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THE EMERGENCY JOB OF FEDERAL TAXATION

RANDOLPH E. PAUL

The defense spending program has now soared beyond the breath-taking mark of \$67,000,000,000, including outlays by the government and its agencies for the Army and Navy, defense plants and equipment, merchant ships, housing, and lend-lease aid to foreign countries, and also expenditures on account of British government orders previously placed. Of the total program authorized to date about \$15,000,000,000 has been spent, and expenditures are now at the rate of more than \$1,500,000,000 a month. The rate of monthly expenditure will continue to expand considerably as the program gains momentum, even though funds authorized for ships and other equipment will be expended over a period of several years; thus, the demands of the defense program upon the productive capacity of the country will constantly increase.¹

Such amounts as \$67,000,000,000 are almost beyond our poor capacity for understanding. The figure exceeds the value of all building construction in the United States since 1927. It is twice as much as the total investment in American railroads. It is twice as much as the total value of all passenger automobiles produced in this country during the past 14 years. It is twice as much as the total expenditure, defense and non-defense, of this country in the two fiscal years 1918 and 1919, covering the period of our actual participation in World War I. It is three times as much as the annual defense expenditure of the entire world in the years just preceding World War II. These comparisons help to make comprehensible a program which a few years ago would have seemed utterly fantastic. But further shivers are in order if we remember that we may still be only at the beginning of a program the outlines of which would dwarf the wildest imagination.

What has been our response to these new compulsions? In 1940 we changed the old system of one revenue act every two years to two revenue acts in one year. The first 1940 Act imposed a 10 per cent defense tax, which has been integrated by the 1941 Act into the regular schedules. The second 1940 Act reinaugurated the excess profits tax, abandoned with little sorrow in 1920. These two acts increased revenues by approximately \$1,500,000,000. We have just enacted a 1941 rate-raising act, which extends the number of taxpaying families and single persons to about 30 per cent of our population.² The 1941 Act is to be followed in 1942 by a bill

¹In the 1941 fiscal year our expenditures were \$6,255,000,000.

²Blough, The Federal Personal Income Tax under the Revenue Act of 1941, address before the National Tax Association, Oct. 14, 1941.

containing "technical" amendments. This bill will undoubtedly increase the tax burden. Recent newspaper accounts suggest that it may make widespread use of the mechanism of withholding at the source.

In a speech of October 2, 1941, Mr. Morgenthau announced that our tax structure, as modified by the 1941 Act, will yield about \$14,000,000,000 in revenue. The personal income tax is expected to produce \$3,420,500,000 of this total. The estate tax will produce \$492,000,000 and the gift tax \$116,000,000. The corporate income and excess profits tax will produce a total of \$5,360,300,000. The taxes named will produce \$9,389,100,000 annually. This is an increase of \$2,749,500,000, or 41 per cent, over the comparable tax yield under the pre-existing law. The total yield figure of \$14,000,000,000 may well be a conservative underestimate.

When taxes reach such levels, the problem of fair distribution³ becomes highly acute. On the one hand, a burden escaped by some taxpayers and passed to other taxpayers becomes intolerable, and on the other hand, the effect of hard provisions becomes disastrous for taxpayers. The Secretary of the Treasury has said that our tax structure "still contains many inequalities and many omissions which will have to be corrected next year." Our revenue system, founded as it is so largely upon the principle of self-assessment, needs the co-operation of taxpayers.⁵ Indeed, one may say in the most emphatic terms possible that our tax system simply will fail in the existing crisis if it breeds widespread dissatisfaction and resentment. This will most certainly happen if there is a failure to distribute the enormous burden of taxation equitably among taxpayers. The people may have a new willingness to pay taxes, but high rates must make for a new unwillingness to see other people avoid their share of the aggregate tax burden.

Taxation is not a thing apart; it has an intimate relationship with our whole economy. For years that economy has been running well under capacity. National income reached a miasmatic low of \$40,000,000,000 in 1932, and morale was at a corresponding level. Defense has given a blood transfusion to the economy, and morale has risen accordingly. For 1940 our national income was \$76,000,000,000; in 1941 it will probably be in the neighborhood of \$87,000,000,000. It has been estimated that national income in 1942 may be 10 to 15 per cent higher than in 1941. This will be a new high which was hardly to be imagined before the advent of World War II.

³Cf. FRANKFURTER, MR. JUSTICE HOLMES AND THE SUPREME COURT (1938) 42; Blough, *The Federal Personal Income Tax under the Revenue Act of 1941*, address before the National Tax Association, Oct. 14, 1941.

⁴Morganthau, Address delivered in Chicago, Oct. 2, 1941.

⁵Gaskill, *Preserving a Willing Attitude among Taxpayers* (1938) 16 TAX MAG. 649.

When we reach the peak of our immense productive capacity through the utilization of manpower and facilities, the question of budget balancing is relevant. If a nation at such a time cannot contemplate budget balancing upon the basis of a new normal average of expenditure, with allowance for increased maintenance, when will it face its issues? Mr. Eccles, Chairman of the Board of Governors of the Federal Reserve System, while admitting that the drastic tax necessary for balance would be politically impossible at this time, has urgently suggested the need of greater effort in the direction of such a tax.⁶ And he has also asked the cognate question: why should our tax system not recapture for the government a large part of the defense expenditures it is making?⁷ Are we going to allow a part of our population to make an inordinate profit out of war? The President has repeatedly answered this question in the negative, but so far his policy remains in large part unfulfilled.

Taxes enter also into the highly complicated problem of inflation.⁸ The threat of inflation is a dark shadow across the future. Taxes are a principal instrumentality of prevention, for, in the language of Mr. Eccles, they can "reduce consumer demand for goods where the supply is inadequate."⁹ Here taxes have a function which may be even more vital than revenue production.¹⁰ The good effect of increased governmental revenue will be more than neutralized if the government must spend in a wild boom market, and the public will lose the benefit of an amplified national income if the purchasing power of that income is reduced in greater effect than the increase of income. Furthermore, inflation is a bubble, which like all bubbles eventually bursts.¹¹ The point cannot be too strongly emphasized that every citizen has what Mr. Morgenthau has called a "personal stake" in the prevention of the chaos of inflation.

