Cornell Law Review

Volume 29
Issue 3 *March 1944*

Article 5

Simplification of Federal Tax Laws

Randolph E. Paul

CORNELL LAW QUARTERLY

VOLUME XXIX MARCH, 1944 NUMBER 3

SIMPLIFICATION OF FEDERAL TAX LAWS†

RANDOLPH E. PAUL

A spirit of humility is not amiss in dealing with the problem of simplification of our tax laws. The subject is vast.[1] Many have tried and no one has conquered. The job is interminable. It spreads octopus-like in all directions. One does well to take with him as he starts out on the long journey toward simplification the message given to Everyman, in the old play, by Knowledge, the sister of Good Deeds:

> "I will go with thee, and be thy guide,
> In thy most need to go by thy side."

Our difficulties with simplification begin with its place in the pattern of taxation. It is not a thing *in vacuo*. It does not stand alone like a pyramid in the desert. To mix metaphors, it is but one strand of a thread which is woven into an intricate design. We must have revenue. We must get it as fairly as possible from many millions of people. We must apply uniform rules. Simplicity must be weighed against all of these competing considerations. We cannot have it without a price. The question always is: Are we willing to pay the price in revenue, equity and uniformity?

Kinds of Simplification

To begin with, there is more than one kind of simplification.[2] There is simplification of concept. There is simplification of language. There is simplification of what the taxpayer must do. Simplification may exist at different levels. The very word means different things to different people. These considerations are pointers which indicate the complexity of the subject.

The statute, of course, is always merely the beginning—a point of departure. In time it is enriched by the live content of concrete factual patterns as administrative interpretations and judicial decisions add their commentary

†Much of the material herein was originally presented by the author in an address before the Second Annual Institute on Federal Taxation, at Rhode Island State College, on January 14, 1944.

[1]See Dobson v. Comm., — U. S. —, 63 Sup. Ct. 239, 243 (1943).

[2]*Cf.* Eichholz, *Should the Federal Income Tax Be Simplified?* (1939) 48 YALE L. J. 1200.

on legislative intention. But beginnings are important, for while one does not end with the words of the statute, "one certainly begins there."[3]

Some people say the language of the statute should be less legal: We should abolish verbosity and make the statute read as chastely as the Ten Commandments. This is easier to promise than to deliver. While I hold no brief for verbosity, it is safe to say that legislative reticence on a subject may often do more harm than good.

Just as simplification itself is not a thing apart, so none of the levels of simplification is separate from any other. The statute conditions the return. What may be put on a small piece of return paper conditions the statute. The regulations cannot go beyond the statute. And, of course, rulings of a less formal character than regulations are, to use Judge Frank's metaphor, merely reflectors, serving as administrative moons.[4]

Simplicity is a part of fairness. Regardless of whether we should have a government of laws or men, laws are made for men. Men must live by them. They must understand them.[5] For understanding is the first step toward orderly compliance. In paying taxes men and women are giving part of their time and energy to the Government. It is unfair for the Government to demand from them the extra time and energy required to master unnecessary complexities.

The American people have shown a remarkable capacity to pay high taxes. But they have also shown a streak of independence, a capacity for protest against taxes they did not want to pay.[6] You cannot impose an unwelcome

[3]Federal Trade Comm. v. Bunte Bros., 312 U. S. 349, 350 (1941).

[4]Choate v. Comm., 129 F. (2d) 684, 686 (C. C. A. 2d, 1942).

[5]*Cf.* General Utilities Co. v. Helvering, 296 U. S. 200, 206 (1935).

[6]"History, so often an aid to law, as Mr. Justice Holmes has said, here helps understanding. Tendency to escape high taxes and rigidity of enforcement have many times brought increased frauds on the revenue. In post-Civil War days collection of taxes was so difficult that the Government scandalously resorted to percentage contingent contracts. Bowers, The Tragic Era, p. 422. There was wholesale evasion by corrupt methods. Woodward, Meet General Grant, p. 420. Sudden jumping in the whiskey tax in the Civil War period from 50c to $2.00 a gallon caused not only marked decline in consumption, but marked increase in revenue frauds. Seligman, The Shifting and Incidence of Taxation, 4th Ed., p. 9. There was rebellion against the crushing whiskey excise tax of 1792. McMaster, History of the People of the United States, Vol. II, p. 189; Adams, Taxation in the United States, 1789-1816, pp. 45, 46. One defect of the general property tax was its 'incentive to dishonesty.' Enforcement brought 'evasion and deception.' Seligman, Essays in Taxation, 9th Ed., pp. 19-28.

