

\textsuperscript{163} Thus, with ironic but justifiable contrariety, the act requires the full rentals from such sources to be reported as holding company income, but limits the allowable operating expenses to the amount of rents received. Revenue Act of 1936, § 355(b) as changed by Revenue Act of 1937 § 1. However, the taxpayer can still obtain the deduction if he is able to convince the Commissioner that the rent was the highest obtainable; that the property was held in the course of a bona fide business carried on for profit; and either that the property was necessary to the conduct of the business or that there was a reasonable expectation of profit from the operation of the property. \textit{Ibid.} This provision should breed a considerable progeny of cases and administrative rulings.

\textsuperscript{164} Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 10 (1937).

\textsuperscript{165} Revenue Act of 1936, § 355(b) as changed by Revenue Act of 1937 § 1. The Ways and Means Committee, feeling compunction at the possibility of causing practical hardship, retained this provision over the objection of the Joint Committee that individuals were not allowed any such privilege. See Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 10–11 (1937); and \textit{cf.} Report of Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 9 (1937). The Senate made certain minor changes in the verbiage of this section, such as adding the words “any kind” of indebtedness, to avoid restricting the deduction to bond indebtedness; see, Finance Committee Report No. 1242, 75th Cong. 1st Sess. 2 (1937).


\textsuperscript{167} See John A. Brander, 3 B.T.A. 231 (1925), where an individual who owned a yacht, used incidentally in the business of a corporation of which the taxpayer was president, was held not entitled to a deduction for depreciation. The Board recognized that yachting is universally regarded as a gentleman’s game for the idle rich, not as a business activity; and felt that taking prospective customers on free trips to the Mediterranean to cultivate their good will was carrying the salesman’s traditional free cigar to abnormal extremes, even in a keenly competitive era. But see, E. E. Dickinson, 8 B.T.A. 722 (1927), where the yacht was used as a sales-producer with more regularity and with more tangible results.

\textsuperscript{168} Under Secretary Magill draws a distinction between the incorporation of a farm and the incorporation of a yacht. The former is a “closer question,” but the incorporation of a yacht “reaches the border of complete absurdity.” \textit{Hearings before the Joint Committee on Tax
hobbies, are owned individually.\textsuperscript{169} Individual ownership means, therefore, that the taxpayer may not in the usual case offset the expenses of maintaining his yacht or farm against his income from salary, dividends, interest, and other orthodox sources.

A number of taxpayers have tried to meet this situation by transferring income-producing securities \textit{and} a yacht or farm to a corporation. The theory is that all activities of a corporation are its business; it cannot by definition have personal expenses, the deduction of which is prohibited. The corporation may, under this theory, do what the individual may not do, \textit{viz.}, offset yacht expenses against income from securities.\textsuperscript{170} Sometimes the individual owners of these corporations paid sufficient rent (more than 20\% of the gross income) to take the corporation out of personal holding company classification.\textsuperscript{171}

\textbf{Example:} A taxpayer owned a New York corporation which in turn owned a yacht.\textsuperscript{172} The first yacht owned by this corporation was sold in 1929. Its successor

\textsuperscript{169} The solution of this question turns upon whether the operation of the farm in the particular case constitutes a business run for profit. In Thacher v. Lowe, 288 Fed. 994 (D.C.N.Y. 1922), a New York attorney, playing at gentleman farming as a hobby, and at a loss, was held not entitled to a deduction. The court felt that since the attorney had never in any year made a profit the farm was obviously run for pleasure. Sometimes, however, the courts have allowed incorrigibly optimistic taxpayers, with alleged expectations of making an ultimate profit, to deduct such losses even though expenses have always greatly exceeded receipts. See Field v. Com'r, 67 F. (2d) 876 (C.C.A. 2d 1933) (racing stable). Such cases proceed on the assumption that the possibility of profits is inextricably associated with the race horse. Some people who have had sad non-judicial experience at the race track would probably question this premise. See also Widener v. Com'r, 8 B.T.A. 651 (1927), aff'd 33 F. (2d) 833 (C.C.A. 3d 1929); Wilson v. Eisner, 282 Fed. 38 (C.C.A. 2d 1932); Whitney v. Com'r, 73 F. (2d) 580 (C.C.A. 3d 1934); Ackerman v. Com'r, 24 B.T.A. 512 (1931), aff'd 71 F. (2d) 585 (C.C.A. 9th 1934). The keeping of books of account, the general business-like atmosphere of the enterprise, and a host of other factors, are important in showing the taxpayer's intentions.

\textsuperscript{170} Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 12 (1937). Thus the taxpayers turned back upon the government the same argument which the government itself depends upon to justify the imposition of capital stock and other excise taxes. But whether the use of the yacht is \textit{intra-vires}, and whether its use constitutes an "ordinary and necessary business expense," might be two very different inquiries. In other words, the Treasury might plausibly have met the dialectical dilemma by arguing that a corporation was not carrying on a business for profit where it was clearly impossible to make any gains out of the yacht's operations; and also that the yacht expenses were not "ordinary" and "necessary" expenses, unless promoting the happiness and comfort of the officers could be considered a necessary phase of the corporation's business.

\textsuperscript{171} See Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 6 (1937); Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 12 (1937).

\textsuperscript{172} Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 231-33 (1937).
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was completed in Germany in 1931, at a cost of $2,130,812.13. This yacht has been kept from entering American waters, and thus the corporation has avoided import duties on foreign-built yachts imposed by the Tariff Act of 1930.173

Except for one or two charters the yacht has been used exclusively by the taxpayer's family. Yet the expenses of the yacht, $630,799.34, for the years 1931 to 1936, inclusive, have been offset against the income from securities also owned by the corporation and transferred to that corporation by the taxpayer. The taxpayer apparently saved $220,183.65 through the deduction by the corporation of these expenses. The tax on the basis of a disregard of the entity of the ship corporation would have been $332,729.06 greater than the tax paid by the taxpayer and her corporation.

Example: A taxpayer174 formed a New York corporation, to which he transferred securities valued at $1,623,385, and racing and breeding stock valued at $656,978. For the years 1932 to 1936, inclusive, the loss on stable operations amounted to $1,325,940.57. In four of these years he apparently saved $396,125.47 in tax by applying the stable losses against the security income of the corporation.175

Example: Another taxpayer176 used a Delaware corporation organized in 1929, in much the same way as in the previous example, except that she applied the idea to farm property and in addition had her corporation pay her husband a salary, which in 1936 reached the respectable amount, even in modern terms, of $36,000.

The set-off of farming expenses against ordinary income may sometimes be accomplished without the use of a special corporation where the income is derived from a closely held corporation.