Mr. Morgenthau has promised a genuinely "all-out" tax bill in 1942, to be levied "upon all in accordance with their ability to pay." Of course, no one outside intimate governmental circles knows Mr. Morgenthau's precise plans, and one would assume that his mind is far from closed to what may be revealed by further study of the tremendous problem before him. When

⁶Testimony before the Committee on Banking and Currency, House of Representatives, 77th Cong., 1st Sess., Sept. 29, 1941.

⁷Eccles, *Price Fixing Is Not Enough* (1941) 24 FORTUNE, No. 2., p. 56.

⁸This word has a record number of meanings. Cf. CHASE, *THE TYRANNY OF WORDS* (1938) 291. It is used here not in the sense of the German or French inflations after the last war, but in the sense of the United States price rises in that war.

⁹Eccles, *Price Fixing Is Not Enough* (1941) 24 FORTUNE, No. 2, pp. 56, 150.

¹⁰PAUL, *SELECTED STUDIES IN FEDERAL TAXATION, SECOND SERIES* (1938) p. 262; PAUL, *FEDERAL ESTATE AND GIFT TAXATION* (1941) § 1.07.

¹¹Cf. Foreword of Mr. Wickard, Secretary of Agriculture, to *FARMERS, FARM PRICES, AND INFLATION* (September, 1941).

he referred to an "all-out" tax bill, he was undoubtedly intending to state policy in the broadest terms, leaving details to the future. But in the end we shall need a bill of particulars; and one may suggest some points of an increased tax program for the consideration of those who will have to bear its burden, though in a short article that has to be done in a more or less categorical fashion without detailed discussion of the reasons for and against each proposed change. Indeed, the subject is so vast that one cannot even list the host of technical amendments our revenue laws demand if they are to be put in condition to endure the strain of an emergency. But one may suggest some points of revenue revision that may soon be items of tax history.

1. *Interest on State and Municipal Obligations*

Much discussion of the subject of the taxation of interest upon the obligations of the states and their political subdivisions has generated little light in the midst of much heat. The consensus of well-informed and unbiased opinion¹² is in favor of taxing the income from *future* issues of such bonds.¹³ For too long we have provided a haven from the sweep of the surtax with the result that a mass of tax-exempt securities is endangering the system of the progressive income tax.¹⁴ The constitutionality of taxing the income from *future* issues of state and municipal bonds is no longer very doubtful.¹⁵ It might be constitutional to tax even the interest from *past* issues, but such a step might have elements of unfairness that would make it inadvisable. The Glass proposal, that the surtax on income from taxable sources should take into account the existence of tax-exempt income, is perhaps too indirect an approach to provide a satisfactory solution.

2. *Capital Gains*

The rate of capital gain tax has been reduced by the 1941 Revenue Act from 16.5 per cent to 15 per cent.¹⁶ Apparently this reduction was inadver-

¹²See Foley, *Twenty-five Years of Tax-Exemption Privileges* (March 1939) *FORDHAM ALUMNI MAG.* 30; Foley, *Reciprocal Taxation of the Income from Federal, State and Municipal Bonds* (1941) 6 *LEGAL NOTES ON LOCAL GOVERNMENT* 178; Kades, *Taxation of the Income from Governmental Securities*, address before the National Tax Association, Oct. 13, 1941.

¹³This involves the elimination of Section 22(b) (4) of the Internal Revenue Code.

¹⁴Paul, *Redesigning Federal Taxation* (1941) 19 *HARV. BUS. REV.* 143, 146. Cf. Lutz, *Some Errors and Fallacies of Taxation as Exemplified by the Federal Income Tax*, address before the National Tax Association, Oct. 14, 1941.

¹⁵See Department of Justice Study entitled *TAXATION OF GOVERNMENT BONDHOLDERS AND EMPLOYEES* (1938) 21, 43. Cf. Chandler, *The Case for the Municipalities against Federal Taxation of Municipal Securities*, address before the American Bar Association, September 30, 1941.

¹⁶Section 117 of the Internal Revenue Code remains unchanged by the 1941 Act.

tent, and we may expect in 1942 a revision of the capital gain rate at least to the level of 1940.

But the capital gain and loss situation must, of course, be approached from a larger viewpoint. The subject has always stirred emotional attitudes. We have complete variety of opinion from one extreme, which is against all taxation of capital gains and recognition of capital losses,¹⁷ to the opposite extreme, which maintains with equal emphasis that no differentiation at all should be made between capital gains and ordinary income.¹⁸ This sharp difference of opinion gets nowhere in discussion. Opponents talk past each other in a curious way. Mixed in the confusion is the question of profit motive, and it is gravely asserted that our venture capital will not blaze new trails if incentive is further reduced. Inconclusive statistics prove anything a wishful thinker desires.

In this intellectual wilderness an observer of facts may at least point out that the existing capital gain rate is the most favorable in our income tax history. The capital gain rate in the twenties was 12.5 per cent, but we ended this period with a highest surtax bracket of 20 per cent. At this time the capital gain rate was, therefore, five-eighths of our top surtax bracket. This relative position of the capital gain rate should be compared with a relationship of a rate of 15 per cent to 77 per cent. The fraction mentioned has dropped from five-eighths to one-fifth.