Like difficulties were encountered in the colonial period. Farrand, The Development of the United States, p. 51; Cochran, New York and the Confederacy, pp. 156-158; Hart, Commonwealth History of Massachusetts—Davis R. Dewey, Vol. III, pp. 351-353; Hill, Colonial Tariffs, Quarterly Journal of Economics, 1892, p. 98; Spears, The Story of the American Merchant Marine, pp., 47-50; Shannon, Economic History of the People of the United States, pp. 26-29; Schwab, History of the New York Property Tax, Publications of the American Economic Association, Vol. V, No. 5, p. 378; Brod-

tax by forcibly feeding it to 50 million taxpayers. You may persuade, but you cannot coerce. Taxpayers are, after all, to some degree in control of their destinies. Paying taxes gives citizens a very real sense of participation in Government. But they must participate with the feeling of partners, not arithmetical slaves. They cannot derive satisfaction from contact with their Government when they are befuddled by a maze of complexities.

Income Tax Return Forms

This month millions of taxpayers face the prospect of filing their income tax returns for 1943. About 12 million taxpayers will soon face the necessity of declaring their 1944 incomes. The old jokes about the Ides of March have a grim flavor again. Several months ago the Bureau of Internal Revenue released the 1944 versions of Form 1040 and the short form 1040A. One newspaper expressed its reaction in no uncertain terms: "It must be seen to be believed. The form and its junior sister Form 1040A, are so complicated as to defy description in a newspaper during a paper shortage." This statement was but a preface to a long series of bitter complaints.

The returns due this month will have a new understructure. For the first time taxpayers will have paid some or all of their tax liability in advance. They will have made payments under four different headings:

(1) March and June, 1943, installments based upon their 1942 returns;
(2) Victory tax withholding in the first half of 1943;
(3) Income tax withholding in the second half of 1943; and

---

head, History of the State of New York, Vol. I, pp. 465, 466; Adams, Taxation in the United States, p. 47.

English history is punctuated with tax evasions and revolts. Farmers in the Middle Ages deserted their homes to escape purveyance levies. Tayler, The History of the Taxation of England, p. 2 (see also pp. 7, 12, 18, 19). Tax abuses led to the Wat Tyler and Jack Cade insurrections. Wells, The Theory and Practice of Taxation, 1907, p. 67; Henry VIII's demand for 'the sixth part of every man's substance' brought revolt and 'forcible opposition.' Hallam, The Constitutional History of England, Vol. I, p. 18, Little, Brown & Co., 1854. In Queen Anne's reign an income tax failed because taxpayers opposed inquisition into their private affairs. Trevelyan, England Under Queen Anne, p. 292. Self-assessing income-taxpayers in the early nineteenth century 'overlooked half their income.' Tranter, Evasion in Taxation, p. 10. See also Morgan, The History of Parliamentary Taxation in England, pp. 211, 219; The Saturday Review of Politics, Literature, Science and Art, August 4, 1894, p. 122.

Tax evasion and tax avoidance have an ancient lineage. The early Roman nobility evaded payment of the *vectigal* by gradually appropriating the *ager publicus*. Homo, Roman Political Institutions from City to State, pp. 95, 96. The Emperor Galarius's threat of onerous taxes led to Italy's revolt and choice of a new emperor; Gibbon, Decline and Fall of the Roman Empire, 10th Ed., Vol. I, p. 401. In the Empire's last days venality of the tax collectors led many Roman citizens to go into exile to escape the taxes. Gibbon, Decline and Fall, Vol. IV, pp. 17, 18. See also Withers, Our Money and the State, pp. 5, 6 (1917)." PAUL, STUDIES IN FEDERAL TAXATION (1937) 83, n. 283.

(4) September and December, 1943, installments based upon estimated 1943 income.

At the same time they have had to compute and pay one half of the uncancelled fraction of the 1942 tax. They will soon have to file a declaration of estimated tax on 1944 income, and make the first quarterly tax payment for 1944. There should be a bull market in aspirin.

In these dark days of March, I hope you will remember that income tax returns are but the outward and visible sign of the legislation which makes them what they are. Return forms must be prepared by the Bureau of Internal Revenue. But the Bureau is not a free agent; it works under a statute which it did not pass. This year the statute is necessarily complicated because we are changing over to a system of paying-as-we-go. No statute could entirely eliminate complexity during this shift from one payment method to another. But I cannot claim that the transition process accounts for all complexities. Simplicity has other statutory impediments which must be recognized if they are to be overcome.

Simplification of the 1943 Revenue Act

Let me give credit where credit is due by saying that the 1943 Revenue Act accomplishes some simplification. It eliminates the earned income credit.[7] This step was recommended by the Treasury as early as 1942 on the ground that failure to distinguish between different sources of income below $3,000 deprived the credit of its chief significance.[8] The earned income credit has complicated both the return and the computation of the tax.

The Act repeals the so-called second windfall provision of the Current Tax Payment Act of 1943.[9] This provision, designed to cut down tax forgiveness when an individual's income was very substantially increased in the war years 1942 and 1943 over what it was in pre-war years, applied in comparatively few cases.

