REPORT OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

(Pursuant to the revenue act of 1926)

WASHINGTON, D. C., *December 22, 1927.*

The joint committee was established under the provisions of the revenue act of 1926, and is composed of 10 members, 5 of whom are members of the Committee on Ways and Means of the House of Representatives and 5 of the Committee on Finance of the Senate. The joint committee is required by the act to investigate the operation, effects, and administration of the internal-revenue tax system and to investigate measures and methods for the simplification of internal revenue taxes, particularly the income tax. The organization of the joint committee was effected by electing a chairman and vice chairman and by making provision for a staff to consist of a division of simplification and a division of investigation. The division of investigation was organized and a chief of the division appointed on August 2, 1926. The division of simplification, due to difficulties encountered in securing the services of qualified individuals, was not organized until April, 1927. At the present time the division of investigation consists of a chief, an assistant chief, an engineer, and three auditors, and the division of simplification consists of a chief and two assistants. It is believed that the work of the division of investigation alone has resulted in direct savings which exceed the total expenses of the committee.

In April of this year an unofficial advisory committee was appointed, consisting of Dr. T. S. Adams, Mr. A. A. Ballantine, Mr. George E. Holmes, Mr. George O. May, and Dr. Thomas Walker Page. The advisory committee has served without compensation. Mr. Charles D. Hamel, counsel to the joint committee, acted as chairman of the advisory committee. The joint committee wishes to record its appreciation of the services rendered by the advisory committee.

WORK COMPLETED TO DATE

On November 15, 1927, the joint committee submitted a report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate, for use in connection with the current revenue bill. Previously, there had been printed for the use of the committee, a tentative plan of procedure for each division and preliminary reports on depletion of oil and gas wells, evasion of surtaxes by incorporation and certain phases of State and local taxation. The report of November 15 covers the work completed up to that time and approves a number of suggested recommendations for legislation; some relating to simplification of the law, some to the operation and effects of various provisions in the last preceding revenue act and others to the administration of the law. Most of these recommendations are embodied in the pending revenue bill. For convenience and to avoid duplication, the recommendations are summarized in the appendix at the end of this report. The report of November 15 is extensive and a study of the full report by all Members of Congress is advised. Appended to the report of November 15 is a survey of administration prepared and submitted to the committee by the Treasury Department. The survey contains much valuable information relating to the administration of the income and profits taxes.

Among the simplification recommendations approved in the report of November 15 there are several relating to the form of the statute. It was believed that measures of formal simplification could safely be adopted without the extended study which must precede general simplification of the law. A recommendation was approved that the act be rearranged so as to collect at one place (preferably near the beginning of the act) the general provisions which apply to the cases of practically all taxpayers, and to carry to appropriate places at subsequent parts of the act the special provisions which apply only to the occasional transaction or to particular classes of tax cases. The result of such a rearrangement is that the ordinary taxpayer is likely to find in the first few pages of the act all of the statute law of interest to him. There were also recommendations for the use of headings to sections and subsections, for improved forms of cross reference and for the use of certain typographical improvements which make the finding of a particular provision less difficult than under prior laws. Finally, it was recommended that the 1926 act be retained in force so far as it relates to the estate tax and the miscellaneous taxes, thus avoiding the repetition of those provisions in the new act. A similar recommendation was made with respect to the administrative provisions which relate solely to taxes imposed by the act of 1926 and prior laws. The result is to make the new act an income tax act which is practically free of the complicated provisions relating to prior years, most of the tax cases of which are closed out at the present time. The relatively limited application of the estate and miscellaneous taxes seemed to justify their exclusion from the new act, except for the making of necessary amendments.

In the report of November 15, the following subjects were discussed and, with certain exceptions, recommendations were approved with reference thereto:

1. The earned income credit.
2. Capital gains and losses.
3. Evasion of surtaxes by incorporation.
4. Installment sales.
5. Consolidated returns.
6. Federal tax liens.
7. Transferees of property.
8. The bar of the statute of limitations.
9. Basis for gain or loss on sale by an executor.
10. Interest on overpayments and underpayments.
11. Congestion and delay in settlement of cases.
12. Closing agreements.
13. Deduction of estate and inheritance taxes.
14. Extensions of time for payment of deficiencies.

UNCOMPLETED WORK—SIMPLIFICATION

Obviously, the simplification of the income tax is an undertaking of magnitude and difficulty. As heretofore suggested, the formal measures of simplification recommended in the report of November 15 are in the nature of preliminary steps which should be supplemented by investigations designed to develop means of simplifying the substance of the law, the form of returns, and the administration of the law.

The income tax presents two essentially different problems, both of which must be kept in mind in formulating policies of legislative and administrative simplification. The first is the collection of tax from a large number of taxpayers whose sources of income are few and simple; the second, the collection of tax from a much smaller number of taxpayers whose incomes are derived from the highly complicated operations of modern business. It should be possible to make the application of the law to the simpler forms of income more readily understandable and so to arrange and state the law that the great majority of taxpayers can glean from it all that relates to their own cases without becoming involved in the very complex provisions which are necessary to provide for complex business transactions. It is even possible that simpler means may be found for handling some of the inherently complicated questions and states of fact which appear, as a rule, in the larger cases. It is impossible however, without real hardship, to make the law as a whole simple in its application to the infinite variety of business transactions, and it seems the part of wisdom to recognize at the outset the futility of pursuing a simplification program which is so broad as to be impracticable. Some of the steps which may be taken with reasonable hope of tangible accomplishments are indicated below.