Without attempting to decide which, if either, of two bitterly opposed schools of thought is nearer to the truth, it may be confidently asserted that the present relationship of the capital gain rate to the surtax brackets involves a violent discrimination against individuals who derive their income from personal services and sources other than capital gains. If this is true, the capital gain rate should be substantially increased. The principal theory for a differential in favor of capital gains is that the accrual of such gains stretches over several taxable periods, and we might do worse than to go back to the flexible rule established by the 1934 Act, which at least gave recognition to varying periods of accrual. At the very least, the tax on

Section 101 of the 1941 Act at the same time integrated the defense tax into the surtax rates. Section 15 of the Code, imposing the defense tax, was entirely revamped and no longer deals with the defense tax.

¹⁷Nelson, *The Question of Taxing Capital Gains, The Case against Taxation* (1940) 7 LAW & CONTEMP. PROB. 208; 2 MAY, TWENTY-FIVE YEARS OF ACCOUNTING RESPONSIBILITY (1936) 144.

¹⁸SIMONS, PERSONAL INCOME TAXATION (1938) 148; Kent, *The Question of Taxing Capital Gains, The Case for Taxation* (1940) 7 LAW & CONTEMP. PROB. 194. On this subject see also Haig, *Taxation of Capital Gains*, WALL STREET JOURNAL, March 23, 25, 29, April 2, 8, 13, 1937; Blough and Hewitt, *Capital Gains*, contained in 2 STUDIES IN INCOME AND WEALTH (New York, National Bureau of Economic Research, 1938) 191; Colm, *The Revenue Act of 1938* (1938) 5 SOCIAL RESEARCH 255.

capital gains should, in deference to the principle of ability to pay,¹⁹ take into account other non-capital gain income of the taxpayer. An increase in capital gain rates should perhaps be accompanied by a longer loss carry-over.

3. Pension Trusts

The institution of pension trusts has in its favor many of the arguments put forward on behalf of social security. Business efficiency may also be promoted by the timely retirement of employees who have lost their usefulness. But it is hard to avoid profound misgivings that pension trusts are a growing menace to governmental revenue. In practice the deferment of tax granted²⁰ is being grossly abused by the establishment of trusts in favor of high salaried key employees and stockholders.²¹ Some qualifying provisions should be placed in the revenue act to limit the pension trust exemption to cases of bona fide trusts with valid *social* and *business*, as distinguished from *tax-avoiding*, purposes. The underlying legislative purpose should not be lost sight of in any further consideration of this problem, because some taxpayers have abused the pension trust provision.

The temptation will be to punish innocent beneficiaries with the guilty when the deluge comes. But intelligent amendments can draw a line between those who deserve a postponement of the tax and those for whom the benefits of tax postponement could hardly be seriously intended. This type of problem is constantly faced in revenue legislation. One must find a way of reaching particular cases of avoidance without striking, like Herod's massacre, indiscriminately at all cases irrespective of deserts.²²

4. Interest Deduction

The charge is convincingly made that the interest deduction, now allowable²³ for all interest paid or accrued, except interest on indebtedness incurred or continued to purchase tax-exempt securities, puts too high a premium upon corporate financing by *borrowing* rather than by *capital contributions*. The difference between many preferred stock and bond issues is often more legalistic than real; yet the corporation issuing the stock does not have the interest deduction allowed to the corporation issuing bonds.

¹⁹Cf. Lutz, Some Errors and Fallacies of Taxation as Exemplified by the Federal Income Tax, address before the National Tax Association, Oct. 14, 1941.

²⁰INT. REV. CODE §§ 23(p), 165.

²¹See Altman, *Pension Trusts for Key Men* (1937) 15 TAX MAG. 324; Paul, *The Background of the Revenue Act of 1937* (1937) 5 U. OF CHI. L. REV. 41, 77; *Hearings before the Joint Committee on Tax Evasion and Avoidance*, 75th Cong., 1st Sess. (1937) 294.

²²Cf. PAUL, *STUDIES IN FEDERAL TAXATION* (1937) 65.

²³INT. REV. CODE § 23(b).

The income bond trick is well known. Tax practitioners are frequently visited by clients desirous of converting stock issues into bond issues in order to reduce taxes.²⁴ Some limitation should be placed on the interest deduction not only to raise revenue but also for the collateral purpose of putting equity financing upon a reasonable parity with financing on a less solid business basis. Any such limitation should take into account the fact that small concerns find it difficult, even in these days, to raise equity capital.

5. Percentage Depletion

For a long time oil and mining companies have been granted a special depletion deduction, consisting of a percentage of gross income from depletable property limited to a percentage of the net income from the same property.²⁵ This depletion allowance is optionally greater than the ordinary allowances for loss of wasting assets; it is not restricted to a recovery of cost or value at March 1, 1913, of the producing property; and it goes on as long as production continues, without relation to the recovery of cost or value at March 1, 1913. The elimination of the deduction was recommended at least as long ago as 1933 by the Secretary of the Treasury.²⁶ In 1937 the President recommended the elimination of percentage depletion.²⁷ Congress has failed to act on this recommendation, but the existence of the emergency may change legislative attitudes.

6. Joint Returns

The subject of joint returns for husband and wife has received much publicity in the last year. Much of this publicity, with its emphasis upon constitutional and moral aspects of the problem and its effect upon the institutions of marriage and women's rights, has certainly established a new record for irrelevance. Professor Griswold, who has stated the arguments against the proposal in the most appealing possible way, has admitted the speciousness of these arguments,²⁸ stating that "he who puts his trust in unconstitutionality today in matters of this sort seems to disclose a rather surprising unawareness of the happenings of the past few years."²⁹

²⁴It is an interesting question whether such reorganizations or recapitalizations have the benefit of the statutory exemption. Cf. PAUL, *STUDIES IN FEDERAL TAXATION, THIRD SERIES* (1940) 103, 121.

²⁵INT. REV. CODE §§ 23(m), 114(b) (3) (4).

²⁶Testimony of Under Secretary Magill, *Hearings before the Joint Committee on Tax Evasion and Avoidance*, 75th Cong., 1st Sess. (1937) 33.