[7]1943 Act § 107. See H. R. REP. No. 871, 78th Cong., 1st Sess. (1943) 17, 44; SEN. REP. No. 627, 78th Cong., 1st Sess. (1943) 7, 39. The earned income credit, allowed only for purposes of the normal tax, was, in effect, a deduction from net income of 10 percent of the taxpayer's earned net income. If the taxpayer's net income did not exceed $3,000, his entire income was treated as earned net income, but if his net income exceeded $3,000, his earned net income was not to be considered less than that amount. In no event, however, could the earned net income be deemed in excess of $14,000. See further *Hearings before Committee on Ways and Means on Revenue Revision of 1943,* 78th Cong., 1st Sess. (1943) 6, 121; *Hearings before Committee on Finance on H. R. 3687,* 78th Cong., 1st Sess. (1943) 26.

[8]See *Hearings before Committee on Ways and Means on Revenue Revision of 1942,* 77th Cong., 2d Sess. (1942) 81. See also *Hearings before Committee on Ways and Means on Revenue Revision of 1943,* 78th Cong., 1st Sess. (1943) 6.

[9]H. R. 2570, 78th Cong., 1st Sess., § 6 (c), repealed by 1943 Act, § 506. Section 6 (c) ap-

Two simplification measures relating to excises are included. The first gives effect to the President's recommendation of August 1, 1943,[10] by removing numerous excise tax exemptions conferred by existing law with respect to articles sold to the federal government. The President proposed this step "for the purpose of saving the very considerable manpower utilized both inside and outside the Government for the administration of these exemptions. The termination of this exemption," he added, "will not operate to the disadvantage of the Government inasmuch as the expenditure incurred by the Government in the payment of the taxes will be recovered in the collection of those taxes."[11]

The second measure repeals the provision in the existing law[12] which allows the deduction of Federal excises in computing net income for income tax purposes. This disallowance was recommended by the Treasury because the allowance of deductions was haphazard and depended entirely on legal liability for the tax rather than upon the incidence of the tax.[13] The average taxpayer found it difficult to determine which excises he could deduct; he also found it too burdensome to keep accurate records of the taxes he had paid. Consequently, in many instances the deduction was little better than guess work. From the administrative point of view, the disallowance of this deduction will reduce the amount of work involved in checking individual income tax returns.[14]

Treasury Suggestions for Income Tax Simplification

But other Treasury suggestions looking toward simplification were not adopted. The Treasury recommended the consolidation of the normal tax and the surtax.[15] This would have reduced computation work. You are well aware of the defects of the present system. The earned income credit and

plied generally only in situations where the surtax net income of a taxpayer for both 1942 and 1943 was more than $20,000 greater than his surtax net income received in any of the years 1937 to 1940, inclusive, chosen by the taxpayer and called the base year. In these instances a tentative tax for 1942 or 1943, whichever year was the lower in total tax liability prior to any forgiveness, was to be computed on the amount of surtax net income for the base year plus $20,000. The amount of this tentative tax acted as the upper limit of tax forgiveness.

[10]See H. R. REP. No. 871, 78th Cong., 1st Sess. (1943) 31. See also *id.* at 67.

[11]See also SEN. REP. No. 627, 78th Cong., 1st Sess. (1943) 17, 87.

[12]I. R. C. § 23 (c) (1).

[13]See *Hearings before Committee on Finance on H. R. 3687,* 78th Cong., 1st Sess. (1943) 35, n. 10.

[14]The deduction is still allowable as a business expense or an expense incurred for the production or collection of income. See H. R. REP. No. 871, 78th Cong., 1st Sess. (1943) 21, 46; SEN. REP. No. 627, 78th Cong., 2d Sess. 7, 43.

[15]See *Hearings before Committee on Ways and Means on Revenue Revision of 1943,* 78th Cong., 1st Sess. 6; *Hearings before Committee on Finance on H. R. 3687,* 78th Cong., 1st Sess. 99.

the issuance prior to 1941 of partially exempt federal bonds are the only remaining excuses for two concepts of net income—one for normal tax purposes and the other for surtax purposes.[16] With the earned income credit removed, only one reason remains for submitting to the difficulty involved in expressing the rates of tax.

The obvious solution was to integrate rates into one schedule and limit ourselves to one concept of net income. The rate for the first $2,000 of net income could then have been 19 percent—6 percent present normal tax plus 13 percent, the first surtax bracket. For the second $2,000, the rate could have been 22 percent—6 percent plus 16 percent. This simplification could have been extended throughout the rate structure.

It could have been done without any windfall to the owners of partially exempt Federal securities by allowing, in lieu of the present credit against net income, a credit against the tax of 6 percent of partially exempt tax interest, or of net income after the exemption, whichever was lower. This would have given partially tax-exempt bondholders the exact benefit they possess today and would have limited extra computations to the few taxpayers who own tax exempt bonds.

Another unaccepted Treasury recommendation was graduated withholding.[17] The Treasury proposed that collection at the source be made to apply to the taxpayer's full liability rather than merely to his partial liability under the normal tax and the first bracket of surtax. The method for accomplishing this result would have been to set up a series of withholding rates applicable to gross wages, as a substitute for the present precise rates. This series of withholding rates could have been expressed in tables based on the status of the taxpayer. There could also have been tables calculating the amounts to be withheld, as at present.