Example: A taxpayer,177 the owner of a Delaware corporation, which markets a candy bar, placed her farm in the candy manufacturing corporation. This corporation in 1936 showed a net profit of $857,971.59, after a deduction of farm operating loss in the amount of $288,477.79.178

The effectiveness of the incorporation of yachts and gentleman farms as a tax-saving device is certainly questionable even under acts previous to the 1937 Act.179 Assuming that the corporate entity is respected,180

174 Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 237 (1937).
175 In other words, his tax would have been greater if he had owned and operated the racing and breeding stock individually, as he had previous to 1932, and if he had not been able to prove that he was individually in this business for profit.
176 Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 238 (1937).
177 Id. at 239.
178 The theory of the taxpayer seems to have been that the operation of the farm served as an advertisement for the candy company's products. As Mr. Kent, the representative of the Treasury stated, "wherein the advertising value for a candy bar of this farm and racing stable consists does not appear." Id. at 240.
179 Section 356(b) of the Revenue Act of 1936, added Revenue Act of 1937 § 1 is designed to take care of this situation for the future.
180 See cases cited in note 248. The Supreme Court meant in Gregory v. Helvering, 293 U.S. 465 (1935), "to indicate that in applying the provisions of a Revenue Act it would not be
and that the corporation and stockholder are scrupulous in going through the motions involved in an ownership by the corporation of what would in natural course be owned by an individual, expenses are allowable as a deduction only if they are "ordinary and necessary," and depreciation is allowable as a deduction only if the depreciable property is "used in the trade or business." While most activities of a corporation must be regarded as its business, a corporation may indulge in activities beyond the scope of its powers and the purposes attributable to it as a business concern. It is hardly to be doubted that the courts will subject to special scrutiny a corporation which is virtually an alter ego for an individual stockholder. Are expenditures made by such a corporation normal business expense? Are they "ordinary" and are they "necessary"? Is the property being "used in the trade or business" in the sense of the statute? The words are to be interpreted "according to the ways and the forms of speech prevailing in the business world." 

Expenditures for a pleasant cruise in the Caribbean will scarcely meet the test of being "ordinary and necessary" to the corporation; a yacht engaged on such a cruise is not being used in the business of the corporation. It is being appropriated by the stockholder to serve purposes outside the corporate business. Perhaps, constructively, the cruising stockholder has income; he certainly has something for which he spent his income in the days before he conceived the brilliant idea of incorporating the instruments of his pleasure.

Change Made by Revenue Act of 1937. The provisions discussed in rela-

stopped by the mere regularity of the proceeding and its 'apparently strict conformity with the statute'; in judging a transaction it will insist upon looking at the entire plan (citing Shoenberg v. Com'r, 77 F. (2d) 446 (C.C.A. 8th 1935), cert. denied 295 U.S. 586 (1935); Royal Marcher, 32 B.T.A. 76 (1935), appeal dismissed (C.C.A. 2d, Feb. 4, 1936) and considering the general import of the transaction. (Citing Equitable Trust Co. v. First National Bank, 275 U.S. 359 (1928).) See Paul, Studies in Federal Taxation 144 (1937).


This is the theory id. § 23(q). A corporation is not organized to do so, yet it may make charitable contributions. See Paul and Mertens, Law of Federal Income Taxation § 23, 66 (1934).

Wtelch v. Helvering, 290 U.S. 111 (1933). In this case the court also said (Cardozo, J., at 114):

"Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle."

See Hal E. Roach, 20 B.T.A. 915 (1930), in which the government contended that the expenses paid by the company and not by the taxpayer, for operating and maintaining a yacht were additional income to the individual stockholder and this claim was denied by the Board on the grounds that the doctrine of constructive receipt should be sparingly applied.
tion to domestic and foreign personal holding companies are designed to prevent employment of the yacht and farm incorporation device.\textsuperscript{186} Domestic personal holding income includes amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at any time during the taxable year 25\% or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property, whether such right is obtained directly from the corporation or by means of a sub-lease or other arrangement.\textsuperscript{187} Likewise, the allowable operating expenses are limited to the amount of rents received.\textsuperscript{188}

5. ARTIFICIAL DEDUCTIONS

The general idea motivating the device of artificial deductions is the transfer or shift of income from a high to a low-bracket taxpayer. A loan not occasioned by business necessity may be made by a corporation to another corporation owned by various members of the family, or between corporations or trusts owned or controlled by members of the same family, or even between members of the family directly. The loan is made to a person in a high surtax bracket, who is thus enabled to reduce his income at the modest expense of raising the income of a person subject to a lower tax bracket.\textsuperscript{189}

Example: A taxpayer\textsuperscript{190} in 1927 formed trusts for her seven children, naming her husband as trustee of each trust. The corpus of these trusts consisted of stock of the United States Steel Company. In 1931 the taxpayer reacquired this steel stock, giving notes to the trusts aggregating $381,414.66, bearing 5\% interest. In the years 1931 to 1934 she paid only a portion of the interest due. In 1935 she paid $42,000 to her husband, the trustee, as interest on the notes for the current year and for previous years. In 1936 she paid $35,639.71 accrued and current interest in full. This case is alleged to suggest "the possibility that a taxpayer on the cash basis may take advantage of loan transactions within the family to pay or withhold interest in such a way as to accomplish substantial tax savings, through concentration of interest payments in years when taxable income is large."

\textsuperscript{186} See pages 55, 56 \textit{supra}.

\textsuperscript{187} Revenue Act of 1936, § 353(f), added by Revenue Act of 1937, § 1. See Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 6 (1937); Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 12 (1937).

\textsuperscript{188} Revenue Act of 1936, § 356(b), added by Revenue Act of 1937, § 1. See Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 12 (1937); Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 13 (1937).

\textsuperscript{189} Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess 15 (1937).

\textsuperscript{190} Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess 241 (1937).
Example: On June 6, 1932, a taxpayer borrowed $1,000,000 from the Irving Trust Company, which he gave to his wife.19 On the same day she created trusts for her own benefit by depositing the money with the Irving Trust Company as trustee. On the same day the taxpayer borrowed $1,000,000 from the trust created by his wife, giving four notes for $250,000 each. This borrowed money was immediately used by the taxpayer to repay the loan from the Irving Trust Company. These transactions were all consummated within a few hours before the enactment of the Revenue Act of 1932; they were also accomplished by the use of checks with the result that no cash ever left the bank. The taxpayer has claimed deductions of $60,000 each year on his individual income tax returns for interest paid on these notes. The trust being revocable, his wife has reported the trust income in her individual return. The Treasury alleges that for the years 1932 to 1936, inclusive, the tax saving accomplished by this well-advised shifting of income from husband to wife amounted to $86,471.20.