Simpler policies.—It is by no means certain that we have found the simplest, most direct policies by which to handle problems in the simpler tax cases or even the more complex questions and states of fact in the larger cases. In fact there are many provisions in the law which appear as a matter of substance to be unnecessarily complicated and which may perhaps be simplified without hardship to any taxpayer or class of taxpayers. Simpler policies may be practicable with respect to some of the deductions, the earned-income problem, interest allowances and computations and the limitation periods, to mention only a few of the complicated provisions now in the law. A thorough canvass of the act, for the purpose of discovering simpler policies appears to be necessary. It will be recognized that policies which are inherently complicated, can not be stated simply.

The language of the statute.—Revenue legislation must often be framed under circumstances which afford insufficient time for simplifying the language of the law. Though it is a long and difficult task, a careful rephrasing of the more complicated language of the act should be undertaken. Such an undertaking may create ambiguities and give rise to fresh uncertainties unless it is done with care and discrimination. Every effort should be made to retain the benefit of certainty due to interpretations which have attached to the statute by reason of court and board decisions, regulations, rulings, administrative practices, and prior legislation.

It is obvious that considerable time—at least a year—will be required to carry out this work in a proper manner.

An administrative code.—The administrative provisions relating to the income tax have never been available in any one enactment or compilation. Some are to be found in the general statutes and others in the various revenue acts. Moreover, some of the older provisions are not well adapted to the provisions of the later acts nor to the present methods of administration. It seems desirable to collect all of these administrative provisions in a code and at the same time, where necessary, to adapt them to modern conditions and eliminate complications in wording and phraseology. The code should probably embrace not only the administrative provisions relating to the income tax but also those relating to the estate tax, miscellaneous taxes, and other internal revenue taxes.

Simplified returns and administration.—A simple statute is not effective if the form of the returns and the procedure of administration are complicated. The forms of the current returns are about as simple as the present law permits. Further simplification of returns must be sought by appropriate changes in the statute.

The complications of the general administration of the law are evidenced by delay, uncertainty in the regulations and rulings, the reopening of cases and an excessive number of appeals to the board and suits in court. It seems certain that the factor of personnel is one of the most important to be considered in this connection. A thorough canvass of the elements which go to complicate the administration is a necessary part of the simplification of the income tax.

UNCOMPLETED WORK—INVESTIGATION

It is obvious that many investigations are required in regard to subjects of both a general or specific nature in order that the facts may be developed for improvement in or simplification of the act. These investigations are all in process and some are nearing completion.

General subjects.—The following subjects of general importance have been considered worthy of investigation:

(*a*) *Administration.*—While the committee has secured an excellent report on this subject prepared by the Treasury Department, it has seemed advisable to review this report and to supplement it by a report prepared by our own staff in the light of the facts submitted and of suggestions made by taxpayers to the committee.

(*b*) *Tax on individuals.*—An investigation of a method of eliminating the three normal tax rates and the surtax rates and the substitution therefor of one graduated scale of tax rates for individuals has been thought proper.

(*c*) *Statistics.*—A statistical report showing comparative tables and graphic charts of normal and surtax rates for all years is being prepared, together with a study of corporation taxes and their distribution.

Specific subjects.—The following subjects, which have proved troublesome in our revenue acts, are being investigated:

(*a*) *Depletion.*—A study of depletion, with special reference to percentage depletion, has been in progress for some eight months. The determination of depletion has been troublesome, as this deduction is almost always based on valuations. The reports of the committee have already shown that valuations are the cause of much difficulty. Percentage depletion is not based on valuations but on incomes, therefore it would go far toward eliminating the present trouble. An exhaustive study of the statistics of all mining industries has been made. While a percentage depletion method which is entirely satisfactory from the standpoint of equity, from the standpoint of the taxpayer, and from the standpoint of the revenue has not yet been devised, it is hoped that a solution will be found.

(b) *Inventories.*—A report on inventory methods with special reference to the determination of the market value of inventories has seemed advisable. Considerable amounts are refunded annually on account of adjustments to inventories of prior years.

(c) *Insurance.*—There are many special provisions in the revenue act relating to insurance companies. It appears that but little attention has been given to these provisions since the revenue act of 1921 was enacted. One of the specific points being investigated on this subject is the effect of exempting such companies from all tax on capital gains.

(d) *Foreign corporations.*—Certain statistical information seems to make it probable that foreign corporations with branches in this country are able to avoid taxes by shifting profits to the parent company. An investigation of this matter is under way.

(e) *Gifts and trusts.*—A certain amount of income appears to escape taxation through our present laws affecting gifts and trusts. A report on this subject which will develop the necessary facts has been ordered.

(f) *Gain or loss.*—The provisions relating to the recognition of gain or loss from sales or exchanges have presented difficult questions. A report on this subject that will show the operation and effect of the present statute has been undertaken.

(g) *Reorganizations.*—The provisions in reference to reorganizations are among the most technical contained in the revenue act. A report covering certain aspects of this subject has been considered advisable.

(h) *Earned income.*—Further study and investigation of the earned income problem should be made in order to obtain, if possible, a more simple method of treatment than has yet been found.

(i) *Net losses.*—It appears that the net loss provisions are somewhat difficult of interpretation. A report on the present effect of this provision has been ordered.

(j) *Miscellaneous.*—There are a great many provisions in the act, some of vital importance and broad application, the operation and effects of which should be further investigated.