Any objections to the inaccuracies resulting from the wide brackets in the present-law tables could have been minimized by providing substantially narrower brackets over the ranges of wage within which most employees fall.

It may seem surprising that the suggestion for graduated withholding was made largely in the interest of simplification. It may even seem astonishing that employers responded enthusiastically to the suggestion. Employer groups with whom the Treasury discussed withholding problems signified the desirability of graduated withholding from the standpoint of their relationships with employees. At the time for filing the first quarterly declara-

[16] I. R. C. § 25 (a).

[17] See *Hearings before the Committee on Ways and Means on Revenue Revision of 1943*, 78th Cong., 1st Sess. 7, 122; *Hearings before Committee on Finance on H .R. 3687*, 78th Cong., 1st Sess. 30, n. 6.

tions last September, several large employers reported that requests from employees for information as to total amounts of wage and of withholding over the year, as well as for assistance in the computations and the preparation of the form, resulted in significant additional burdens for their tax and accounting staffs. The question arose whether graduated withholding would unduly complicate the preparation of payrolls. Careful study, as well as discussions with employer groups, indicates that little or no extra burden upon employers would result.

Investigation of this proposal reveals further interesting data. At present the first $2,000 bracket covers about 34,000,000 taxpayers.[18] The remaining 23 brackets cover less than 7,000,000 taxpayers. The lesson of these figures is that our rate structure lacks refinement for the great majority of taxpayers. Thirty-four million taxpayers have the same rate of tax on their income without any progression. The progression in our tax rates is limited to the remaining seven million taxpayers. However, the moment we try to provide better progression, we have to face the necessity for graduated withholding. As I have said, this could have been accomplished. The by-product of graduated withholding—which would have enabled us to achieve the desirable objective of refining the rate structure for the great majority of taxpayers—would have been the elimination of many quarterly declarations for persons receiving salaries above the present first bracket of surtax. A greater number of declarations would have been eliminated if, in addition, we could have raised the present requirement[19] relating to outside income, other than salaries, from $100 to a somewhat higher figure.

I have not exhausted the list of Treasury defeats on the simplification front. Its major reverse was the retention of the Victory tax.[20] This tax is a stalwart barrier to simplification. First, the Victory tax introduces a separate concept of taxable income; second, it uses an exemption different from the regular income tax exemption; third, it requires an entirely separate tax computation; and fourth, it recognizes family status only through a complicated credit. The logical move in the direction of simplification would have been to shift the burden of the Victory tax to the regular income tax structure. To that end the Treasury proposed that the Victory tax be eliminated and that with a reduction of exemptions and dependency credits, its burden be absorbed into the net income tax scale.[21]

[18]For additional data, see *Hearings before Committee on Ways and Means on Revenue Revision of 1943*, 78th Cong., 1st Sess. 17.
[19]I. R. C. § 58 (a) (2).
[20]I. R. C. § 450 *et seq.*
[21]See *Hearings before Committee on Ways and Means on Revenue Revision of 1943,*

The tax bill, as passed by the House,[22] would have repealed the Victory tax. However, instead of integrating it with the regular income tax, it would have set up a separate minimum tax.[23] In other words, it replaced an additional tax with an alternative tax. For the simplification riddle this was an inept solution.

If the minimum tax had become law, the taxpayer would have been confronted with two alternative taxes, each with different rates and each with an entirely different set of exemptions. The relationships between the minimum tax and the regular tax were so complex and elusive that many husbands and wives would have been forced to go through a lengthy series of alternative computations to determine their lowest possible tax liability. All in all, the Treasury concluded that the minimum tax "cure" prescribed in the House bill was worse than the Victory tax "disease."[24]

Fortunately, the defects of the minimum tax plan in the House bill were so patent that the Senate Finance Committee refused to accept it.[25] Unfortunately, the Committee was unwilling to abandon the Victory tax, although it did effect some simplification by changing its present differential rate to a flat 3 percent for every taxpayer regardless of marital or dependency status.[26] However, the Committee's plan failed to eliminate the double tax computation, the double income base, and the separate exemption of the Victory tax.

A good deal of additional simplification in tax returns is possible if changes are made in the law to simplify the concept of income. With such changes, returns might be reduced to very simple statements for persons subject to withholding of the full tax on wages and salaries and having no other income. This would make compliance easier and would reduce taxpayer irritation. The changes in the law necessary for extreme simplification of returns would reduce the fairness of the tax. However, it may well be that the simplicity gained would offset the equity lost. It is doubtful whether it would be desirable completely to eliminate a statement or simple return by the taxpayer to the Government. Returns have a certain value both to the Government and to the taxpayer. They serve as a basis for adjusting the over-collections and under-collections which are inevitable in any withholding system. They

78th Cong., 2d Sess. 5, 121; *Hearings before Committee on Finance on H. R. 3687*, 78th Cong., 1st Sess. 26.