Example: A taxpayer,192 three nephews and a business associate used the cash and accrual methods of reporting income to considerable advantage. The taxpayer's books were kept on the accrual basis. This method of accounting enabled him to deduct accrued interest in 1935 of $99,002.22, of which $49,010.43 was accrued at 6% on debts of about $1,000,000 owed to the three nephews and the business associate. Since these creditors, who were relatives and who theoretically received the deductible accrued interest, were on the cash basis, they were not required to take up the accrued interest as gross income until it was paid. This combination of circumstances meant that the nephews and the life-long business associate paid no tax on the interest deducted by the taxpayer in his return.193

Example: A taxpayer194 of Chicago was the beneficiary of two estates, that of his grandfather and his wife's grandfather. He formed three Canadian holding corporations, the entire stock of one of which was issued to himself. The entire capital stock of the second corporation was issued to his wife and the entire capital stock of the third was issued to his children. The taxpayer subscribed to $1,800,000 of the capital of the first corporation, and paid in 10% thereof, giving his demand notes of $1,620,000 for the balance. These notes were not paid, and the taxpayer was thus able to deduct in each of the years 1929 and 1933, interest of approximately $100,000 per year on these notes. It is claimed, certainly not without plausibility, by the Treasury that this operation of "giving notes for inflated capital" was deliberately designed to support artificial deductions for interest.195

Change Made by Revenue Act of 1937. Steps have been taken in the Revenue Act of 1937 to prevent the allowance of any such artificial deductions as have been described. The family loss section196 of the Revenue

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191 Ibid.
192 Id. at 243.
193 This case is described in Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 29 (1937). Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 16 (1937).
194 Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 240 (1937).
195 In 1933 the taxpayer waived the American flag and became a British subject.
Act of 1936 has been considerably expanded to prevent deduction of losses on transactions, not only between members of a family and individuals and 50% owned corporations, but also between 50% owned domestic and foreign personal holding corporations and between a grantor and fiduciary of any trust.\textsuperscript{197} It is also provided in this expanded section\textsuperscript{198} that in computing income no deduction shall be allowed with respect to expenses or interest if not paid within the taxable year, or within two and one-half months after the close thereof; and if by reason of the method of accounting of the person to whom the payment is to be made the amount thereof is not, unless paid, includible in the gross income of such person in the taxable year in which or with which the taxable year of the taxpayer ends; and if at the close of the taxable year of the taxpayer or any time within two and one-half months thereafter, both the taxpayer and the person to whom the payment is to be made are persons between whom losses would be disallowed.

6. MULTIPLE TRUSTS

The device of multiple trusts has as its general purpose the splitting of the income of the family economic unit into a number of entities. Two purposes are served:\textsuperscript{199} (1) additional personal exemptions are secured;\textsuperscript{200} and (2) the more that income is divided among different taxpayers, the lower are the applicable surtax brackets, and the less the tax upon the aggregate income of the group. This idea has been applied to capital gains and ordinary income. One variation of attempted tax saving by trusts is discussed in the note below.$^201$


\textsuperscript{199} Testimony of Under Secretary Magill, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 31 (1937).

\textsuperscript{200} Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 30 (1937); Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 16 (1937).

\textsuperscript{201} On October 29, 1931, a taxpayer created a trust, the income of which was to be paid to his wife during her life. The trust instrument, on a casual reading, would not seem unusual, but it contained a peculiar provision to the effect that the trustee shall accumulate "for a period of one year and fifteen days the quarter-annual income from this trust property, and at the end of said period pay the amount thereof over to" my wife "for and during her life time." There follows a provision as to the computation of quarter-annual periods, and a provision that the income of the quarter-period, January, February and March, shall be accumulated until April 15 of the succeeding year, and "on said April 15, the amount thereof shall be paid" to my wife "if she then be living." The April–June quarterly period income is accumulated until July 15 of the succeeding year; the income of the quarter period July to September accumulated to October 15 of the succeeding year, and the income of the quarter period October–December accumulated until January 15 of the second succeeding year.

The taxpayer in this case contended that income which cannot be distributed during the
One type of tax-saving is the _annuity_ trust. In these cases the saving turns upon the amorphous legal distinction between "income" and "capital." Under the present federal law gifts and bequests are among the express exclusions from gross income. Although income from a trust fund is ordinarily taxable as income to the beneficiary when received, it has been held to be exempt if construed as an annuity chargeable against the corpus of the estate. It is difficult to perceive any rational reason why the mere permission to invade the corpus should, by legal prestidigitation, transform the payments from income into capital, at least when or to the extent that the payments actually are paid out of the trust income. Even if the existence of income is to be determined by looking at the technical source of payment rather than the benefit to the recipient, the sensible solution would still be to allocate the payments, taxing the beneficiary at least in so far as the payments actually have been derived from income. Nothing short of legislation, however, seems likely to change the clear judicial sanction which has been given to taxing the trustee, and not the beneficiary, in these situations. This principle made it inevitable that taxpayers, through the creation of trust annuities, would accomplish a splitting of income and a lowering of the surtax brackets by shifting a portion of the tax from the beneficiary to the trustee. The incidental fact that the foregoing rule is closely related to, and a logical aftermath of, the Treasury's denial of a deduction to the trustee, for the amounts distributed to the beneficiaries under such arrangements, illustrates the necessity of keeping an eye open to the logical corollaries of any position taken by the government in attempting to safeguard the revenues.

The so-called reciprocal trust is another type of tax-saving trust. It is usually created between husband and wife. The idea is that a husband creates a trust for the benefit of his wife, and as part of the same transaction she creates a trust for his benefit. Part of the income of each trust is

calendar year but is received by the trustee and must be accumulated for a year and 15 days is not currently distributable. If the taxpayer should be correct in this contention, this accumulated income would be taxed to the trustee. His wife after the first year of the trust, would also be supplied with a regular annual income, and such income would be taxable neither to the grantor of the trust, her husband, nor to the beneficiary, herself. The trust referred to was created October 29, 1931. On the next day, October 30, 1931, the taxpayer created another trust for his wife with identical provisions; a still further trust was created on November 19, 1931, and yet another on November 20, 1931, making a total of four such trusts. Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 279 (1937).

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202 Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 28r (1937).
not distributable, and is, therefore, taxed to the trustee. This means the creation of two extra taxpayers, making four taxpayers instead of two, with a consequent decrease in surtax brackets.

Example: On December 31, 1931, a taxpayer and his wife executed an instrument whereby $100,000 was transferred in trust to the taxpayer and The Fiduciary Trust Company of New York. It was provided that the trust property should be divided into three equal distinct funds, one for each of the three children, who were then fifteen, six, and three years old. The income of each fund was to be accumulated during the minority of the beneficiary and paid to each as he or she attained the age of 21. Thereafter, the income was to be paid to the beneficiaries during their lives. The position was taken in income tax returns filed by the trustees that this instrument created three separate trusts. This gave a modest aggregate personal exemption of $3,000, and divided the remainder of the income into three parts, resulting in moderately reduced surtaxes.

So far this case is not unusual. But during the next three and one-half years, thirteen additional trusts were created for the benefit of the same three children; three on June 2, 1932, immediately prior to the enactment of the Revenue Act of 1932; four on December 31, 1934, and six on August 12, 1935, eighteen days before the enactment of the 1935 Act. The trust instruments were more or less similar, the trustees being the taxpayer and The Fiduciary Trust Company of New York. One of the four trusts created in 1934 provided that the trustees might accept or acquire insurance against the death, disability, or sickness of the taxpayer and might use the trust income and principal to pay premiums on such insurance. Whether income has been so used does not appear, but it does appear that none of the income of this trust not needed for premium purposes was distributed to the children. The creation of this last mentioned trust by the wife, instead of the husband, was an obvious avoidance of Section 167 of the Revenue Act of 1934.

