SIMONS ON TAXATION

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THE appreciative essay on the late Professor Henry C. Simons reprinted from *Fortune* in this issue of the *Review* gives no indications of his considerable and distinguished work on taxation. This is more than a mere oversight; it represents a general failure to appreciate his work in this field. Though he was not a "specialist," Simons' first major work in economics was on taxation, and he continued to give tax reform a prominent place in his positive program for economic reconstruction. His tax program, first elaborated in the late 1920's, constitutes now as then the most promising outline for reform of the federal tax system.

In the field of taxation, as in his other work, Professor Simons was essentially a utopian interested in long run objectives. He was at the same time the most practical of reformers in that he always embodied his objectives in specific proposals for legislation. His own summary of the specific content of his tax program as formulated in 1943 is appended to this note. Except for the recent repeal of the excess profits taxes, all of his proposals are still on the agenda for the future.

The tax program with which Simons concluded his work in taxation is identical in essential respects with the program contained in his book on *Personal Income Taxation*.[1] This book was planned and largely written in the late 1920's although not published until 1938. During the 20's economic progress and stability appeared to be within our grasp. The free market method of organizing economic life appeared to be well entrenched and the virtues of greater equality most in need of emphasis. Accordingly Simons' tax program was dominated by a central theme—the role of taxation as the major instrument for mitigating the inequalities which arise in a capitalist society.

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[1] The proposal dealing with inheritance taxation is less definite than it was in 1938. He remained convinced that inheritance taxation should take the form of taxation of recipients in accordance with their economic circumstances and not in accordance with those of "some one who is dead." But in 1938 he adhered rigidly to his definition of income for tax purposes with the consequent inclusion of all gratuitous receipts as part of taxable income. While he continued to hold that this was in general the sound approach, he was increasingly aware of the "technical difficulties which inhere in the intricacies of property law." Hence the tentative character of proposal 13. The proposal for integration of estate and gift taxes (12) was an interim measure for estate tax rates based on the size of estates and on the total of decedent's taxable gifts inter vivos.

If equality is to be the master of taxation, a progressive personal income tax must be the mainstay of federal revenue. And this tax must bear equally on all types of gain. The present federal income tax does not satisfy this requirement principally because of its treatment of so-called capital gains and losses. "Realized" gains are taxed at different rates than other types of gain and, even more important, and more difficult to change, "unrealized" gains are not taxed at all, either during the lifetime of the recipient or when he dies. As long as taxpayers are in a position to transform taxable income into nontaxable gain either in this or in other ways, little progress can be made in using the tax system to mitigate inequality. Public policy thus threatens to become a mighty contest between legal talent skilled in the transformation of income and the Treasury seeking to close the resulting gaps in the structure. It is at this point that Simons made his important contribution with the principle of constructive realization.

His proposal is to treat all transfers of property as realizations for tax purposes. A final accounting of all personal income is thereby assured and, provided capital gains are taxed at the same rate as ordinary gains, the taxpayer can be left free to transform one type of gain to another without damage to the tax system. And, as a consequence, it becomes possible for the first time to discuss seriously the abolition of business taxes, which have no place in a personal income tax system. The chief defense of business taxes rests largely and properly in the utilization of the corporate form of organization to keep the owners' gain from becoming taxable income.

The ominous developments of the 1930's, by threatening the foundations of the free market method of organizing economic life, directed Simons' attention to other problems. After 1934 he was increasingly concerned with the broader issue of the establishment of social arrangements that would enable a free enterprise society to maintain output at a high and stable level. The impact of this shift in emphasis is first shown by passing references to the problem of enterprise and output in *Personal Income Taxation.* It is clearer still in the manuscript which he prepared in 1943. Yet this shift in emphasis led him to make no significant changes in his tax program. He found the tax program whose dominant objective was the reduction of inequality equally appropriate when the dominant objective was the preservation of a free enterprise society.

Simons made few changes in his tax program despite the change in emphasis because he examined taxation as but one aspect of "total arrangements" of public policy for a free society. He thus eschewed the great temptation to convert the tax system into a gadget to solve all of our problems. The major obstacles to enterprise and investment are to be found in widespread restraints of trade and monetary uncertainty. He dealt with both directly through his program for deconcentration of industry and his program for monetary stability. It is true that but little progress has so far been made in either direction. This may explain, though it hardly justifies, the many suggestions for tearing the tax system apart in order to offset, with uncertain results, our failures in other phases of public policy.

But Simons did not retain his original tax program simply because he found other techniques for accomplishing his new objectives. He retained it primarily because it seemed to him well suited to promote these new objectives. The present tax system interferes with enterprise and investment primarily because it fails to adhere to consistently equalitarian objectives particularly in taxing business directly and in its treatment of capital gains and losses. It was his contention that the abolition of business taxes with the resulting freeing of business decisions from tax considerations would do more to stimulate enterprise than any possible further discriminations designed to promote correct decisions. His consistent treatment of capital gains and losses dictated by equity and equalitarian considerations would, he held, do much to promote risky undertakings. His own method of taxing gains and losses with the consequent averaging of fluctuating incomes would further work in the same direction. To this he added a simple averaging device involving rebates at periodic intervals to equalize the remaining fluctuations of income through time. Finally, it was Simons' contention that the possible conflict between progressive rates and incentive should be examined openly and not resolved by giving taxpayers freedom to choose their own rates of progression.