[22]H. R. REP. No. 3687, 78th Cong., 1st Sess. § 105.

[23]*Id.* at §§ 102, 106. See H. R. REP. No. 871, 78th Cong., 1st Sess. 12, 39, 42.

[24]See discussion in *Hearings before Committee on Finance on H. R. 3687*, 78th Cong., 1st Sess. 26 *et seq.*

[25]See SEN. REP. No. 627, 78th Cong., 1st Sess. 7.

[26]See SEN. REP. No. 627, 78th Cong., 1st Sess. 7, 39.

provide a cross-check against employers' reports, thus eliminating a possible source of tax evasion. They also serve as a direct contact between the taxpayer and his Government, which has wholesome civic value.

Other Suggestions for Simplification

So far I have discussed simplification for the masses of taxpayers. That is the immediate job. Moreover, it is our most important job to make the income tax understandable to the great mass of the 50 million taxpayers who cannot employ lawyers and accountants. Simplification should begin at that level.

But simplification need not end there. The business man is entitled to as much certainty as is feasible. Corporations and trusts need not be harassed with complexities. Individual taxpayers employing lawyers and accountants deserve all the clarity we can achieve. Some newspaper comment to the contrary, there is plenty of work for tax lawyers and accountants for many years to come without benefit of needless complexity. As Mr. Justice Jackson said in the recent *Dobson* case:[27] "No other branch of the law touches human activities at so many points. It can never be made simple, but we can try to avoid making it needlessly complex."

In this territory there is so much unfinished business that I can do little more than mention a few items. Tax law relating to trusts is in confusion.[28] Reorganization tax law is a morass of such transcendental metaphysics[29] that exact meanings can be discovered only by the hair-splitting theoreticians of Von Jhering's "heaven of legal concepts."[30] The whole corporate tax structure needs overhauling; we need better integration between the personal and the corporate tax. The bankruptcy act has to be coordinated with the tax law.[31]

Estate and Gift Taxes

Perhaps we may profit most by concentrating on one or two phases of this part of the vast simplification problem. We might first choose the estate[32] and gift[33] taxes for the purpose. In considering these taxes I want to re-

[27]Dobson v. Comm., — U. S. —, 64 Sup. Ct. 239, 243 (1943). See also Black, J., in Comm. v. Heininger, — U. S. —, 64 Sup. Ct. 249, 254 (1943).

[28]See, *e.g.*, with respect to estate and gift taxes, PAUL, FEDERAL ESTATE AND GIFT TAXATION (1942) cc. 7, 17, and authorities cited therein.

[29]See generally PAUL, STUDIES IN FEDERAL TAXATION, Third Series (1940) 3 *et seq.*

[30]See Cohen, *Transcendental Nonsense and the Functional Approach* (1935) 35 COL. L. REV. 809.

[31]See generally Paul, *The Emergency Job of Federal Taxation* (1941) 27 CORNELL L. Q. 3.

[32]I. R. C. Ch. 3.

[33]I. R. C. Ch. 4.

iterate that this is a narrow segment of our subject. Very few people die with enough wealth to bring estate tax problems to the Treasury. In 1942, 19,884 estate tax returns were filed and total estate tax collections for the calendar year amounted to only a little over 370 million dollars.[34] Very few people have sufficient surplus of property to create gift tax problems.

This is not to say, however, that these are not important taxes. They may affect only a relatively few people, but they affect them at a sensitive point. They bring to the Congress, the Bureau, and the courts a host of difficult questions.

The gift tax was ostensibly designed to prevent the avoidance of the estate tax in addition to the income tax.[35] From this point of view the most successful gift tax would be a tax which so discouraged gifts that it yielded little revenue. However, the drafters, it would seem, promptly made certain that this objective would not be realized. The gift tax rates were so arranged that transfers during life to circumvent estate and income taxes would actually be encouraged, with the Government procuring its revenues at an earlier date. While avoidance no longer was tax-free, the price in gift tax was sufficiently small to make avoidance profitable.

The disparity in rate was apparently intended to stimulate the transfer of wealth during life rather than at death. This fundamental break-down in tax theory is reflected not only by the deliberate disparity in rates,[36] but by double exemptions[37] and an annual gift tax exclusion.[38] Moreover, every transfer during life, up to a certain point, tumbles out of the highest applicable estate tax brackets into the lower gift tax brackets, and the earliest gifts may produce the greatest income tax savings while yielding the lowest gift tax. The gift tax has necessarily been caught in a whirlpool of conflicting purposes and is therefore comparatively impotent to fulfill its original function as a protective device. It certainly does not attain the objective of imposing "a tax which measurably approaches the estate tax which would have been payable on the donor's death had the gifts not been made and the property given had constituted his estate at death."[39] As a "policeman tax" the gift tax has been a conspicuous failure.[40]

---

[34]Comparative Statement of Internal Revenue Collections by Sources for the Calendar Years 1942 and 1941, Treasury Release of February 11, 1943.