²⁷Letter of President Roosevelt, dated June 1, 1937, quoted in 1 *Report to the Joint Committee on Tax Evasion and Avoidance*, 75th Cong., 1st Sess. (1937) 1.

²⁸Griswold, Letter published in *New York Times*, July 27, 1941, sec. 6E, col 7.

²⁹Cf. Satterlee, statement submitted on behalf Committee on Taxation of New York County Lawyers Association, *Hearings before the Senate Finance Committee on H. R. 5417*, 77th Cong., 1st Sess. (1941) 170 *et seq.*

As to moral grounds, Professor Griswold calls attention to A. P. Herbert's chapter "Rex v. Pratt and Merry—The Tax on Virtue" in his *Uncommon Law*,³⁰ adding that it would be hard to show that the British institution of marriage has been impaired by the long-standing practice of requiring joint returns. Stern events may well force a reconsideration of this whole problem in connection with an "all-out" revenue act,³¹ for the following reasons:

(a) No one has been able to suggest any politically practicable method, other than joint returns, of eliminating the unfair advantage enjoyed by residents of the community property states.³² Obviously there is no sound foundation for a rule that makes the federal income tax depend upon where the taxpayer lives, and which requires a married couple living in New York, for example, to pay a much higher tax than a married couple living in California.

(b) No one has been able to suggest any convincing reason for a substantial tax disparity between a family in which the husband is the sole source of income and a family in which the wife contributes to the family economic unit. While there may be some increased expenses of earning income where the wife is working, the family, generally speaking, will spend approximately the same amount for rent, food, support of children, and other basic items, whether its income stems entirely from the husband or derives in part from the wife. The income tax should recognize such compelling economic realities.³³

(c) In the majority of families in the United States practically all the family income is earned by the husband. If joint returns are not required, the families of this majority will have to pay a higher tax than the families in the minority group have to pay. Recently increased rate brackets make this discrimination all the more unworthy of continuance.

7. Life Insurance

Life insurance is today serving to an alarming degree as a tax avoidance

³⁰HERBERT, *UNCOMMON LAW* (2d ed. 1936) c. 62.

³¹See letter of Mr. Harry Rudick to Chairman Doughton of the Ways and Means Committee, July 17, 1941, reprinted in the *CONGRESSIONAL RECORD*, vol. 87, No. 139, p. 6618 (1941). See also RUDICK, *THE PROBLEM OF PERSONAL INCOME TAX AVOIDANCE* (1940) 252-3, 264, where Mr. Rudick advocates that joint returns cover not only spouses, but also minor children. See Blough, *The Federal Personal Income Tax under the Revenue Act of 1941*, address before the National Tax Association, Oct. 14, 1941. Cf. Shoup, *Married Couples Compared with Single Persons under the Income Tax* (1940) 25 *NATIONAL TAX ASS'N BULL.*, No. 5, 130-5.

³²The community problem is discussed at length in PAUL, *FEDERAL ESTATE AND GIFT TAXATION* (1941) § 1.09.

³³See PAUL, *FEDERAL ESTATE AND GIFT TAXATION* (1941) §§ 1.08, 1.09, 1.12.

instrumentality.³⁴ Insurance is sold to many purchasers upon the basis of its tax avoidance appeal.³⁵ The highly special \$40,000 life insurance estate tax exemption is a discrimination in favor of insurable persons. And what need is there for a special \$40,000 exemption for a beneficiary who is receiving millions in insurance? Conversely, with estate tax rates and interest rates at their present levels, the question is in order whether our estate tax exemptions are sufficient for a surviving wife and dependents when there is little or no estate.

Much may have been accomplished by the recently promulgated Treasury Decision 5032 which makes the payment of premiums the test of taxability of insurance proceeds payable to named beneficiaries, in so far as the proceeds are purchased after January 10, 1941.³⁶ But this remedy is insufficient to reach the common avoidance mechanism of cross policies taken out and paid for by spouses with their separate funds; moreover, it is difficult to see how this device may be successfully combatted by any conceivable extension of the theory of substitute for testamentary disposition.³⁷ A limitation upon the income tax exemption of insurance proceeds or a special excise tax upon the receipt by a beneficiary of life insurance proceeds in excess of premiums paid by him are two possible remedies which should be given careful consideration.³⁸

In connection with the subject of insurance a peculiar defect of the statute may be mentioned in passing. Section 812(a) of the Internal Revenue Code provides for the deduction of claims against the estate which are allowed in the jurisdiction in which the estate is being administered. The statute has been interpreted as allowing the deduction even of claims which are not enforceable against some particular asset of the estate, such as life insurance proceeds. In one case³⁹ an estate valued at over \$2,000,000, more than half of which consisted of life insurance, had valid claims amounting to \$6,000,000, none of which was a charge against the insurance proceeds.

³⁴PAUL, *FEDERAL ESTATE AND GIFT TAXATION* (1941) c. 10.

³⁵WRIGHT AND LOWE, *SELLING LIFE INSURANCE THROUGH A TAX APPROACH* (1937) 26-8.

³⁶The American Bar Association has recently voted against this change. Payment of premiums is probably intended as the sole test under subdivision (g) of Section 811, but it requires a high degree of optimism to think of that as the sole test of taxability for purposes of the entire statute. Subdivisions (a) and (c) and (d) may still be called to the service of tax collection where incidents of ownership are retained.

³⁷Cf. Stone, J., dissenting in *Heiner v. Donnan*, 285 U. S. 312, 332, 52 Sup. Ct. 358 (1932) *second hearing*, 61 F. (2d) 113 (C. C. A. 3d 1932); *Whitney v. State Tax Comm.*, 309 U. S. 530, 60 Sup. Ct. 635 (1940); *Helvering v. Bullard*, 303 U. S. 297, 58 Sup. Ct. 565 (1938).