Investigation of refunds over $75,000.—The urgent deficiency bill (H. R. 16462), approved February 28, 1927, provided that no money should be paid out of the appropriation on any claims in excess of $75,000 until after the expiration of 60 days from the date upon which the Commissioner of Internal Revenue had submitted a report on such claims to the Joint Committee on Internal Revenue Taxation. The division of investigation, in accordance with the instructions of the chairman of this committee has reviewed such claims and has made a report to the committee thereon, which report the committee now has under consideration.

Very respectfully,

W. R. Green,

Chairman Joint Committee on Internal Revenue Taxation.

APPENDIX

SUMMARY OF RECOMMENDATIONS TRANSMITTED WITH REPORT OF JOINT COMMITTEE TO COMMITTEE ON WAYS AND MEANS OF THE HOUSE OF REPRESENTATIVES AND COMMITTEE ON FINANCE OF THE SENATE DATED NOVEMBER 15, 1927

SIMPLIFICATION

In approaching the simplification of the income tax, two essentially different aspects of its operation must be recognized and each measure of relief must be tested from both viewpoints. Relatively small sums are collected from a great many taxpayers whose sources of income are few and simple. On the other hand, relatively large sums are collected from a smaller group whose incomes often result from the highly complicated operations of modern business. *It must be recognized that while a degree of simplification is possible, a simple income tax for complex business is not.* The task is to simplify the law and the administration for all taxpayers so far as possible, without causing real hardship to those with complex sources of income and varied business enterprises who can not be taxed justly under a simple, elementary law.

The act itself may be simplified by two principal methods. The first is to simplify the underlying policies or principles; the second to simplify the arrangement, phraseology, and other matters of form. Both are indispensible. It is convenient first to discuss simplification of form.

The arrangement of sections in the act is not satisfactory. A taxpayer can not find at any one place, a simple statement of the basic principles of the income tax. A complete rearrangement, published in Volume II of this report, is recommended, a principal feature of which is that all provisions of general interest to the great body of taxpayers are collected in 16 pages at the beginning of the act.

In its present form the act embraces several complicated provisions relating solely to taxes under earlier laws. The Bureau of Internal Revenue is almost current with its work and these provisions no longer have the importance they once had. They should be omitted from future revenue acts. Accordingly, it is recommended that the revenue act of 1926 be continued in force for the adjustment of old cases and that the sections above referred to be entirely omitted from the next revenue act. Similarly it is recommended that the estate tax and miscellaneous tax titles of the 1926 act be omitted from the next act. This will result in an *income tax act*, less bulky and more simple than the present law.

Typographical improvements, such as the use of varied types in printing the law, catchwords, headnotes, indentations, and the like, simplify the form of the statute, and these are incorporated in the proposed rearrangement.

A code of Federal tax administration appears desirable. Its compilation is discussed in Part II of this report. It will result in collecting the administrative provisions relating to all kinds of internal-revenue taxes in one act. At the present time, some are in the revenue acts and some in the general statutes. Most taxpayers have no great interest in these provisions and they seriously complicate the successive revenue laws. Simplification, uniformity, and other advantages will result from the compilation recommended.

The substance of the act is so complicated that simplification of form alone will not afford an adequate measure of relief. There should be a thorough reexamination of the entire statute for the purpose of developing simpler basic policies. This is the fundamental need in statutory simplification.

Some complicated policies may be mentioned as illustrating the need for simplifying the substance of the law. The act abounds in formulæ and mathematical ratios; there are something like a dozen different bases for determining gain or loss; there is a long list of technical deductions to be mastered by all taxpayers, including the large group of wage earners who have few deductible items; the double structure of a graduated surtax on net income and a flat normal tax on net income less certain credits, in itself is inherently complicated; the bewildering complexity of sections 201, 202, 203, and 204, dealing with corporate distributions and the basis for and the determination and recognition of gain or loss, is universally recognized. Many of these and other similar provisions were placed in the law to alleviate intolerable hardships and to prevent injustice during a period when the income-tax system was growing rapidly and in the midst of great financial stress incident to war. The outstanding need to-day is to reexamine and simplify the substance of what has come into the act in the past 10 years. This large undertaking is a major element in any plan of simplification. Recommendations will be found in this report for simplification of certain provisions in the law, including the earned-income credit, the interest provisions, section 1106(a), and consolidated returns.

Simplified administration, the second branch of the general problem, centers to a large degree on the element of personnel within the bureau and it presupposes simplification of the act itself. The recommendations with respect to the earned-income credit are calculated to simplify administration. Revenue agents are agreed that in its present form it is a prolific cause of mistakes, cost, and delay in handling returns, all of which complicate administration. Delay in the disposition of cases, including accumulations on the docket of the Board of Tax Appeals, is the subject of recommendations in this report, and delay is undoubtedly one of the most complicating factors in administration. Changes in section 220 relating to evasion of surtaxes are recommended which should simplify the administration of that section. Recommendations are made for simplifying releasing of Federal tax liens. Recommendations with respect to section 280 will tend to simplify procedure in collecting taxes from transferees of property.

The Bureau of Internal Revenue, during the past years, has made rapid strides toward the improvement and simplification of administrative procedure, particularly in the prompt closing of the smaller cases, decentralization of assessment and review, final settlement of cases under section 1106(b), and the creation of a special advisory committee to reduce the volume of appeals. In Volume III will be found a survey of administration, prepared for the committee by the Treasury Department.