Further improvement was worked out in the 1935 trusts. Instead of creating one insurance trust for the benefit of all three children, as in 1934, a separate trust was created for each child. The result was that in 1936 each of the three children was the sole beneficiary of five separate trusts, and was in addition one of the ultimate beneficiaries of the insurance trust of December 31, 1934. The ultimate result was the payment of a tax of less than $11,000. on an annual income of over $70,000, instead of $77,311.30, which would have been the tax if only one trust had been created. This lower tax liability is partly ascribable to the fact that $16,000 went tax-free as the total personal exemption of the sixteen trusts, and partly to the fact that the remainder of the income was split sixteen ways.

Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess 264 (1937).


Up to this point there was a trust in favor of each child. There may be plenty of valid reasons for the creation of separate trusts for different children. The Treasury complaint against multiple trusts is not directed against a reasonable number of trusts, considering the family situation, but rather against the multiplication of trusts beyond all natural limits for no purpose other than the avoidance of tax. The problem is one of degree. See text supported by notes 32-40.

The Revenue Act of 1932 was introduced into Congress on April 4, 1932.

The Revenue Act of 1935 was introduced into Congress on August 30, 1935.
Example: The taxpayer,\textsuperscript{210} his wife, his brother, his brother’s wife, and the mother of the brothers, owned the stock of the X Securities Company, a personal holding company for the family. The principal asset of the X Securities Company was stock of Champion Spark Plug Company. In the period from 1920 to 1932 the Champion Spark Plug Company paid approximately $25,000,000 in dividends, approximately $20,000,000 of which went to the X Securities Co. This company distributed during this period $8,260,000, leaving undistributed $14,126,230 at the end of 1932.

On June 3, 1932, three days before the enactment of the Revenue Act of 1932,\textsuperscript{211} the taxpayer and his wife each created ten trusts: The largest two of these trusts were created for the benefit of each other. The other eighteen trusts were created for the benefit of their nine children, each child being sole beneficiary of two trusts. The two trusts referred to were reciprocal trusts. The instruments provided that $60,000 per year was to be distributed to the beneficiary and that the remainder of the trust income was to be accumulated. Supervision over expenditures of the trust funds was vested in a so-called advisory committee consisting, in the case of taxpayer’s trust, of the donor’s brother, the donor’s wife, the beneficiary of the trust, and two close associates of the family. The advisory committee of the wife’s trust was the same except that the taxpayer was substituted for his wife. Each advisory committee as to its trust had complete power to direct at any time the distribution of accumulated income or principal to the beneficiary, or to any of the donor’s children. The result was an accumulation in a separate taxpayer of approximately two-thirds of the income of each trust, with the additional provision that this accumulated income might be distributed at any time at the instance of the family or closely associated group.\textsuperscript{212}

By reason of the accumulation of the trust income in this array of different trusts, there were savings in taxes as follows: 1932, $200,128.00; 1933, $112,157.27; 1934, $88,941.04, and the total for three years was $701,227.48. By the use of the reciprocal trusts, the taxpayer and his wife saved $62,924.73 for the year 1934 and the taxpayer’s brother and his wife saved $48,823.86 for the same year.

Example: The example presented by the Treasury of a trust created to split capital gain into several parts, thus reducing surtax brackets, is that of a taxpayer,\textsuperscript{213} who, with his son, owned the stock of Lord Baltimore Filling Stations, Inc. and American Oil Company. Class A stock of both these companies was in 1924 sold outright to Pan American Petroleum & Transport Co., the control of which about this time passed to the Standard Oil Company of Indiana.

In 1932 the taxpayers executed declarations of trust whereby father and son each

\textsuperscript{210}Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 278 (1937).

\textsuperscript{211}See note 208 supra.

\textsuperscript{212}The taxpayer’s brother and his wife went through this same procedure, each executing thirteen trusts, making a total of twenty-six trusts. Eighteen of these trusts were for the benefit of the nine children of his brother and his brother’s wife, making each of these children the sole beneficiary of four separate trusts. Six of the remaining trusts created by his brother and wife were for the benefit of a son and two grandchildren. The two largest trusts created by the brother and his wife were reciprocal trusts for the benefit of each other. This made a total of forty-six trusts for the family group.

\textsuperscript{213}Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 283 (1937).
declared himself trustee of substantially 50% of the stock of the Baltimore and American Oil corporations in favor of the American Trading Company, all the stock of which was owned by the father and son. Thus, the two taxpayers declared themselves trustees of stock which they owned in favor of a corporation which they also owned. Dividends of $522,900, received on the American Oil stock in October, 1932, were received by the two taxpayers as trustees and passed to the American Trading Company as beneficiary. Since the law at the time did not provide for any tax on receipt of dividends by a corporation, approximately $275,000 in taxes were saved by this device, if it be legal.

In 1933 father and son exchanged, in a tax-free transaction, their Lord Baltimore Filling Station stock and their American Oil stock for stock of Pan American Petroleum and Transport Co. As part of this transaction there was an agreement with the Standard Oil Company of Indiana that it would buy the taxpayers’ Pan American stock, in the event of any disagreement between the taxpayers and the Pan American Board of Directors. On October 30, 1934, the father, anticipating a sale of their Pan American stock, pursuant to this provision, upon which there would be a profit of $3,697,243.50 of which 30%, or $1,543,571.99, would be taxable income,214 created sixty-four trusts, nineteen for his wife, fourteen for his son, seventeen for one daughter, and fourteen for another daughter. He then transferred 277,500 shares of Pan American stock to these trusts and the trusts sold to the Standard Oil Company of Indiana. His ultimate tax saving was considerable, even if we include the gift tax of approximately $500,000, payable on the transfers to the sixty-four trusts.215

The Treasury may with poetic justice apply in connection with multiple trusts a converse of the argument successfully urged by the taxpayer to spell several trusts out of one trust.216 There is reasonable justification for one trust for the benefit of a wife and a separate trust for each child or other beneficiary of a trust grantor. But if one instrument be amended so as to create three trusts, why is it not also true that several instruments may be interpreted to create one trust? Such an argument would be in line with recognized law in connection with contracts,217 and may be adopted by courts that are vigilant to prevent avoidance.

Change Made by Revenue Act of 1937. No attempt was made in the Revenue Act of 1937 to close the multiple trust loophole except that the


215 The gift tax will, no doubt, put a stop to much of this practice. Taxpayers who anticipated the gift tax are now reaping their rewards. It is still cheaper to pay the gift tax, Paul, Studies in Federal Taxation 34 (1937). But the gift tax has unquestionably put a considerable check upon trust multiplication.