³⁸For a more extended discussion of this subject see Paul, *Life Insurance and the Federal Estate Tax* (1939) 52 HARV. L. REV. 1037 (1939). See also MAGILL, *TAXABLE INCOME* (1936) 335.

³⁹*Comm'r v. Ames*, 88 F. (2d) 338 (C. C. A. 7th 1937).

These claims eliminated estate tax liability, leaving the life insurance, against which they could not be asserted, entirely free from estate tax.

8. Powers of Appointment

For years powers of appointment have been a fruitful instrumentality of tax avoidance.⁴⁰ It is impossible to compress in short space the ramifications of this very abstruse subject, but it may be suggested that taxability should be extended to at least some *special* powers of appointment as well as *general* powers. If we assume the propriety of existing law, which imposes only one tax where property goes from *A* to *B* for life, remainder to the named children of *B*, this subject carries with it an important policy decision. One must consider the kinship of two patterns of devise: *A* to *B* for life, remainder to named children of *B*, which is regarded as a single disposition of *A*'s fee simple absolute; and *A* to *B* for life with a power in *B* to appoint the remainder to *B*'s issue. The difference between these two nontaxable types of devise is in the fact that one of them involves a deferred act of selection.

We have, therefore, the question whether the mere fact that the life tenant and donee may exercise his own choice among his issue warrants treating a special power confined to the donee's issue as a double transfer and therefore taxable, while a remainder is treated as a part of a single transfer and is not taxable on the death of the life tenant. If the donee's power of selection is regarded as sufficient to distinguish this situation from the life estate-vested remainder situation, there is no justification for exempting any special power of the type mentioned. On the other hand, if it is admitted that a certain minimum flexibility is sufficiently desirable from the social standpoint so as not to be discouraged by additional taxation, the problem becomes one of degree. The legislator's choice will involve a reconciliation of the protection of a socially desirable devolution of property and the prevention of tax avoidance.

The problem will be to devise a practical legislative formula for distinguishing between special powers which are closely akin to the vested remainder situation and those where the donee's power is sufficiently valuable to justify a tax on his estate for the full value of the property. Thus where the donee *must* appoint to someone within the designated special class, there being no gift over to other takers in default of appointment, or where the donee is a third person having no share in the life enjoyment of the property and no direct relationship to the appointees, inclusion of the property

⁴⁰This subject is ably discussed in Griswold, *Powers of Appointment and the Federal Estate Tax* (1939) 52 HARV. L. REV. 929; Leach, *Powers of Appointment and the Federal Estate Tax—A Dissent* (1939) 52 HARV. L. REV. 961. See also discussion in PAUL, FEDERAL ESTATE AND GIFT TAXATION (1941) c. 9.

in his estate may not be expedient. Similarly an exemption would appear proper in the case of a nonexclusive special power, in so far as the donee cannot exclude each member of the class from participation.

Under the Code as it stands today, even property subject to appointment under a general power is not taxed unless the power is *exercised*. Although a devise over in default of exercise is no more than a distribution in accordance with the donor's intentions, it is a distribution pursuant to the joint acts of donor and donee if it is subject to another person's power to defeat it at will. This would seem to make the donee a contributory source of the transfer, regardless of the motives behind his nonexercise. The statute should, therefore, be reworded to eliminate the requirement of exercise. Similarly, the estate tax should also apply to powers released in contemplation of death. A collateral change or clarification should be made with respect to the application of the gift tax to the *inter vivos* exercise or release of a power of appointment.⁴¹

9. Contemplation of Death

For many years the estate tax statute has contained a provision to the effect that transfers in contemplation of death are part of the gross estate.⁴² No one can read the contemplation of death cases without realizing that this provision has been a dismal failure.⁴³ It is almost enough to demonstrate the inadequacy of the statute to remember that one gift made about four months prior to death by a decedent 91 years old was held not to be in contemplation of death.⁴⁴ It is commonly held that transfers by persons of advanced age are not in contemplation of death.⁴⁵

The failure of the contemplation of death provision derives from the basic difficulty of securing proof of a state of mind.⁴⁶ As Mr. Justice Frankfurter has observed, "The devil himself . . . knoweth not the mind of man; and even if he did, the devil's advocate might experience considerable difficulty in proving it to a court of law."⁴⁷ Dr. Harriss tells the story of a case in

⁴¹Amelia Solomon, 43 B. T. A. 234 (1941).

⁴²PAUL, FEDERAL ESTATE AND GIFT TAXATION (1941) § 6.01.

⁴³The percentage of cases in which the government is able to prove contemplation of death is probably less than 5 per cent. See 2 *Reports to the Joint Committee on Internal Revenue Taxation, Federal and State Death Taxes* (1933) pt. 2, 14, 109, 111, 168. See also Stone, J., dissenting in *Heiner v. Donnan*, 285 U. S. 312, 332, 52 Sup. Ct. 358 (1932), *second hearing*, 61 F. (2d) 113 (C. C. A. 3d 1932).

⁴⁴*Rochester H. Rogers*, 21 B. T. A. 1124 (1931). See Mr. Justice Stone's analysis of cases from the age standpoint in *Heiner v. Donnan*, 285 U. S. 312, 344, 52 Sup. Ct. 358 (1932), *second hearing*, 61 F. (2d) 113 (C. C. A. 3d 1932).

⁴⁵See, e.g., *Commercial National Bank*, 36 B. T. A. 239, 243 (1937).

⁴⁶*Cf. Learned Hand, J., in United Business Corp. of America v. Comm'r*, 62 F. (2d) 754, 755 (C. C. A. 2d 1933), *cert. denied*, 290 U. S. 635, 54 Sup. Ct. 53 (1933).