The field organization which to-day is charged with a very large measure of responsibility in tax determination, should be designed, first, to encourage efficient collection of taxes; second, to make the collection and adjustment of taxes as little burdensome to taxpayers as is possible; third, to harmonize with the system of administration at headquarters; and fourth, subject to the foregoing requirements, to keep the cost of administration at a minimum.

At present there is a dual organization consisting of 64 collectors' offices and 36 offices of revenue agents in charge with which the taxpayers must deal and which the administrative authorities of the Bureau of Internal Revenue must keep in harmony.

The collectors of internal revenue are charged by the statutes with the responsibility for collecting taxes and for canvassing their respective districts for delinquent taxpayers. To the internal-revenue agents has been assigned the task of auditing the more intricate individual returns and all corporation returns. However, in order to bring the audit work current, collectors of internal revenue have been assigned the task of auditing all the smaller individual returns, and during the past few years have also audited a majority of the larger individual returns. It is frequently necessary during the progress of the audit, to make a field examination of the taxpayers' accounts and the law specifies that but one examination of a taxpayer's account may be made each year. It is obvious that constant vigilance is required to avoid a duplicate examination, as a taxpayer may file a return one year that is to be audited by the collector's office and the next year he will file on a different form and the return will be audited by the internal-revenue agent. A single organization would avoid this duplication.

It is recommended that serious consideration be given to the consolidation of the offices of the collectors of internal revenue and the offices of the internal-revenue agents. It is also recommended that the Treasury submit detailed plans for carrying the consolidation into effect.

EARNED INCOME

(Section 209)

The present revenue act provides, in section 209, for a tax credit within certain limits and subject to certain requirements, amounting to 25 per cent of the tax which would be payable on the taxpayer's earned net income if such earned net income constituted his entire net income.

Investigation discloses that at least 10 per cent of all taxable returns filed by individuals are in error on account of this provision, showing that many taxpayers fail to understand the principle of the credit or the method of its computation. As a consequence, taxpayers are obliged to pay for professional advice, administration is delayed, and expense increased.

A lowered rate of tax on earned income appears expedient and proper and, therefore, a means of simplifying the present complicated method is desirable. After a study of several proposals the following is suggested in lieu of the present method:

In computing taxable net income allow a deduction equal to 10 per cent of the amount of the earned net income, subject to maximum and minimum limits equivalent to those fixed by the present act.

The advantages of this method are as follows:

1. It is simple, requiring but four entries on the general form of tax return.
2. It eliminates 13 separate entries from the present general form of return, and does away with much of the present complexity in computation.
3. It does not substantially increase, in any case, the tax which would be payable under the present method.
4. It slightly decreases the tax in some cases, generally to the advantage of the married man with dependents.
5. It is practical, for a similar method has been in use for some years in Great Britain.

The above proposal is, it is believed, as effective a step toward simplification as is possible while preserving both the principle and the limitations of the existing credit.

It should be recognized that even with the present credit, earned income bears a greater burden than does income from capital. The opportunities for distributing capital among members of a family or among corporations and for determining just when gain shall be realized, the reduced rate of taxing capital gains, the allowance for depreciation and depletion are all important factors in making the effective rate of tax on income from capital less than the effective rate on earned income.

There are thus strong reasons for removing the limit on the earned income to which the credit is to be applied. It may be, that for reasons of policy or on account of practical difficulties of administration, this course is not feasible. In that case, there is much to be said on the ground of simplicity for the elimination of the earned income credit and a compensatory modification of the rate of tax on income between $5,000 and $20,000.

CAPITAL GAINS AND LOSSES

(Section 208)

The taxation of gains from capital transactions has long been the subject of discussion, although such gains have been taxable in all our income tax laws since 1913. The constitutionality of taxing these gains has been upheld by the Supreme Court.

Several years ago the Congress recognized that many normal business transactions were prevented by the high tax on capital gains and, accordingly, beginning with the taxable year 1922, a maximum tax of 12½ per cent was provided on such gains as were realized on the sale of assets held for over two years. Since 1924, tax reduction on account of capital net losses has been limited to 12½ per cent.

Suggestions for the entire elimination of the tax on capital gains and the credit for losses have been numerous. Arguments for this change have been based on economic grounds and on grounds of simplification. A careful investigation of the question has therefore been made. This study shows that no change in the existing law relating to this subject should be recommended at present for the following reasons:

1. The capital net-gains tax produces a very considerable revenue over the credit allowed for capital net losses as shown by the following figures:

Net revenue from 12½ per cent tax, 1924	$39,567,328
Net revenue from 12½ per cent tax, 1925	109,912,033
Total for the 2 years	149,479,361

2. To eliminate the tax on capital transactions would shift the tax burden from those realizing gains to those sustaining losses; in other words, it would put the burden on those less able to pay.

3. The flat 12½ per cent tax, while not operating, perhaps, in accordance with the principle of ability to pay, has nevertheless justified its place in the revenue acts, for it appears to have resulted in more tax, at least during the high-surtax years, than would have been collected if the regular rates had been applicable. This comes about through the encouragement given to profit taking.

Studies already made show that the elimination from tax computation of capital gains and losses would remove some complications but would create new ones, and it is doubtful if, on balance, there would be any material gain in simplicity.

EVASION OF SURTAXES BY INCORPORATION

(Section 220)

The Congress has recognized since 1913 that corporations could be formed, or availed of, for the purpose of avoiding surtaxes on the stockholders of such corporations. If a corporation permits its earnings to accumulate instead of declaring dividends, which are subject to surtax, the stockholders will escape such surtax as would have been payable if a distribution had been made.