[35]See Smith v. Shaughnessy, 318 U. S. 176 (1943); 2 PAUL, FEDERAL ESTATE AND GIFT TAXATION (1942) §§ 15.02, 15.04.

[36]See 2 PAUL, FEDERAL ESTATE AND GIFT TAXATION (1942) § 15.02.

[37]I. R. C. §§ 812 (a), 935 (c), 1004 (a) (1).

[38]I. R. C. § 1003.

[39]H. R. REP. No. 708, 72d Cong., 1st Sess. (1932) 28; SEN. REP. No. 665, 72d Cong., 1st Sess. 40.

[40]See Twentieth Century Fund, *Facing the Tax Problem* (1937) 315.

Our present irrational framework is by no means confined to the evils of rates and exemptions. Our courts have for years been struggling with a grossly inadequate and antiquated estate tax base. By an adroit use of trusts, the impact of the estate tax can be suspended over several generations.[41] Faced with the constant specter of avoidance, it is small wonder that the courts have heroically attempted to fashion a transfer concept prepared to meet a variety of exigencies.[42] And judicial attempts to import clarity into legislation often yield fine distinctions which lie beyond the discernment of average mortal man.

Simultaneously the courts have sought to adapt the gift tax to the needs of the estate tax, although this is frequently impossible unless one is willing to sacrifice the interests of the income tax. On the other hand, the desire to assist the income tax may seriously impair the estate tax.[43] All these difficulties derive from a failure to focus upon objectives and to draw the appropriate lines of incidence. The time has passed when we could afford the luxury of sitting by and watching our revenue system grow like Topsy. Any tinkering within our present framework can only lead to further tinkering and to more baffling judicial niceties and refinements.[44]

Corporate Taxation

Our federal tax system, like the traditional American family, has its black sheep. More than a century ago, Nicholas Francois Canard said:[45] "Every old tax is good, every new tax is bad, but the new becomes good in time." Most countries have at one time or another found themselves saddled with taxes which do not conform to the currently accepted pattern of a "good" tax. Yet the bad tax may be more easily ejected than the traditional black sheep. A tax may not be good because it is old, but age and habit enable us to tolerate in an old tax features to which we should violently object in a

[41] See Mills, *Transfers from Life Tenant to Remainderman* (1941) 19 TAXES 195; Eisenstein, *Powers of Appointment and Estates Taxes:* II (1943) 52 YALE L. J. 494, 552; Griswold, *Co-ordinating Federal Income, Estate and Gift Taxes* (1944) 22 TAXES 6, 8. *Cf.* Griswold, *Powers of Appointment and the New Revenue Act* (1943) 55 HARV. L. REV. 739, 740.

[42] See, *e.g.*, Reinecke v. Northern Trust Co., 278 U. S. 339 (1929); Burnet v. Guggenheim, 288 U. S. 280 (1933); Porter v. Comm., 288 U. S. 436 (1933); Helvering v. City Bank Farmers Trust Co., 296 U. S. 85 (1935); Helvering v. Bullard, 303 U. S. 297 (1938); Estate of Sanford v. Comm., 308 U. S. 39 (1939); Helvering v. Hallock, 309 U. S. 106 (1940); Smith v. Shaughnessy, 318 U. S. 176 (1943); Robinette v. Helvering, 318 U. S. 184 (1943).

[43] See PAUL, FEDERAL ESTATE AND GIFT TAXATION (1942) § 7.02, c. 17.

[44] *Cf.* Griswold, *A Plan for the Coordination of the Income, Estate, and Gift Tax Provisions With Respect to Trusts and Other Transfers* (1942) 56 HARV. L. REV. 337, 340-42.

[45] This quotation appears in STAMP, THE FUNDAMENTAL PRINCIPLES OF TAXATION (1936 ed.) 52.

new tax. The path of tax reform is not one along which movement can be swift. It must be a slow, uphill climb.

Although there are blacker sheep in our tax fold—the declared-value excess-profits tax[46] could easily qualify for this distinction—the tax which promises to give us the most trouble after the war is the corporation income tax.[47] Even before the present war this tax was believed to be rough on equity owners; it has frequently been blamed for frightening potential venture capital into "safer" investment outlets.[48]

For the moment we need not be greatly concerned since normal investment outlets are closed for the duration. But with the opening up of investment opportunities after the war the effect of high corporation tax rates on the ability of corporations to raise equity capital will pose a more serious problem. In addition to its effect on levels of investment the corporation tax makes its contribution to the complexity of our tax law. One of the most perplexing questions of the postwar period will be what should be done about the corporation income tax.

The complexities of business make it doubtful that the corporation tax could ever be a simple tax, although the averaging of income through the operation of carryforward and carryback provisions[49] would make a substantial contribution towards simplification by reducing the importance of depreciation rates[50] and other annual adjustments in arriving at taxable income. Real simplification of our tax laws from the point of view of the business man might well require the repeal of the corporation income tax, which, of course, would be a major tax change involving many important considerations besides simplification.