⁴⁷FRANKFURTER, LAW AND POLITICS (1939) 55.

which the state was unable to get any testimony from the doctors or the family indicating bad health. During a cross-examination of the estate's witness, an architect who had built a new home for the decedent at about the time of the gift, the state's attorney asked the random question why provision had been made for a first-floor bedroom. The question was a lucky one; the architect replied that the decedent had had a bad heart and could not climb steps. Thus the state obtained critical evidence at the eleventh hour of a very important factor affecting contemplation of death.⁴⁸

Short of a more basic integration of the estate and gift taxes⁴⁹ we shall have to resort eventually to some form of presumption in contemplation of death cases. One suggested remedy⁵⁰ is that the statute provide for a conclusive two-year presumption in cases of transfers by a decedent of a minimum specified age, say 65 years, who has made a transfer by trust or otherwise of a substantial part of his property in the nature of a final disposition to his heirs at law or other natural objects of his bounty. Such a provision would involve three conditions: (1) a minimum age, (2) transfer of a substantial part of the decedent's property, and (3) a transfer to heirs or natural objects of the decedent's bounty.

No one could reasonably claim that such a provision would be so arbitrary as to be condemned by the Fifth Amendment. It would not make age the sole criterion, but would add to the equation the relative size of the gift, its character, and the relationship of the beneficiary to the decedent. Surely such a provision would secure the sanction of a majority of the existing Supreme Court. Nothing short of such a provision will serve to prevent substantial avoidance of the estate tax by *inter vivos* gifts.⁵¹

10. *The Gift Tax*

The gift tax may share in the process of amendment. One possible amendment in this connection would be the lowering of the \$4,000 annual exclusion. In the first place, as Dr. Harriss points out,⁵² there are very few people in the world fortunately enough situated to make "casual" (as contrasted with "capital") gifts of \$4,000 in addition to the \$40,000 exemption. A much smaller exclusion would eliminate the great bulk of such gifts. The ability to make such large gifts indicates tax-paying ability.

⁴⁸Harriss, *Gifts in Contemplation of Death* (1941) 19 TAXES 16.

⁴⁹Warren, *Correlation of Gift and Estate Taxes* (1941) 55 HARV. L. REV. 1.

⁵⁰This remedy has been suggested by Mr. Carlton Fox of the Department of Justice. Cf. the suggestion made in Harriss, *Gifts in Contemplation of Death* (1941) 19 TAXES 151, 216, 219; 2 *Reports to the Joint Committee on Internal Revenue Taxation, Federal and State Death Taxes* (1933) pt. 2, 112-3.

⁵¹The integration of the gift and estate taxes would also solve this problem. See Warren, *Correlation of Gift and Estate Taxes* (1941) 55 HARV. L. REV. 1, 42, 43.

⁵²HARRISS, GIFT TAXATION IN THE UNITED STATES (1941) 69.

In addition, the widespread abuse of the \$4,000 exclusion is well known. Its principal purpose is to allow reasonable latitude for Christmas, wedding, and intra-family gifts.⁵³ But many taxpayers spread large amounts of gifts among several persons and accomplish substantial transfers of property without any gift tax whatever.⁵⁴ Moreover, a donor who looks sufficiently into the future may over a span of years give away a large amount of property free from tax.

Integration of the Gift and Estate Taxes

The suggestion has been made that "the gift tax and the estate tax be combined into a single cumulative transfer tax along the lines of the present gift tax, with the transfers in the year of death, both inter vivos and testamentary, regarded as the final transfers. The rate brackets applicable to the year of death would be determined by adding these final transfers to the aggregate of transfers made in prior years, and only one specific exemption of \$40,000 would be allowed."⁵⁵

This suggestion relates only to the estate and gift taxes, and apparently overlooks the income tax aspect of the correlation problem. It has been proposed that the estate and income taxes be applied in all cases where the grantor retains a string upon the property. The gift tax would then fasten upon all transfers freeing the grantor from estate and income tax liability.⁵⁶ It will, of course, be difficult in many cases to answer the question whether a string has been retained, but this proposal deserves serious consideration.

The Excess Profits Tax

The excess profits tax, as it is now constituted, is designed to recapture a part of the excess profits of the emergency. It is not intended to take any part of what might be called ordinary excess profits not attributable to the present emergency. In this respect the tax goes on the false premise that it is possible ever to make a clear-cut differentiation between emergency profits and non-emergency profits. No one can tell what part of the profits of any particular concern in 1941 is attributable to the emergency and what part of such profits is the natural culmination of previous years of effort. The tax should discard this ephemeral distinction and frankly exact a contribu-

⁵³See *Helvering v. Hutchings*, 312 U. S. 393, 397, 61 Sup. Ct. 653 (1941).

⁵⁴See, e.g., *Lawrence C. Phipps*, 43 B. T. A. 1010 (1941), in which the taxpayer made gifts to thirteen persons on the same day, thereby securing an exclusion of \$65,000 (the exclusion has since been reduced from \$5,000 to \$4,000).

⁵⁵Warren, *Correlation of Gift and Estate Taxes* (1941) 55 HARV. L. REV. 1, 42-3. Cf. Merry, *Federal Estate and Gift Tax: Concept of a Transfer* (1940) 38 MICH. L. REV. 1032, 1044.

⁵⁶Cf. *Wales, Indian Gifts* (1939) 34 ILL. L. REV. 119, 135.

tion from corporate profits not attributable to the emergency, as well as from corporate profits which are undoubtedly the result of governmental defense expenditures.

It will be unhealthy for all of us if the large corporations, which are being given the bulk of the emergency orders, are permitted to keep for their own such a share of emergency profits that small business is put at a further disadvantage. Corporations as well as individuals must carry their part of the load, and a stiffer excess profits tax than we now have is essential for that purpose. For the theory of that tax I go along with Mr. Eccles in the belief that we should return to the original scheme of the Treasury, making a flexible invested capital determinative of the exemption of excess profits.⁵⁷ That formula provided an exemption from the tax, dependent upon the previous earnings of the corporation, of at least 5 per cent and at most 10 per cent of the invested capital.⁵⁸ Such a formula serves the double function of recapturing emergency profits and of collecting a share of defense cost from corporations which were highly prosperous in the depression period. The income credit in the present bill⁵⁹ gives an undue advantage to corporations with established records, and puts new corporations and corporations without high depression earnings at an undue disadvantage. If the income credit is retained, it might be subordinated in importance by imposing an excess profits tax consisting of one-half of the tax computed on the basis of the income credit plus one-half of the tax computed on the basis of invested capital.