In order to prevent avoidance, the present revenue act in section 220 provides for a tax of 50 per cent on the net income (including dividends received) of a corporation which permits its gains and profits to accumulate for the purpose of preventing the imposition of the surtax upon its stockholders. It is further provided that "the fact that any corporation is a mere holding or investment company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to escape the surtax."

A careful investigation of this subject and of individual cases which appear to come within the scope of the provision has been made, resulting in the conclusion that the present statute is obscure and difficult of administration. The provision has been effective only in so far as it has deterred the formation of personal holding companies or has stimulated distributions.

The two greatest difficulties facing the administration in applying the present provision consist, first, in proving the "purpose" to evade, and, second, in proving what constitutes "the reasonable needs of the business." The evidence necessary to prove the first point is almost always unobtainable, and the definition of the reasonable needs of a business, required in the second case, is generally beyond the power of the bureau, at least, in the case of operating companies.

The incentive to incorporate in order to avoid surtaxes has largely disappeared. In fact, there is now noted a tendency to disincorporate. To-day a resident of New York, subject to the maximum surtax, who holds property through a corporation, pays in Federal and State taxes on the corporate income 10 per cent more than he would pay in State tax and normal Federal tax as an individual; this is one-half of the surtax he would pay as an individual and he remains liable to that surtax on the amounts distributed by the corporation as dividends.

A provision is suggested which will tend to give some incentive to corporations to make reasonable distributions, without going to the extent of forcing unwise distributions. The principle can be stated as follows:

Allow the corporation a deduction in computing net income equal to, say, 20 per cent of the excess of dividends paid over dividends received, the deduction in no case to be more than, say, 25 per cent of the corporation's taxable net income before such deduction. In the computation, no account should be taken of stock dividends.

This proposal is transmitted without approval or disapproval by the joint committee.

INSTALLMENT SALES

The present law provides that a taxpayer may report his income on the installment basis, at his option, and include in income the "proportion of the installment payments actually received in that year which the total profit realized or to be realized when the payment is completed bears to the total contract price." The regulations, based on the law and its legislative history, provide that in the period subsequent to the change from the accrual basis to the installment basis, all installment payments must be included in income regardless of the fact that such payments may have been previously reported on the accrual basis and have been subjected to tax. The law also provides that in the case of sale of real property the installment basis can not be used unless the initial payments received in the taxable year do not exceed 25 per cent of the selling price. This limitation is not applied to sales of personal property, except in the case of casual sales.

An investigation of the operation and effect of the installment sales provisions has been made, since many objections have been raised by taxpayers, especially in regard to the features of alleged double taxation and the 25 per cent limitation mentioned above.

Whenever a change of method is made, one of two alternative courses must be adopted. If profits already reported are excluded, the tax in the year of change will be seriously subnormal. If the profit is not excluded there is a certain measure of double taxation, but so long as the business remains stable or increases, the tax will still be less than if no change had been made. The burden is felt only where the business seriously declines or is abandoned. A provision which necessarily subjected taxpayers to double taxation would ordinarily be objectionable, but this objection does not seem to us to apply to an optional method which will probably not be adopted unless the advantage to the taxpayer offsets any incidental disadvantages. On the other hand, there is no substantial ground in equity for making the payment of a low rate of tax in a previous year a ground for permitting a taxpayer to return an altogether subnormal amount of income in a later high-tax year.

The double-taxation feature in the past has not, in our opinion, imposed any seriously unjust burden. This conclusion is strongly supported by the fact that the original regulations embodied this feature, yet the option was freely availed of under those regulations. The adoption of the method has always been optional. The substance of the grievance of complaining taxpayers in regard to the past in reality seems to be that under amended regulations, for a time in force, other taxpayers of the same class received much more favorable treatment. It does not, however, seem that this inequity as between taxpayers in the same class should be remedied by a further concession to the class at the expense of the general body of taxpayers. Where, however, returns have been filed and accepted on the basis of regulations more favorable than the original regulations or the present law no additional tax should, in our opinion, now be assessed by reason of the subsequent change of regulations or law.

An arbitrary limitation on real property sales similar to the 25 per cent limitation is necessary, because there is a fundamental difference between the business of a real property dealer and a personal property dealer.

There are exceptional classes of cases where the receipt of 25 per cent cash in a real-estate sale clearly does not create a substantial assurance of the subsequent recovery of the deferred purchase money and some relief in such cases is called for. Such relief might be governed by the application of the principle of article 46 of regulations 69, which provides that—

> If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold, and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the reduced basis as provided above and the amount realized therefor.

It seems desirable, however, that specific authority should be given to the commissioner to apply article 46 to cases to which it is not now being applied. It is suggested that there be added to section 212 a clause, embodying the rule above quoted from article 46 and authorizing its application wherever the obligations received by the vendor had *no fair market value determinable with reasonable certainty by the application of standards customarily accepted in business practice.*

CONSOLIDATED RETURNS

It is not uncommon in this country to find one corporation owning all or substantially all of the stock of one or more subsidiary corporations. In other cases the same group of individuals own the stock of several corporations in substantially the same proportions. Prior to the war period, at least in the first case, consolidated balance sheets were recognized as properly reflecting the position of the affiliated corporations, but no standard accounting method was generally recognized. Largely on account of invested capital computations and the danger of artificial intercompany transactions, the regulations of 1917 and the revenue acts since 1918 have recognized the principle of affiliation.

This section of the law has given trouble in the way of interpretation and administration.