Even if we wanted to banish this particular member of our tax family, it would not be easy to do so. In the metaphorical sense, sheep are hardly ever altogether black. The productivity of the corporation income tax offers at least partial compensation for its faults. It is a tax that without much prodding can be depended upon to bear a substantial part of our revenue burden. Besides, opinions conflict and the corporation tax is not universally

[46] I. R. C. § 600 *et seq.*

[47] I. R. C. §§ 13-15.

[48] *Cf.* MAGILL, THE IMPACT OF FEDERAL TAXES (1943) 26, 126.

[49] The present two-year carry-back and carry-over of net operating losses [Sections 23 (s), 122, 711 (a) (1) (J), and 711 (a) (2) (L)] permit losses to be offset, chronologically, against income earned in the two years preceding and the two years subsequent to the loss. For example, if an income of $1,000 were earned for two years and then a loss of $4,000 suffered, $2,000 of the loss could be deducted from income in the two preceding years and a refund of taxes secured. The balance of the loss—$2,000—would be available as a deduction from any income earned in the next two years.

[50] See Virginian Hotel Corp. v. Helvering, 319 U. S. 523 (1943).

regarded as bad. In fact, it has many friends, especially among persons who regard corporations not as organizations of individual stockholders, but as entities possessing individuality and taxpaying ability. What should be done about this tax will not be an easy question to resolve.

If the corporation income tax is truly a black sheep, you may ask how it has been permitted to assume such an important place in our federal tax system. Why was it enacted in the first place, and why has it been increasingly relied upon with each passing decade? To answer these questions we must glance back at the circumstances which surrounded the enactment and subsequent development of the tax on corporate income.

The first chapter in the history of the corporation income tax was written in 1909,[51] largely as the outcome of a threatened split in the Republican party on the issue of the individual income tax. The incipient revolt of the western Republicans on this issue was ultimately quieted by the promise of President Taft to place an income tax amendment before the states for ratification, and his offer of a 2 percent excise tax on corporations measured by net income.[52] This compromise legislation, resulting finally in a tax of 1 percent, went on the premise that corporations were proper subjects of taxation. In the forest of taxation great oaks from little acorns grow.

With the ratification of the Sixteenth Amendment and the passage of the 1913 income tax law,[53] the 1 percent excise tax on corporations became in name what it had been in fact—a 1 percent income tax. However, since this rate was the same as the normal tax rate on individual incomes, and since dividends were not subjected to the normal tax on individual incomes, the new corporation income tax was not so much a tax on corporate enterprise as a collection-at-source tax on individuals. Had it remained so, the problem which is now confronting us might never have arisen. But, as you all know, the corporation income tax did not long remain a mere adjunct of the individual income tax. Events abroad were bringing us to the threshold of the First World War and to a series of wartime tax bills in which the corporation income tax would he given an independent status.

The Revenue Acts of 1917[54] and 1918[55] not only raised the normal tax rate on corporations above the level of the normal rate on individual incomes, but subjected corporations to an excess-profits and war-profits tax at rates

[51] 1909 Act, Sec. 38.
[52] See BLAKEY, THE FEDERAL INCOME TAX (1940) Ch. 2; RATNER, AMERICAN TAXATION (1942) 280 *et seq.*
[53] 1913 Act, Sec. II (G).
[54] Act of October 3, 1917, Secs. 4, 201.
[55] 1918 Act, Secs. 230, 301.

ranging from 30 to 80 percent. With the cessation of hostilities, when individual income taxes were promptly lowered,[56] no attempt was made to restore the pre-war relationship between individual and corporation income taxes. Corporation income tax rates were not reduced. In fact, the repeal of the excess-profits tax was made the occasion for a compensatory 2½ percent increase in the corporation income tax from 10 percent to 12½ percent.[57]

Little consideration appears to have been given at the time to the rationale of the corporation income tax or to the possible effects of giving this tax a permanent place in the federal tax system. The belief that corporations as such possessed taxpaying ability had by this time undoubtedly taken root in the minds of many, but we embarked upon the taxation of corporate enterprise not so much because we believed the corporation tax to be a good tax as because we had found it to be a productive one.

In 1936 an attempt was made by the administration to de-empbasize the taxation of corporations as such; this attempt recognized the problem of undistributed corporate profits as a tax-avoiding device. Under the plan proposed by the President in that year the undistributed profits tax, designed to replace all other corporation taxes, would have been an adjunct of the individual income tax. Corporate income would have been taxed only once, either as individual income or as undistributed profits.[58] The House followed the recommendations of the President,[59] but the Senate was reluctant to relinquish the corporation tax,[60] and the 1936 Act contained both a tax on corporate income[61] and one on undistributed profits.[62] Few were satisfied with this compromise, and the undistributed profits tax after a short period of invalidism died.[63] There are many in business today who wish it had been a healthier child.