With all my belief in the principle of the excess profits tax, as compared with the crude instrumentality of the straight corporate income tax, I must confess to misgivings as to the treatment of concerns in which capital is a relatively minor income-producing factor. We may as well admit that we are far from a solution of this problem. The personal service corporation provision⁶⁰ does not afford a complete solution; neither do the so-called relief provisions.⁶¹ I cannot but feel that there is some answer to this problem which we have all missed. Perhaps we could optionally exempt from the tax certain types of corporations on the condition that they would accept some fair substitute tax.

⁵⁷Hearings before the Committee on Banking and Currency on H. R. 5479, pt. 19, 77th Cong., 1st Sess. (1941) 1173.

⁵⁸H. R. REP. No. 2894, 76th Cong., 3d Sess., 4, 22 (1940—2 CUM. BULL. 498, 512). The floor percentage recommended by the subcommittee was 4 per cent. *Hearings before Ways and Means Committee and Finance Committee on Excess Profits Taxation*, 76th Cong., 3d Sess. (1940) 4, 12.

⁵⁹INT. REV. CODE § 713.

⁶⁰INT. REV. CODE § 725.

⁶¹INT. REV. CODE §§ 721, 722, 723.

A word may be said with respect to the much advertised difficulty of computing invested capital. On this point one hears much defeatism. In view of better records and a more efficient Treasury personnel, the job is relatively easy compared with what it was in 1917 and 1918, particularly with the adoption of the unadjusted basis for loss as the measure of the inclusion in invested capital of property paid for with stock. Invested capital is not the esoteric concept many try to make it appear to be. It is simply the capital, surplus, and undivided profits, or net worth of the corporation, without taking into account any unrealized appreciation or depreciation in value of assets. It is true that stock dividends, liquidations, and reorganizations raise problems, but they are far from insuperable. We could afford a little greater degree of optimism about the possibility of computing invested capital.

Amendments to Eliminate Hardship

At a time when we are considering amendments of the statute designed to eliminate discriminations, it is certainly not out of order to speculate upon changes which would have the effect of reducing revenue. Intelligent generosity is possible in a revenue act; even in an emergency we need not raise our revenue by the hardship method. Several changes of this sort are dictated by considerations of equity. The provision of the last Senate bill allowing the deduction of expenses incurred in conserving and conducting business affairs should be passed.⁶² With rates at their present level a limited deduction for medical expenses would be no more than a reasonable concession to hard-pressed taxpayers. The same is true of the credit for dependents, which now stops when the dependent reaches the age of 18 years, unless the dependent is physically or mentally incapable of self-support.⁶³ It need hardly be argued that many physically and mentally capable dependents are at the peak of their dependency immediately after the age of 18 years.

The treatment of alimony has been a sore spot in our tax system for many years,⁶⁴ and the provision inserted in the last Senate bill⁶⁵ taxing alimony to the wife should be enacted. The law surrounding the status of mortgage foreclosure transactions should certainly be clarified.⁶⁶ We could no doubt

⁶²Senate Bill, 1941 Act, Sec. 119, as amended on floor. See Conf. Report No. 1203, 77th Cong., 1st Sess., p. 12.

⁶³INT. REV. CODE § 25(b)(2).

⁶⁴*Helvering v. Leonard*, 310 U. S. 80, 60 Sup. Ct. 780 (1940); *Helvering v. Fuller*, 310 U. S. 69, 60 Sup. Ct. 784 (1940); *Douglas v. Willcuts*, 296 U. S. 1, 56 Sup. Ct. 59 (1935); *Helvering v. Fitch*, 309 U. S. 149, 60 Sup. Ct. 427 (1940). See also Paul, *Five Years with Douglas v. Willcuts* (1939) 53 HARV. L. REV. 1.

⁶⁵Senate Bill, 1941 Act, Sec. 117; Sen. Finance Comm. Report No. 673, 77th Cong., 1st Sess., p. 11.

⁶⁶See *Electro-Chemical Engraving Co., Inc. v. Comm'r*, 311 U. S. 513, 61 Sup. Ct. 372

afford to legislate away some of the hardship caused by the Supreme Court decision in *Helvering v. Bruun*,⁶⁷ at least we might arrange for a reasonable postponement of payment where so much non-liquid income is precipitated in the hands of a lessor by the termination, cancellation, or forfeiture of a lease.

There is need for relief from the hardships latent in Section 42 of the Internal Revenue Code when the income tax rates have been so sharply increased. The possibilities of unfairness have been accentuated by the Supreme Court's decision in *Helvering v. Enright*⁶⁸ that a partner's share of partnership fees accrues at the date of death even though partner and partnership have filed returns on the cash basis. Lawyers will sometimes be flattered by the high estimates which the Bureau under this doctrine places on the value of their unfinished legal services. It would seem fairer to provide, regardless of accrual for estate tax purposes, that the recipient of the income should have the privilege of reporting the income as taxable when received.