While the excess-profits tax was in force, the consolidated return was indispensable as a method of preventing avoidance and evasion. Under the income tax the consolidated return renders the important service of permitting a loss sustained by one corporation to be charged against profit or net income realized by another corporation affiliated with it. Where one corporation owns 95 per cent or more of the stock of another corporation it is in accordance with both equity and sound policy to charge the loss of one against the profit or gain of the other. This beneficial feature, however, can be preserved without retaining the manifold complications and difficulties of consolidated returns and accounting. We, therefore, recommend:

1. That the consolidated return as such be discontinued or abandoned.

2. In any case in which an affiliated corporation sustains a loss for a given taxable year, such loss, with the written consent of the corporation sustaining it, may be offset or charged against the net income of any other corporation or corporations with which it is affiliated, provided that such loss be not thereafter carried forward to any subsequent year or otherwise availed of.

3. That affiliation be confined to so-called class A affiliations by repealing clause (2) of section 240(d), which provides that two or more domestic corporations shall be deemed to be affiliated if at least 95 per cent of the stock of two or more corporations is owned by the same interests.

4. That a reasonable interval of time be given affiliated corporations to adjust themselves to this change. It is suggested that these amendments should not take effect before January 1, 1929.

FEDERAL TAX LIENS

The law to-day has no provision for releasing a tax lien on the giving of a bond. There is difficulty in selling or mortgaging property subject to a Federal tax lien. If the taxpayer has no other resources from which to pay the tax, the lien may tend to deter quick collection. Moreover, in the case of real-estate dealers the lien practically stops the taxpayer's business. The general situation is objectionable particularly in certain areas which at the present time are suffering from business depression. Legislation is recommended authorizing the release of a tax lien on the giving of a surety bond satisfactory to the commissioner in an amount not more than twice the tax due.

Where an estate-tax lien is released the commissioner may issue a certificate to that effect. The certificate facilitates proof of titles and is desirable for other reasons. It is recommended that provision be made for the issuance of a similar certificate where an income-tax lien is released. It is believed that there is ample authority for such a certificate at the present time; but in view of the specific authority for estate-tax cases in section 315 (a), a similar provision relating to income-tax cases is recommended.

The law now provides that the lien shall extend to all property and rights in property owned by the taxpayer, and it does not in terms authorize the filing of a lien against specific property. It seems desirable in some cases to permit filing the lien against a particular parcel or parcels of property. If a taxpayer owns five lots of land each clearly worth $10,000, there seems to be no reason for filing a small $1,000 tax lien against all parcels. One would afford ample security. The commissioner should be authorized, where he is satisfied as to the security, to file the lien against specific parcels of real estate or other property. Where there is reasonable doubt as to the security, the commissioner should be allowed to file a general lien against all property as under the present law.

TRANSFEREES OF PROPERTY

(Section 280)

If a taxpayer transfers his property (other than by a *bona fide* sale) and thus is unable to pay a proposed additional tax, it becomes necessary to proceed against the transferee, whose liability for the tax is based ordinarily on the so-called "trust-fund" doctrine. Such transfers commonly occur in the everyday dissolution of corporations and distributions of estates, though occasionally property transfers are made for the specific purpose of evading payment of the tax.

Prior to the 1926 Act, collection procedure against the transferee (except where a lien had attached before the transfer) was by a suit at law or in equity in the Federal district court. Though section 280 does not purport to change the transferee's liability, it does introduce a new method of collection. In effect the transferee is subjected to the same collection procedure as though he were the taxpayer. A deficiency letter is sent to him, he may appeal to the Board of Tax Appeals, collection may be enforced by distraint if he does not appeal, and he is subject to jeopardy assessments.

The constitutionality of the section has been questioned and a district court in Kentucky has held it unconstitutional. (Owensboro Ditcher & Grader Co. *v.* Lucas, 18 F. (2d.) —.) The case has been appealed.

Section 280 appears to be the exclusive remedy at the present time; that is, the commissioner no longer may proceed against transferees by suit in the lower Federal courts. The docket of the Board of Tax Appeals is congested. Moreover, in certain kinds of cases it seems desirable to permit the commissioner to bring suit in the Federal courts rather than to proceed under section 280. This is particularly desirable where the transfer was made in good faith and where the liability ought to be apportioned among many transferees. It is recommended that the procedure by suit be restored as an alternative method of collection.

A transferee should have the same rights as the transferor with respect to bureau hearings, copies of returns and documents, and general administrative procedure. It is understood that at the present time the practice of the bureau is to give these rights to the transferee.

An important point of difference between collection by suit in the Federal courts and under section 280 is that under the former method the burden of proof was on the Government while in the latter it is on the transferee.

It is believed that a change should be made in the present law with respect to the burden of proof in proceedings before the board under section 280. There are two distinct elements; first, proof that there was a transfer at such a time and place and under such circumstances as to give rise to liability on the part of the transferee for the transferor's tax; second, proof that the tax was actually due and owing from the transferor. At the present time the transferee has the burden as to both elements, and this frequently works hardships which are almost intolerable. It is recommended that the burden on the first element be placed on the commissioner.

The transferee should have access to the books, records, and other evidence bearing on the transferor's liability for the tax. Existing law authorizes the issuance of a subpœna to bring these records before the board at the trial, but this does not enable the transferee properly to prepare his case. Consideration should be given to a provision authorizing a *preliminary* examination of this evidence. It is suggested that a transferee who has appealed to the board should have the right to compel the transferor or any custodian of the transferor's books, records, and documents to produce such evidence prior to the trial for inspection by the transferee, the board to be first satisfied that the evidence is necessary and that it would not be an undue burden to the transferor or custodian to produce the evidence at a time and place designated.