217 See O'Meara v. Com'r, 34 F. (2d) 390 (C.C.A. 10th 1929); Com'r v. Moore, 48 F. (2d) 526 (C.C.A. 10th 1931); Com'r v. Garber, 50 F. (2d) 588 (C.C.A. 9th 1931).

218 The Ways and Means Committee expects to study this problem further. Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 30 (1937); see also Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 16 (1937).
personal exemption is denied to trusts if the trust instrument requires or permits the accumulation of any portion of the income of the trust and there is not distributed an amount equal to the net income.

7. HUSBAND AND WIFE OR PARENT AND CHILDREN PARTNERSHIPS

In many cases members of partnerships have attempted to divert to their wives or children a part of the income of the partnership of which they were formerly members. These attempts have usually been unsuccessful on the ground that the wife or child was not a member of the partnership; the diversion therefore constituted nothing more than an assignment of income, as distinguished from an assignment of the corpus which produces the income. The decisions left the question somewhat open whether a taxable diversion of income might not be successfully accomplished if the wife or child became a member of the partnership or was an owner of capital in the partnership. This opening has been explored by diligent taxpayers, as may be surmised from a decision by the Second Circuit Court of Appeals to the effect that where a wife is genuinely a member of a partnership, her distributable share will be taxable to her, and not to the husband. In the case establishing this point two wives of partners were held members of a partnership, the chief activities of the partnership being the rendering of legal and accounting services, without any substantial proof that services were rendered by the wives. Indeed, neither of the wives was a lawyer or an accountant, and the court seems to have placed its decision almost entirely upon the ground that capital had been furnished by the wives and that they were responsible for debts.

There are no doubt plenty of partnerships with non-working partners. It would be administratively impossible for the government to check each


221 See Lucas v. Earl, 281 U.S. 111 (1930); and see cases cited in Paul and Mertens, Law of Federal Income Taxation § 15.03 (1934).


223 See testimony of Secretary Morgenthau, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 13 (1937). See also testimony of Under Secretary Magill, id. at 32.

224 See, however, the statement in the court’s opinion, at 432, that they shouldered certain duties in the matter of employing office assistants and were also personally responsible for all the debts of the accounting business.

225 Humphreys v. Com’r, 88 F. (2d) 430, 432 (C.C.A. 2d 1937).
partner's right, in terms of his contribution of labor or capital, to his share of the profits of a partnership. The point is again one of degree, whether partnerships valid under state law should be respected for federal tax purposes when the partnership constituency is a matter, not of \textit{bona fide} business association, but of mere tax saving.


8. \textbf{Pension Trusts}

In the Revenue Act of 1921, Congress first introduced a provision exempting from tax trusts created by employers as part of a stock bonus or profit-sharing plan for the exclusive benefit of \textit{"some or all"} of their employees. Under this provision, which has been repeated in various revenue acts, the trust itself is not taxable, and there is no tax upon the employee beneficiary until there is a distribution from the trust. Deduction was allowed to a contributing employer on account of payments to a pension trust if the trust was separate from the employer. In the Revenue Act of 1928 and later acts, there was added a provision permitting the deduction by the contributing employer of amounts paid to a pension trust representing past accumulations. In other words, the 1928 Act changed the law in the sense that it permitted the deduction not only of ordinary pension payments, but also, over a period of ten consecutive years, of reserve funds turned over to a pension trust to cover past accumulations. The general purpose of these statutory provisions was:

(1) To relieve the recipient of a pension from any tax until the distribution to him of the pension funds;

(2) To state the law that the employer will be permitted to deduct

\textsuperscript{26} The Treasury has been none too successful in this regard in its attempt to check whether salaries are reasonable. See Paul and Mertens, Law of Federal Income Taxation § 23.81 (1934).

\textsuperscript{27} See text supported by notes 32-40.

\textsuperscript{28} Section 219(f); see Conference Report No. 486, November 19, 1921, 67th Cong. 1st Sess. 29 (1921).

\textsuperscript{29} Revenue Acts of 1926, 1924, § 219(f); Revenue Acts of 1936, 1934, 1932, 1928, § 165.


\textsuperscript{31} See Revenue Acts of 1934, 1932, 1928, § 23(q); Revenue Act of 1936, § 23(p). For an explanation of this section see Ways and Means Committee Report No. 2, 70th Cong. 1st Sess. 22 (1927); Finance Committee Report No. 960, 70th Cong. 1st Sess. 21 (1928).
pension payments as soon as they are placed beyond his control, even though they are not yet taxable to the employee; and

(3) To extend this permission to deduct even to pension payments not strictly allocable to the taxable year.

It is required that the pension plan established be reasonable and actuarially sound, and that the trust shall be perpetual or "of such a character as to evidence good faith on the part of the employer actually to pay the amounts placed in trust for employees' pension purposes."\(^{232}\)

It could scarcely have been intended that the employer secure any tax benefit from these statutory provisions. The benefit to him would be a business benefit; pension payments would tend to cement the loyalty of executives and employees, and would relieve the employer from moral obligation to keep employees on the payroll after they had outlived their usefulness, since the employees would have a pension upon which they could live. The employee, on the other hand, was certainly intended to have a distinct tax benefit. The incidence of the tax on all amounts turned over to a pension trust and deducted for tax purposes by the employer was suspended for what might be a considerable period between the payment by the employer to the trust and the receipt by the employees from the trust. This applied not only to amounts immediately set aside, but also to income derived in the interim period from funds set aside. The employee thus obtained social security in terms of a safely invested fund, not in the usual way through the investment of his own earnings, but with respect to contributions made by his employer. He did not pay any tax on the employer's contributions until he was in a position to use the social security obtained. The incidence of the tax was thus postponed until later years when he was not earning a salary, which would raise his income tax bracket.\(^{233}\) In short, the statute permits an employee social se-


\(^{233}\) An example may make this point somewhat clearer. Assume the case of an employee, aged 50, married but with no children, having a salary of $40,000. a year and no other taxable income, whose employer wishes to make provisions to retire him at the age of 65 with an annuity paying $10,000. a year. This the employer may accomplish by payment of $6,000. a year during the 15-year period by meeting the requirements discussed above.

If the employee reaches the age of 65, and if he is still married and has no other taxable income, the total tax payable each year on the $10,000. annuity received would, at present rates, be less than $500. a year. In other words, he could, because of this provision, have full enjoyment of at least $9,500. a year.

If it were not for the benefits provided by these provisions, the $6,000. paid each year by the employer for the purchase of an annuity might be considered taxable additional compensation to the employee, and in the case assumed the approximate tax rate would be 28% of the $6,000., thus reducing the amount available for the purchase of an annuity. From this reduced principal fund the annual income, which the employee would enjoy after he reached the age of
curity without tax in his high-earning high-bracket years, placing the tax upon the trust earnings and the employer's contributions in the later years when the actual enjoyment of the security came to the employee in the shape of distributions from the trust fund.