Any such provision should apply equally to accrued income arising from personal services or any other type of accrued income.⁶⁹ Consistency would require an amendment to Section 43, eliminating from the decedent's final return any accrued deduction in the event that the decedent's estate availed itself of the option to report income when and as received. The underlying purpose of Section 42—that no income should escape tax—could thus be fulfilled without the gross inequity of throwing several years' income into one return. Perhaps at the same time the estate should be required to report the income on the same basis—cash or accrual—as the decedent used prior to death, and perhaps it should also be required to use the same accounting period.⁷⁰

Further Questions for Consideration

The foregoing suggestions are not intended to be all inclusive. Many possible amendments of the statute should be canvassed in order to determine whether changes are advisable.⁷¹

(1941); *Helvering v. Hammell*, 311 U. S. 504, 61 Sup. Ct. 368 (1941). See also PAUL, *STUDIES IN FEDERAL TAXATION, THIRD SERIES* (1940) 296.

⁶⁷309 U. S. 461, 60 Sup. Ct. 631 (1940).

⁶⁸312 U. S. 636, 61 Sup. Ct. 777 (1941). See also *Pfaff v. Comm'r*, 312 U. S. 646, 61 Sup. Ct. 783 (1941).

⁶⁹An amendment to this provision might be framed along the lines of the provisions of Section 44(d), relating to the transmission of installment obligations at death. In order to protect the revenue, the government might be empowered to require the filing of a bond as is required under Section 44(d) [INT. REV. CODE § 44(d)].

⁷⁰*Estate of Cyrus H. K. Curtis*, 36 B. T. A. 899 (1937).

⁷¹Two clearly advisable somewhat minor amendments may be mentioned in a foot-

It is a serious question whether we should allow the basis of value at the date of death for the purpose of determining gain or loss on the sale or exchange of property transmitted at death. Our system of taxing foreign corporations involves a marked discrimination in their favor.⁷² It should not be taken for granted that we ought to allow as a deduction non-business casualty losses,⁷³ non-business interest,⁷⁴ non-business bad debts,⁷⁵ and non-business taxes.⁷⁶ For example, the deduction for taxes on residential property could well be eliminated. It is well worth consideration whether we should return to the principle of consolidated returns in the case of affiliated corporations. The problem of intercorporate dividends is far from solved.⁷⁷ Our reorganization provisions need a thorough overhauling.⁷⁸ Perhaps we should frankly admit the impossibility of preventing the avoidance of the regular surtax on gains from preferred stock redemptions, and apply the capital gain rate to such redemptions.⁷⁹ The Chandler Act in its relationship to the basis provision should again be revised.⁸⁰ Dividends on fully paid-up life insurance or endowment policies should be taxable, as proposed in 1938, regardless of whether the consideration paid has been recovered.⁸¹

note. The statute has a flagrant defect in its provision permitting value at date of death as a basis even in cases in which an executor has elected under Section 811(j) of the Internal Revenue Code to report assets of the estate at their value a year after the death of the decedent. To illustrate the point: A decedent may leave assets having a value of \$1,000,000 at the date of his death which a year after death have dropped in value to \$500,000. In such a case an executor paying estate tax on only \$500,000 secures a basis of \$1,000,000. Obviously the statute should insert a new subdivision in Section 113 to the effect that where the optional valuation privilege is exercised, the basis of property shall be the value as used in the estate tax return.

In the case of contributions in the form of property the law now permits deduction to the extent of the value of the property transferred at the date of the gift. Thus, where a taxpayer has transferred securities costing \$1,000, but having a value at the date of the gift of \$5,000, he is allowed a deduction of the latter amount without any tax on the appreciation in value of \$4,000. Although the donor may have received income under the doctrine of vicarious satisfaction established by *Helvering v. Horst*, 311 U. S. 112, 61 Sup. Ct. 144 (1940), some provision should be inserted in the statute to settle this question. A possible provision would be to allow a deduction only in the amount of the adjusted cost basis of the property to the donor or its value at the date of the gift, whichever is lower.

⁷²This discrimination was only partly corrected in 1937. See Paul, *The Background of the Revenue Act of 1937* (1937) 5 U. OF CHI. L. REV. 41, 86.

⁷³INT. REV. CODE § 23(e) (3).

⁷⁴INT. REV. CODE § 23(b).

⁷⁵INT. REV. CODE § 23(k).

⁷⁶INT. REV. CODE § 23(c).

⁷⁷INT. REV. CODE § 26(b).

⁷⁸PAUL, *STUDIES IN FEDERAL TAXATION*, THIRD SERIES (1940) 164.

⁷⁹Cf. John D. McKee, 35 B. T. A. 239 (1937).

⁸⁰See Paul, *Debt and Basis Reduction under the Chandler Act* (1940) 15 TULANE L. REV. 1.

⁸¹Report of a Subcommittee of the Ways and Means Committee on Proposed Revision of the Revenue Laws, 75th Cong., 3d Sess., p. 46.

Finally, without attempting to exhaust the list, one may recall the perennial inadequacy of Section 102.⁸² For years corporate taxpayers have successfully argued that they may pile up surpluses for the mythical rainy day of the unpredictable future, or that they may in the same sort of future go into a new business in the manner of the White Knight, who kept a bee-hive on his horse because he might some day wish to keep bees.⁸³ Both of these arguments have acquired new vitality in the uncertainty of our post-war future.

Conclusion

The formulation of sound tax policy was never so difficult as it is today. We used to think of taxes principally in terms of revenue production, with too little attention to the effect of taxes upon the economy, and with too little inquiry as to whether they came from saving or reduced spending power.⁸⁴ In 1942 there may be need to reduce spending power in order to help control inflation. We have the additional job of keeping the profit out of war. And, finally, the social consequences of tax policy must be weighed on delicate scales. Every step we take has to be tested in the light of this combination of objectives.

⁸²Rudick, *Section 102 and Personal Holding Company Provisions of the Internal Revenue Code* (1939) 49 YALE L. J. 171.

⁸³Paul, *Redesigning Federal Taxation* (1941) 19 HARV. BUS. REV. 143, 145.

⁸⁴*Ibid.* For a more extended discussion see PAUL, FEDERAL ESTATE AND GIFT TAXATION (1941) § 1.07.