Thus we entered the Second World War with the corporation income tax still firmly established in the federal tax system. With the increasing demands for revenue in 1941 and 1942, it was inevitable that we should turn to this tax, as well as to the individual income tax. Combined normal tax and surtax rates were raised to 31 percent in 1941[64] and to 40 percent in 1942.[65] In

[56] 1921 Act, Sec. 211 (a).
[57] 1921 Act, Sec. 230.
[58] See BLAKEY, THE FEDERAL INCOME TAX (1940) 401.
[59] H. R. REP. No. 2475, 74th Cong., 2d Sess. (1936) 4.
[60] SEN. REP. No. 2156, 74th Cong., 2d Sess. (1936) 4. The story in detail appears in BLAKEY'S THE FEDERAL INCOME TAX (1940) Ch. 17.
[61] 1936 Act, Sec. 13.
[62] 1936 Act, Sec. 14.
[63] See BLAKEY, THE FEDERAL INCOME TAX (1940) Ch. 19.
[64] 1941 Act, Sec. 104.
[65] 1942 Act, Sec. 105.

addition, Congress imposed an excess profits tax in 1940,[66] with rates now at the all time peak of 95 percent.[67]

That, in brief, is the life history of the corporation income tax. For the duration, business can expect little relief from this tax. Business might well temper its postwar optimism with a recollection that attempts to eliminate corporate income taxation have in the past been singularly unsuccessful.

Although a frontal attack on the corporate tax may have little chance of success, there remains a method of blunting its edge. In 1942 the public utility industry succeeded in reducing the effective burden of the tax not by working on the rate, but rather by attaining an adjustment in the base. The deduction of preferred dividends from surtax net income of the utility companies is more than a straw in the wind.[68] Where preferred dividends have led, common dividends may follow. I leave it to you whether businessmen will be inclined to push further along this path, bearing in mind, as they should, that it leads directly back to the undistributed profits tax of 1936.

Conclusion

I have proposed several specific measures designed to achieve simplification for the masses of taxpayers. It is hardly an exaggeration to state that this type of simplification is necessary if our tax system is to survive. I have also advocated simplification of the provisions affecting a smaller number of taxpayers. There are many more of those provisions than I have been able to discuss here.

The road to tax simplification is beset with obstacles. We may travel that road so far, but no further. Tax statutes cannot be completely immunized from the ravages of interpretation and uncertainty.[69] There is a growing awareness among lawyers and others that legislative intention needs to be a dynamic concept and that administrative discretion has a legitimate interest in clarifying areas of uncertainty where interpretation may easily incline either way. Some measure of interpretation and uncertainty must always remain, for human ingenuity is unlimited in its powers of conception.[70]

Mr. Justice Jackson has expressed doubt whether our tax laws can be much

---

[66]Second Revenue Act of 1940, Title II.
[67]1943 Act, Sec. 202.
[68]1942 Act, Sec. 133.
[69]*Cf.* Frankfurter, J., dissenting in United States v. Monia, 317 U. S. 424, 431 (1943); RADIN, THE LAW AND MR. SMITH (1938) 188; Green, *The Duty Problem in Negligence Cases* (1928) 28 COL. L. REV. 1014, 1018.
[70]"Legislation by even the most competent hands, like other forms of composition, is subject to the frailties of the imagination." Frankfurter, J., dissenting in *Ex parte* Peru, 318 U. S. 578, 596 (1943).

simplified for, to use his own words, "the truth is that complexity is in our lives more indelibly than in our laws."[71] In *Welch v. Helvering*[72] Mr. Justice Cardozo voiced much the same doubt:[73]

> "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."

In our search for simplicity we meet again the perennial problem of degree which permeates all legal activity.[74] Tax statutes must be drawn so that they may be as easily understood as possible. But in the rush for simplicity they must preserve their contact with the complexity of modern life; they must be firmly rooted in our fast-moving underlying experience. It is not enough that they be sufficiently comprehensive to reach the old; they must also be sufficiently flexible to reach out to the new. For statutory interpretation is more than the discovery of a pre-existing meaning in the mind of the legislator. It is often a search for a meaning that would have been intended if an unanticipated situation had been presented when the statute was drafted.[75] The courts may not say to the legislator: "We see what you are driving at, but you have not said it; therefore we shall go on as before."[76] They must try to find the major premise of the conclusion expressed in the statute, and then obey the policy they see written in the law.

---

[71]Letter of Mr. Justice Jackson to the author.
[72]290 U. S. 111 (1933).
[73]*Id.* at 114.
[74]See PAUL, STUDIES IN FEDERAL TAXATION, THIRD SERIES (1940) 211.
[75]See CARDOZO, THE NATURE OF THE JUDICIAL PROCESS (1921) 15. *Cf.* HAWKINS, ON THE PRINCIPLES OF LEGAL INTERPRETATION, WITH REFERENCE ESPECIALLY TO THE INTERPRETATION OF WILLS, IN THAYER, A PRELIMINARY TREATISE ON EVIDENCE AT THE COMMON LAW (1898) 577.
[76]Holmes, J., in Johnson v. United States, 163 Fed. 30, 32 (C. C. A. 1st, 1908).