For a long time—perhaps as long as the only apparent beneficiary was an employee—taxpayers seem to have had only a faint interest in these statutory provisions. Recently, there developed a new interest in the provision. Pension trusts came to be termed the richest tax avoidance field yet untapped. Taxpayers, or their insurance agents, discovered new territory.

The abuse of these beneficent provisions of the statute consists in the adoption of pension plans for stockholder officials and key men. Since the act merely requires that a plan be for the benefit of "some or all" employees, some plausibility is given to the argument that a pension trust merely for the benefit of this limited group is entitled to the benefits of the statute. The pension trust provision has an obviously beneficent design. The underlying legislative purpose should not be lost sight of in any further consideration of the problem, because a few taxpayers have sought to abuse the provision. The innocent beneficiaries of the provision should not be punished with the guilty when a few amendments of this provision will serve to draw a satisfactory line between those who deserve a postponement of the tax and those for whom the benefits of postponement can hardly ever have been intended.

65, would be something less than $7,100. In such a case the provision for taxing 3% of the aggregate consideration paid for the annuity, even if applicable, would not make any real change in the figures given.

Approximately 1,000 inquiries have recently been received in the Second New York Division, and many inquiries have been made at Washington as to specific plans. There was also great interest in the decision of the Board in Adolph Zukor, 33 B.T.A. 324 (1935).

Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 296 (1937).

Altman, Pension Trusts for Key Men, 15 Tax Mag. 324 (1937).

The propaganda on the subject of pension trusts has been particularly flagrant. See reprints of various articles, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 294 (1937).

The subject was passed over by the Joint Committee, "... for the present, because it does not appear to have resulted in much loss of revenue to date. However, this matter will be reported on later." Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 7 (1937).

This is an example of a problem constantly faced in tax legislation. A way must be found to reach particular cases of avoidance without causing, like Herod's massacre, great suffering without reaching the cases at which legislation is aimed. Paul, Studies in Federal Taxation 65 (1937).
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9. THE INCORPORATED TALENT LOOPEHOLE

The incorporated talent cases are not separately classified in Mr. Morgenthau's letter of May 29, 1937. They were treated in presentation to the Joint Committee along with the yacht and farm incorporation cases. The Ways and Means Committee lists them separately, which is believed less confusing because the theory of tax avoidance underlying the incorporation of personal talent is different from the theory believed by optimists to support the taxpayer in the yacht and farm cases. The incorporated talent cases were generally described by the Ways and Means Committee in the following language:

"Cases presented to the committee showed that individuals organized corporations for the purpose of hiring out their personal services at a substantial increase over the amount of compensation such principal stockholders contracted for with their corporations. Since such corporations do not come within section 351 of the existing law, the excess compensation retained by the corporation is taxed at lower rates than would be applicable to such excess income in the hands of the individuals who performed the services."

Example: In 1932 a taxpayer organized three Delaware corporations. In January, 1933, he organized a fourth corporation. Three of these corporations were subsequently absorbed by merger into one of the corporations. He had a radio broadcasting contract with the Texas Company and other contracts, which paid him $5,000 per broadcast. The function of the corporation mentioned was to receive the earnings from his radio broadcasting contracts and to pay him a portion thereof as salary. The Treasury alleged that this device, if successful, would accomplish for him a net tax saving for the years 1932 to 1936, inclusive, of $196,728.97.

Example: A taxpayer, a cartoonist, transferred to a corporation all copyrights, trademarks and franchise of the cartoon name together with all real estate owned by

240 See Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 244 (1937). One such case was presented along with the foreign personal holding company device. See text supported by notes 81, 82.


242 Id. at 5. See also Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 13-14 (1937).

243 Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 244 (1937).

244 The Treasury is taking the position that all income from these contracts is income "of the taxpayer individually." Emphasis is placed upon the clause in the contract that "in the event of the death of" the taxpayer "during the period of this agreement, the agreement shall thereupon terminate without further liability of either party hereof to the other." The Treasury relies upon Lucas v. Earl, 281 U.S. 111 (1930). This case is now on appeal before the Board.

245 Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 247 (1937).
him and his wife, receiving in exchange the capital stock of the corporation. Out of a total of 5,000 shares, he took only 100 for himself; 3,400 shares went to his wife; and 1,500 shares went to a trustee under trusts established for the benefit of two children. The corporation paid him an annual salary of $52,000. His wife received a salary of $2,600. The considerable balance of income over these salary disbursements remained in large part in the corporation, although a dividend of $21,616 was paid in 1934 and a dividend of $18,000 in 1935. The Treasury alleges the saving in this case for the years 1933 to 1935, inclusive, to be $72,941.25.

Example: A taxpayer, a well-known violinist, incorporated his talent. He organized a corporation under the laws of Maine in 1924, and a corporation under the laws of Maine in 1926, transferring to the former corporation his "contract sources of income," and to the latter corporation his "royalty income." Apparently, he saved in the years 1934 to 1936, inclusive, $33,264.20.

A foreign corporation may also be used to incorporate talent.

Example: A taxpayer employed a foreign personal holding company for the purpose of saving taxes on his large earnings as a motion picture actor. He did so by entering into a contract with a British holding corporation to pay him a salary of $20,000 for 1935. Under this contract the foreign holding company became entitled to all of his earnings in the United States as an actor, amounting in 1935 to $190,280.22. While the British corporation, the earnings of which consisted of nothing but his American income, was subject to United States tax, these taxes were much less than the taxes which would have been payable by him as an individual if he had directly received the amounts paid to the corporation.

It is extremely doubtful whether this device of incorporating personal talent will prove successful. The earnings are attributable to the peculiar ability or talent of an artist. It is true that such a person, like any other person, may hire out his services to a corporation. But where an individual owns all the stock of a corporation to which he sells his services for less than their market value, and the contract between the ultimate purchaser of his services and his corporation calls for his particular services, the transaction lacks many qualities of reality. Whether the corporate entity is ignored as in a number of recent cases, or the corporation is said to be acting as the agent of the individual, or "the channel for the application of the income" making the earnings go constructively first to the individual and afterwards from him to the corporation, leaving the nature of the basic transaction unaltered, or it is simply said that the individual does not actually do in substance what he pretends to do in form,
the chance of the government in these cases would seem to be excellent under the law as it existed prior to the 1937 Act.\textsuperscript{252}

\textit{Change Made by Revenue Act of 1937.} The Revenue Act of 1937 plugs the incorporated talent loophole by including personal service contract income in "personal holding company income."\textsuperscript{252}

\section*{SUGGESTED AMENDMENTS}

\subsection*{I. ELIMINATION OF PERCENTAGE DEPLETION}

At the instance of the oil and mining companies, and to protect the prospector or wild-catter, who accepted the hazard of going into unknown fields to discover a new and valuable deposit,\textsuperscript{253} and with the purpose of stimulating production,\textsuperscript{254} there was inserted for the first time in the 1918 statute a provision for "extraordinary\textsuperscript{255} treatment of taxpayers discovering mineral properties, giving such taxpayers the benefit of depleting\textsuperscript{256} the value at the date of discovery, or within thirty days thereafter.\textsuperscript{257}

At the time the 1921 statute was in the process of enactment it was deemed that the 1918 Act treated discoverers more favorably than had perhaps been intended, and the result was a limitation that the depletion allowance based on discovery value should not exceed the net income from the property upon which the discovery was made.\textsuperscript{258} This limitation was

\textsuperscript{252} Cases like Comm'r v. Ross, 83 F. (2d) 18 (C.C.A. 6th 1936), to the effect that completed, as distinguished from anticipated, earnings are property and may be assigned, so that they become income of the assignee, do not help these taxpayers much, unless they express the right in a contract for future payments which are not income when the contract is made. There was in this case a time gap between the making of the agreement giving the right to the income and the receipt of the income. The incorporated talent cases are more in line with Lucas v. Earl, 288 U.S. 111 (1936), involving an assignment of anticipated earnings; the services have not been rendered when the contract is entered into with the wholly owned corporation.