Section 280 is capable of harsh application, and many complaints have been received about it. Properly employed, it serves a useful purpose, particularly in cases of colorable transfers. Nevertheless, it deprives the transferee of important advantages which he would have as a defendant in the Federal courts. Chief among these is the right by appropriate process to bring the transferor and other transferees before the court so that orders and decrees as to proportional liability, contribution, and the like may be made in the one proceeding. It is recommended that careful consideration also be given to possible methods of giving these rights to the transferee before the board, and further investigation is being made as to specific methods of accomplishing this end, the results of which will be incorporated in a supplemental report.

There are certain technical matters, such as the statute of limitations in its application to section 280, which are discussed in Part III.

THE BAR OF THE STATUTE OF LIMITATIONS

(Section 1106 (a))

Prior to the enactment of the 1926 Act there was doubt as to the legal effect of the bar of the statute of limitations. Was the taxpayer entitled to recover amounts paid after the statutory period if prior thereto he owed that amount of additional tax? Was it important whether the payment after the period was made freely or under duress? These and related questions were the subject of section 1106(a). Unfortunately the section appears to contain elements of doubt which should be clarified. The principal results of the recommendations submitted is that the bar of the statute, whether against the Government or the taxpayer, shall have the same general effect as though the barred obligation had been satisfied (so far as collecting it after the expiration of the period is concerned), and that payments by either after the period shall be deemed to be overpayments to be recovered in the same general manner as an ordinary overpayment within the period. Another feature of the recommendations may be illustrated: If, within the proper time the taxpayer files a claim for refund of $300, because of a non-taxable item included in his return and if after the statute has barred additional assessments it is found that he owes $500 because of excessive depreciation, neither party should be permitted to enforce any payment from the other. This is subject to the qualifications stated under the next heading.

It is thought unwise, for administrative reasons, to distinguish between payments under duress and voluntary payments. For a more complete statement of the general problem and the recommendations, reference may be had to Part III of the report.

THE PERIODS OF LIMITATION

Under the present law it not infrequently happens that a given case is barred as to a refund or credit, though open for additional assessments or, conversely, that it is barred as to additional assessments but open for a refund or credit. It is recommended that if a case is before the Board of Tax Appeals for the determination of a deficiency (the assessment of which, if found to be due, is not barred by limitation) the taxpayer ought not to be barred from any refund or credit determined by the board in place of the proposed deficiency. Similarly, if the taxpayer, after paying the tax, brings suit in court within the limitation period for a refund, the commissioner ought to be able, as an offset, to obtain judgment for any deficiency proved by him.

Section 277 (a) (4) permits an executor or administrator to file a request for the determination of income taxes based on income received by the decedent during his life, and that the final determination of such taxes must be made within one year after the request was filed. The same privilege should be extended to the determination of taxes on income of the estate. Moreover, it is recommended that a similar privilege be extended to the principal classes of transferees within the meaning of section 280, particularly corporations about to dissolve. Much of the harshness of that section would be eliminated if the transferor's tax liability were definitely determinable one year after a request to that effect.

Section 1106 (a) of the 1926 Act, as well as that section as proposed herein to be amended, raises certain questions with respect to the effect to be given to waivers executed after the running of the limitation periods on assessment or collection. It is recommended that such waivers be not effective if executed after the running of such limitation periods.

BASIS FOR GAIN OR LOSS ON SALES BY AN EXECUTOR

Until recently gain or loss on an executor's sale was measured by the value at the decedent's death of what was sold. As a result of the decision by the Court of Claims in McKinney *v.* United States, and the denial of certiorari by the United States Supreme Court, the rule was changed so as to provide that gain or loss on such a sale would be measured as though the decedent had sold the property during his life.

The rule of the McKinney case is inconvenient, for it is often impossible to determine the decedent's cost or other basis. Moreover, as a practical matter, it results in taxing the value of bequests, devises, and inheritances as income. The old rule seems preferable, and it is recommended that it be set forth in the statute.

Section 204(a)(5) prescribes the basis when the beneficiary sells the property as the value at the time of "acquisition." Some doubt has arisen as to what is meant by the date of acquisition. The "date of death" is recommended to make the basis certain and definite.

INTEREST ON OVERPAYMENTS AND UNDERPAYMENTS

Prior to the Revenue Act of 1921 no interest was paid on overpayments and none was collected on underpayments, except in the nature of a penalty. Provisions for compensatory interest are found in the last three revenue acts. The Revenue Act of 1921 was retroactive with respect to interest on overpayments. The Revenue Act of 1926 was the first to make provision for interest on underpayments relating to years prior to 1921 (even in this case to run only from the date of the enactment of the Revenue Act of 1926).

Many controversies over the interest provisions have arisen from the dependence of the interest period upon circumstances which have no natural association with it. If there are provisions in the law which should be subject to definite and exact mathematical computation, the interest provisions should come within that classification. This has been the primary object of the investigation made of this subject.

The trend of internal-revenue legislation has been toward the payment of interest on an overpayment for the period the overpayment actually existed. The existing act ends the interest period on an overpayment refunded at the date of allowance; on an overpayment credited (unless credited against an additional assessment made under one of the last three revenue acts) the interest period is terminated with the due date of the amount against which the credit is taken.