It is an additional advantage of his tax system that it tends to promote economic stability. A system based primarily on personal income taxes promotes stability through automatic changes in revenue. Moreover it offers appropriate mechanism for induced changes in revenue and fits in well with Simons' program for monetary stability.

There is no good substitute for Simons' own writing to convey the specific content of his tax program, his grasp of the significant problems, and his analytical skill in resolving these problems. Hence in addition to his summary of his specific proposals which follows, the succeeding article in this issue is a series of long excerpts containing his discussion of the central feature of his tax program—the treatment of so-called capital gains and losses—and also some of his comments on business taxes. These are taken from an unpublished manuscript originally prepared for the Committee for Economic Development in 1943 and which it is hoped will soon be made available in its entirety in book form.

SPECIFIC PROPOSALS

1. Utilization of the personal income tax as the predominant source of federal revenues—with source collection from corporate dividends and interest payments, as well as from wages and salaries.
2. Abolition of tax-exempt securities, with moderate compensation, in the form of additional interest payment, for outstanding issues.
3. Outright repeal of the excess profits taxes (including the old declared value tax and capital stock tax)—repeal to be "announced" when the war is over and well in advance of its effective date.
4. Repeal of the income tax on corporations (and introduction of substantial source collection [25 per cent?] from corporate dividends and interest payments).
5. Introduction of a simple averaging procedure under the personal income tax whereby persons with markedly fluctuating annual incomes may claim rebates and thus not finally bear excessive relative burdens merely because of income irregularity.
6. Elimination of all special treatment for realized capital gains and losses as such, gains to be fully taxable and losses fully deductible, without segregation and with generous carry-over provisions.
7. Treatment of *all* transfers of property (by gift, inheritance, bequests, devise, etc., as well as by sale) as "*realizations*," by the transferor or former owner (donor or decedent), of the estimated fair market value at time of transfer (gift or death)—the "basis" of the donee, legatee, devisee, et al., to be that estimated value as reported by or for the former owner.
8. Contingent upon adoption of preceding proposals,
   (a) Outright repeal of (inter alia):
      (1) Section 102 (tax on corporations used to avoid surtax).
      (2) Section 114 (depletion).
      (3) Section 117 (capital gains and losses).
      (4) Section 118 ("wash sales").
      (5) Sections 331–40 (supplement P—Foreign Personal Holding Companies).
      (6) Sections 500–511 (subchapter A—Personal Holding Companies).
      (7) Etc., etc.
   (b) Radical relaxation and simplification of rules regarding annual charges and basis-adjustments for depreciation, obsolescence, and depletion.
   (c) Radical relaxation and simplification of rules regarding inventory procedures and changes of procedure.
   (d) Radical change and simplification of rules regarding basis-adjustments for securities, partners' equities, and other investment assets, primarily to facilitate the charging of accrued but unrealized losses.
   (e) Optional treatment (if and *as* so desired) of all partnerships and other firms like corporations, i.e., extension to all enterprises of the privilege to carry forward (owner-) untaxed undivided profits as potential offsets against contingent

future losses (thus, optional postponement of owner-tax and automatic "averaging" or "carry-over" without specific time-limits).

(f) Special provision for transfer of bases (untaxed old-enterprise earnings reinvested) by active enterprisers transferring their enterprise participation (whether or not by direct exchange of equities) from well established firms to new and more venturesome enterprises—with approval of the Commissioner.

(g) Simple, minimal technical provisions designed to protect the Treasury against essentially fraudulent ultimate avoidance, evasion, or frustration of tax on accumulated gains unrealized—i.e., legislation designed to permit Treasury intervention in cases where an individual is flagrantly abusing postponement privileges, to assure effective accounting integrity through time, and to assure that postponements of tax will be *only* postponements (save for offsetting of the same person's bona fide future losses).

(h) Congressional resolution urging that no tax on undivided profits be enacted while the ("our") general scheme of procedure remains in effect.

9. Elimination of gross discrimination between home-owners and home-renters by requiring the reporting of estimated net rental values (determined possibly as a flat percentage of the fair value of the real property) of owned residences as an item of taxable personal income.
10. Some reasonable solution of the community-property and related problems either by permitting unrestricted division of total income and separate returns by spouses, or by means of compulsory joint returns.
11. Elimination or radical reduction of excise taxes (especially on beer, liquors, tobacco, admissions, etc.) as an element in the federal revenue system.
12. Integration of the Gift and Estate Taxes.
13. Fundamental re-examination of the whole problem of death duties, with regard for the innumerable gross anomalies which have characterized all inheritance-tax laws, and with attention to possibilities of replacing the Estate and Gift Taxes by a more sensible form of tax on beneficiaries of donative transfers.