\textsuperscript{253} Revenue Act of 1936, § 353(e), added by Revenue Act of 1937, § 1. The same provision is made as to foreign personal holding companies. Revenue Act of 1936, § 332(e), added by Revenue Act of 1937, § 201. See also Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 5, 15 (1937); Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 13 (1937).


\textsuperscript{255} See Melville G. Thompson, 10 B.T.A. 25 (1928).

\textsuperscript{256} See S. T. Hunt, 4 B.T.A. 1077 (1926). See also Clarence D. Robinson, 8 B.T.A. 778 (1927).

\textsuperscript{257} Discovery value did not constitute a basis for gain or loss on the sale of properties. Anna Taylor, 5 B.T.A. 1201 (1926); S. T. Hunt, 4 B.T.A. 1077 (1926). See also Bamma Bauum, 17 B.T.A. 1312 (1929), rev'd on another issue 50 F. (2d) 806 (C.C.A. 5th 1931); Sol. Op. 26, CB 3, 44.

\textsuperscript{258} See Report of Senate Finance Committee on Revenue Act of 1921, 67th Cong. 1st Sess. 15.
changed from 100% in the 1921 Act to 50% of the net income in the 1924 Act. In the 1926 Act Congress showed its dissatisfaction even with the limitations it had adopted, and departed altogether from the discovery provision with respect to oil and gas properties, inserting in lieu thereof a flat or arbitrary "percentage depletion" of 27½% of the gross income from the property and 50% of the net income. The discovery provisions were continued with respect to mines with some changes in definition of discovery. The 1928 Act continued percentage depletion in the case of oil and gas wells and valuation discovery depletion in the case of mines. In the 1932 Act percentage depletion was extended to coal, metal and sulphur mines—5% in the case of coal mines; 15% in the case of metal mines; and 23% in the case of sulphur mines—these percentages being based, as in the case of oil and gas properties, upon the gross income from the property and being also limited to 50% of the net income. The 1934 Act for the first time required the taxpayer to elect to have the depletion allowance computed with or without regard to percentage depletion. The 1936 Act continued the same provision as to depletion as was contained in the 1934 Act.

The use of percentage depletion is not a question of tax evasion or tax avoidance in the ordinary sense of these terms, the deduction being clearly permissible under the law as it now stands. The question here is whether this clearly intended deduction should be continued. The elimination of the deduction was recommended by a statement presented to the Ways and Means Committee of 1933 when the Secretary of the Treasury said:

"Our experience shows that the percentage depletion rates set up in the law do not represent reasonable depletion rates in the case of the designated properties, but are

\[259\] See Gregg Report on Mellon Bill 32 (1924).
\[261\] Under this provision depletion is not, like discovery depletion, dependent upon the method of acquisition. Ed Peterson, 25 B.T.A. 1364, 1370 (1932).
\[263\] Revenue Act of 1932, § 114(b) 47 Stat. 202 (1932). This treatment of coal, metal and sulphur mines was regarded as a grant of relief, and the different percentages reflected varying ideas of the customary life of the mining properties.
\[266\] Testimony of Under Secretary Magill, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 33 (1937).
much higher than the true depletion to which the taxpayer is fairly entitled. Moreover, these provisions enable a taxpayer to obtain annual depletion deductions, notwithstanding the fact that he has already recovered the full cost of the property. The deduction is, therefore, a pure subsidy to a special class of taxpayers. For this reason the Treasury recommends that these provisions be eliminated, in order to put all taxpayers upon the same footing.\textsuperscript{265}

The question raised by the above quotation is one of legislative policy. Special subsidies may be justifiable,\textsuperscript{266} it is for Congress to say whether it chooses to continue percentage depletion. The Treasury has made its position entirely clear that the allowance should be omitted from the act.

2. THE DIVISION OF INCOME BETWEEN HUSBAND AND WIFE IN THE EIGHT COMMUNITY PROPERTY STATES

The tax problem presented by the community property system was the subject of considerable discussion in the Hearings before the Joint Committee on Tax Evasion and Avoidance. The tax problem here involved is that husband and wife who live in community property states, of which there are now eight,\textsuperscript{269} are at considerable tax advantage as compared with husbands and wives living together in the other forty non-community property states. The advantage proceeds from the fact that in the community property states, the husband and wife avoid higher tax brackets in that they each may report one-half of the community income.\textsuperscript{270} It is true that in the non-community property states husbands and wives may exercise an option to file separate returns,\textsuperscript{271} but this does not afford the same advantage, since the income in the separate returns must be reported by the owner thereof, and there can ordinarily be no equal splitting of the total family income. The loss of revenue to the government from the community property method of reporting income has been variously estimated\textsuperscript{272} at figures ranging from $20,000,000 to $80,000,000 annually.

Notwithstanding what has been said, husbands and wives gain materially in a good many cases by exercising the election to file separate returns in non-community property states. This is particularly true where

\textsuperscript{265} Quoted in the testimony of Under Secretary Magill, \textit{ibid.}

\textsuperscript{266} Cf. the special subsidy created by Revenue Act of 1936 § 22(b) (6) to ministers of the Gospel.

\textsuperscript{269} Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington.

\textsuperscript{270} Magill, \textit{Taxable Income} 268 (1936); Paul and Mertens, \textit{Law of Federal Income Taxation} § 16.02 (1934).