It is recommended that the date to which interest is to run on a refund be a date determined by the date of repayment rather than the date of allowance. For reasons of Government bookkeeping and accounting, it is recommended that the Government be permitted to stop interest on a refund 30 days (but not more) prior to the date of the refund check. It is believed that this is more certain and more equitable than the present method. In some cases taxpayers now lose interest on refunds for as much as eight months.

CONGESTION AND DELAY IN SETTLEMENT OF CASES

Notwithstanding the efforts of the bureau to which reference has already been made, there still remains a substantial number of cases for the earlier years, as indicated below:

Income Tax Unit and field cases on hand October 7, 1927

Year	In Income Tax Unit	In field	Total
1917	511	86	597
1918	720	111	831
1919	1,050	146	1,196
1920	1,526	331	1,857
1921	1,655	385	2,040
1922	3,502	928	4,430
1923	11,682	12,389	24,071
1924	16,619	68,933	85,552
1925	30,321	196,900	227,221
1926	18,482	579,196	597,678
Total	86,068	859,405	945,473

There is a relatively more serious accumulation of cases on the docket of the Board of Tax Appeals. Of 29,625 cases docketed prior to June 30, 1927, 16,761 were undisposed of on that date. Appeals are coming to the board at the average rate of about 600 a month, the average rate of disposal being not much in excess of 350 appeals per month and the average number of opinions promulgated about 75 a month. The board does not have it within its power to dispose of 600 cases a month. The remedy lies in settling more cases within the bureau.

The good effect of the bureau's accomplishments in bringing the work of more recent years up to date, as already referred to, is largely impaired in the eyes of the public by the existence of the accumulation of old and important cases. This is a problem which we are convinced can be satisfactorily disposed of only by a special effort of a thoroughly competent group created preferably from within, but, if necessary, from without, the bureau.

The essentials to the effectiveness of such a group are:

1. That some of the ablest of the personnel of the bureau should be members of it or at its disposal.

2. That it should approach the cases with a desire to put an end to disputes rather than with a disposition to decide all doubtful points in favor of the Government, even though it is probable that many such decisions would be reversed on appeal.

3. If the group is to be within the bureau, it must be assured of the fullest support of the administrative officers and of Congress.

There is every reason to believe that delay in final disposition of cases results on balance in substantial loss to the Government and that, therefore, the Government would gain by a prompt disposition of pending cases and the avoidance of the delay, expense, and uncertainty of litigation. The same considerations of delay, expense, and uncertainty are powerful incentives to induce taxpayers to accept a reasonable disposition of cases. We believe, therefore, that a competent body acting in the spirit we have indicated could successfully dispose of a large proportion of the pending cases without any sacrifice of revenue and with great advantage to the tax administration as a whole. In this connection it may be pointed out that there is added reason for the Government endeavoring to settle cases without litigation where it is reasonably possible to do so, since the collection of tax is postponed while cases are pending before the Board of Tax Appeals.

A special advisory committee has recently been created within the bureau to deal with these problems, but it has not been operating long enough to enable judgment to be reached on its effectiveness. It is clearly preferable that the emergency should be met by the bureau and every assistance in the form of ablest personnel and otherwise and every encouragement should be given to the committee. With such support the committee should be able to deal with the situation effectively, and no necessity should arise for the creation of an outside "clean up" commission such as has frequently been suggested.

CLOSING AGREEMENTS

Section 1106(b) provides for the definite closing of tax cases by the execution of a written agreement making a given tax determination final and conclusive, except on a showing of fraud, malfeasance, or material misrepresentation of fact. The making of these closing agreements is hampered by a requirement in the statute that any additional tax found to be due must be assessed and paid, and any abatement, credit, or refund must be formally accepted before the agreement can be executed. The actual settlement is often reached in conference with the bureau and these formal steps require considerable additional time. As a practical result this delay tends to prevent the execution of the agreement.

The fullest possible use of closing agreements constitutes an important means of terminating tax disputes. It is recommended that the commissioner, with the approval of the Secretary, be authorized to execute the agreement as soon as the settlement is actually reached with the taxpayer, without awaiting the formal steps above mentioned. It would then be possible to establish a system by which agreements would be reached in the field, subject to proper confirmation or rejection by the commissioner, with the approval of the Secretary, within a specified or limited time. Another factor in preventing the execution of these agreements in the past has been a feeling on the part of taxpayers, which perhaps has been justified, that cases were subjected to intensive reaudit when closing agreements were requested. Practically every tax case contains certain elements which can be made the subject of difference of opinion on an intensive reexamination. The raising of fresh controversy was not, of course, a purpose of section 1106(b) and the practice no longer of course, a purpose of section 1106(b) and the department has stated that the practice no longer obtains in the bureau.

MISCELLANEOUS SUBJECTS

DEDUCTIBILITY OF ESTATE AND INHERITANCE TAXES

A State inheritance tax is deductible under existing law only by the beneficiary and an estate tax only by the executor or administrator. The distinction is troublesome and has no compensating merit. State taxes of either kind should be deductible only by the executor, except where the beneficiary can show that he has actually paid the tax from his own funds, in which case the deduction should be allowed to the beneficiary. The policy of this deduction has not been considered.

EXTENSION OF TIME FOR PAYMENT OF DEFICIENCIES

Section 274(k) authorizes the commissioner, with the approval of the Secretary, to extend the time for payment of any deficiency for a period not in excess of 18 months. The above limitation creates hardship in occasional cases and the commissioner should be given discretion with the approval of the Secretary to grant further extensions of time not to exceed one year.