\textsuperscript{272} Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 309 (1937).
the husband has a considerable income from earnings and the wife has
income from property.\textsuperscript{273}

It has been generally assumed that it is impossible to tax the income of
husband and wife on a joint basis. This doubt is founded principally on
the decision of the Supreme Court in the well-known\textit{Hooper} case.\textsuperscript{274} This
was a state income tax case, and it is by no means certain that it would
bar a\textit{federal} tax upon the joint income of husband and wife.\textsuperscript{275} Whatever
the answer to this question may be, several remedies for the constitutional\textit{impasse} believed to exist have been suggested. One such suggestion has
been to tax husband and wife on principles analogous to those applied
to associations and common law trusts.\textsuperscript{276} Another suggestion has been to
impose tax upon the husband measured by the net income, in which event
the imposition of tax would not be upon the husband with respect to
the wife's income, but his rate of tax would be greater according to the amount
of his wife's income. It has been further suggested\textsuperscript{277} that a provision lim-
iting deductions which are a matter of legislative grace may be made
in the case of persons who do not file a joint return.\textsuperscript{278} The most practicable
solution of this problem that promises to be constitutional is that rec-
ommended by the Secretary of the Treasury in 1933—to require a joint
return in the case of husband and wife living together, each spouse to pay
the tax attributable to his share of the income.\textsuperscript{279}

The Hearings before the Joint Committee on Tax Evasion and Avoid-
dance did not develop this subject to any conclusion,\textsuperscript{280} and further study
will presumably be given to it.

\textsuperscript{273} There are also further tax advantages in separate filing by husband and wife on account
of deductions in connection with transactions between the two taxpayers.

\textsuperscript{274} 284 U.S. 206 (1931). See Hearings before the Joint Committee on Tax Evasion and
Avoidance, 75th Cong. 1st Sess. 313 (1937). This case is discussed at some length in Paul and

\textsuperscript{275} The Federal government may be powerless\textit{a fortiori} where the state government is
powerless. Paul and Havens, Husband and Wife under the Income Tax, 5 Brooklyn L.R.
241, 269 (1936).

\textsuperscript{276} Reiling, Taxing the Income of the Husband and Wife, 13 Tax Mag. 198, 199 (1935).

\textsuperscript{277} Paul and Havens, Husband and Wife under the Income Tax, Brooklyn L.R. 241, 270
(1936).

\textsuperscript{278}\textit{Ibid.} It is probable that this method would be unconstitutional as a discrimination
without substantial basis.

\textsuperscript{279} Magill, Taxable Income 288 (1936).

\textsuperscript{280} Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st
3. NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

The 1936 Act radically revised the previous treatment of nonresident aliens and foreign corporations. Previous tax laws had not faced realistically the problem of taxing nonresident aliens and foreign corporations. There had been plenty of theoretical jurisdictional victories with respect to the right to tax the income of foreigners, but barren jurisdictional victories do not fill Treasury coffers, and in the 1936 Act Congress left its ivory tower to deal with this problem in a more practical way.

The essential change made by the 1936 Act was to classify nonresident aliens and foreign corporations according to whether they had a United States business or office. If they did have such a business or office, they were taxed, as previously upon their net income (including capital gains) from sources within the United States, at a flat rate of 22%. If they did not have such a business or office, a flat tax of 10% was imposed in the case of nonresident aliens and 15% in the case of foreign corporations, but these rates applied only to fixed or determinable annual or periodical gross income from sources within the United States, such as interest, dividends, rents, royalties, annuities and compensation. There was no attempt to tax capital gains of individuals without a United States business or office or nonresident foreign corporations. There were no deductions for purposes of these flat taxes.

The new realism of the 1936 Act consisted in its withholding provisions. The flat taxes upon nonresident aliens and foreign corporations with no United States business or office were withheld at the source. Likewise, tax was withheld at the source in the case of nonresident aliens.

281 See Paul and Mertens, Law of Federal Income Taxation § 37.15 a (supp. 1934), for a general treatment of this subject.


284 See Revenue Act of 1936, § 119, 49 Stat. 1693 (1936). 26 U.S.C.A. § 119 (1929). Such foreign corporations (that is, resident foreign corporations) were taxable at the flat rate of 22% on their net income (including capital gains) from sources within the United States.

285 This rate might be reduced by treaties in the case of citizens of contiguous countries. Such a treaty has been negotiated with Canada. Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 320 (1937).

286 The essential idea of withholding the tax is that it is collected out of income upon which the tax is payable from the payor of the income, the payor usually being a more responsible person and more readily accessible to government control.

THE BACKGROUND OF THE REVENUE ACT

with a United States business or office. These withholding provisions apparently resulted in a decided increase in tax collection. The tax collected in 1935 from all nonresident aliens and all foreign corporations was $5,753,244. An analysis of 5,535 withholding returns received in the Bureau of Internal Revenue as of June 18, 1937 (not a full year's collection) showed a collection of $14,950,684.21.

The principal defect of the system established by the 1936 Act was that foreign recipients of United States income in high brackets paid a much lower tax than United States citizens or residents receiving the same amounts of income. There was thus discrimination in favor of nonresident aliens and foreign corporations.

To remedy this situation the Joint Committee on Tax Evasion and Avoidance and the Ways and Means Committee recommended that the tax upon nonresident aliens with no United States business or office, whose net income from fixed or determinable annual or periodical income from sources within the United States exceeded $21,600, should not be less than the tax imposed upon citizens and residents with respect to such income. Congress has adopted these suggestions.

Some will, we hope, read this factual account of modern tax avoidance with a sense of incredulity. There is something disturbing about a world in which taxpayers desert the protection and advantages of the established corporate laws of their own country in favor of the corporate laws of an insignificant foreign island in the Atlantic Ocean, principally known as a winter pleasure resort; in which taxpayers pass by outstanding solvent domestic insurance companies in favor of an ephemeral insurance company incorporated under the laws of a foreign jurisdiction; in which domestic personal holding companies multiply like mushrooms; and in

288 Revenue Act 1936 §§ 143, 144, 49 Stat. 1700 (1936), 26 U.S.C.A. §§ 143, 144 (1929). In such cases this withheld tax might be taken as a credit against the tax shown on the return with the right of refund to the extent of any overpayment.

289 Testimony of Mr. Kent, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 321 (1937). See also Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 22 (1937); Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 30 (1937). The amount of $14,950,684.21 does not include collections on resident foreign corporations and additional taxes to be paid by non-resident aliens carrying on business in the United States.

290 "This is the approximate point at which the effective rate (normal tax plus surtax) becomes 10%." Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess., 31 (1937); Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 23 (1937).

291 Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 23 (1937); Ways and Means Committee Report No. 1546, 75th Cong. 1st Sess. 31 (1937).

which yachts, racing stables, and other hobbies, are claimed with a straight face to be business activities of a corporation. This excessive zeal of the taxpayer would be funnier than it is if it were not such grim reality. It is not funny, because it is an attack upon legitimate governmental revenues, which may result in an attack upon the whole structure of our government. Whatever may be the moral issues involved, the fact remains that reasonable men are willing to pay the price for living in civilized society. The question is renewed whether there is one law for those who will not pay their income taxes and another law for those who have to pay their sales taxes.

\[293\] It is well to preserve a sense of humor in the consideration of this whole question. It has noticeably departed from the attitude of both sides. Dr. Magill is an exception; so is Assistant Attorney General Morris. See Morris, The Work of the Tax Division of the Department of Justice, 15 Tax Mag. 524 (1937).

\[294\] Letter of President Roosevelt dated June 1, 1937, quoted in Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess. 1 (1937).