

REPORT  
OF  
THE JOINT COMMITTEE ON  
INTERNAL REVENUE  
TAXATION

❧  
VOLUMES I, II, AND III  
❧

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THE COMMITTEE ON WAYS AND MEANS  
HOUSE OF REPRESENTATIVES



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CONGRESS OF THE UNITED STATES  
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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# REPORT OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION TO THE COMMITTEE ON WAYS AND MEANS OF THE HOUSE OF REPRESENTATIVES AND THE COMMITTEE ON FINANCE OF THE SENATE

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WASHINGTON, D. C., *November 15, 1927.*

The Joint Committee on Internal Revenue Taxation was established under section 1203 of the Revenue Act of 1926. The committee 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 principal duties of the joint committee are to investigate the operation and effects of the Federal system of internal-revenue taxes; to investigate the administration of such taxes by the Bureau of Internal Revenue or any executive department, establishment, or agency charged with their administration; to make such other investigations in respect of such system of taxes as the committee may deem necessary and to investigate measures and methods for the simplification of internal-revenue taxes, particularly the income tax.

The committee organized by electing a chairman and vice chairman and providing for a staff, to consist of two divisions, a division of simplification and a division of investigation.

L. H. Parker was appointed chief of the division of investigation on August 2, 1926. The personnel of the division of investigation was later increased by the appointment of G. D. Chesteen, assistant chief, an engineer, and three auditors.

Charles D. Hamel was appointed counsel for the committee and chief of the division of simplification in April, 1927. Edward H. McDermott was appointed assistant counsel. The personnel of the division of simplification consists of the chief of the division and two assistants. It was not possible to establish the division of simplification at an earlier date than that mentioned, due to difficulties encountered in obtaining the services of individuals qualified to perform the work required.

The division of investigation has functioned since August, 1926, though until recently with a considerably smaller force than it has now. The work of the division of simplification began in April of this year.

An advisory committee was appointed in April, consisting of Dr. T. S. Adams, A. A. Ballantine, George E. Holmes, George O. May, and Dr. Thomas Walker Page, the committee serving without compensation. Charles D. Hamel acted as chairman of the advisory

committee. The advisory committee has cooperated closely with the staff of both divisions of the joint committee in carrying out the work assigned to each. Acknowledgment is also made of cooperation and helpful suggestions from Middleton Beaman, Esq., House legislative counsel; Frederic P. Lee, Esq., Senate legislative counsel, and members of their staffs; Mr. Charles R. Nash, assistant to the Commissioner of Internal Revenue; E. C. Alvord, Esq., special assistant to the Secretary of the Treasury; and to other officials and employees of the Treasury Department.

The committee has dispensed with formal hearings, but informal conferences have been accorded. Constructive criticism of the internal-revenue tax system, particularly the income tax, was solicited through the press and by communications to business organizations, bar associations, societies of accountants and engineers, and others interested.

The income tax seemed to merit first consideration, since it is more important than the other internal-revenue taxes in point of revenue conferred and taxpayers directly affected.

To this report of the joint committee, submitted pursuant to section 1203 of the Revenue Act of 1926, are annexed three volumes, under one cover, as follows:

Volume I is a report prepared by the staff of the joint committee and concurred in by the advisory committee. The joint committee approves in principle the recommendations in Volume I except those relating to section 220, which it neither approves nor disapproves; and the provision relating to the expense of transfers in the field service, which it disapproves.

Volume II is a proposed rearrangement of the income-tax provisions of the Revenue Act of 1926, prepared by the staff of the joint committee, the House and Senate legislative counsel, and the special assistant to the Secretary of the Treasury and approved by the advisory committee. The joint committee approves the proposed rearrangement.

Volume III is a survey of the administration of the income and profits tax laws, prepared for the joint committee by the Treasury Department.

Respectfully submitted.

WILLIAM R. GREEN, *Chairman.*

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VOLUME I

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REPORT OF THE STAFF OF THE JOINT  
COMMITTEE ON INTERNAL  
REVENUE TAXATION

(CONCURRED IN BY THE ADVISORY COMMITTEE)

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# REPORT ON INTERNAL REVENUE TAXATION

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## PART I. GENERAL SUMMARY

Consideration has been given to the simplification of the law and its administration and to the modification of provisions in the last act which appear to operate harshly or unfairly. A complete investigation into the operation, effects, and administration of the income tax and the working out in detail of satisfactory measures of simplification is an undertaking of large proportions. The conclusions thus far formulated are not offered as a complete program for legislation but as important steps which may properly be taken at this time.

For convenience the contents of this report are summarized below :

### 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 indispensable. 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.

A single organization will promote efficiency and convenience to taxpayers in the collection of taxes for the following reasons:

(a) Better service will be rendered to the taxpayers since there would be one directing head and one office in each collection district to which a taxpayer would correspond or personally visit in connec-

tion with the assessment, collection of his taxes and audit of his return.

The following incident illustrates what happens under the present plan of organization. An internal-revenue agent makes an examination of the return of a taxpayer residing in Des Moines, Iowa. The taxpayer appeals from the recommendation of the internal-revenue agent, and it is then usually necessary for the taxpayer to make a trip to Omaha, Nebr., where the internal-revenue agent in charge is located. During the conference with the internal-revenue agent in charge, it develops that a settlement can not be reached until first-hand information is obtained, which is available only at the office of the collector of internal revenue at Dubuque, Iowa, where the taxpayer originally filed his return and paid his taxes. There is delay, expense, and annoyance, due to such situations, in numerous districts throughout the country.

This situation exists because it would be economically unsound to establish the office of an internal-revenue agent in charge in every district where we now have a collector's office.

(b) The central office at Washington will be in closer and more harmonious touch with its field organization, due to the fact that there will be one directing head in each field district with whom to conduct correspondence and to whom the bureau can look for settlement of any question that may arise. One supervisory organization operating from Washington could maintain a proper inspection of these offices. Two exist to-day. At present it is necessary to deal both with the revenue agent in charge and the collector of internal revenue before final action can be taken in the bureau. This is especially true in connection with bankruptcy cases, fraud cases, and claims for refund.

(c) A very careful study of the present organization has been made, and compared with the organization plan as recommended, and there is no doubt but that a saving of approximately \$2,000,000 per annum can be effected. At present there are 100 administrative offices in existence, and it is believed that all of the field work can be effectively performed and executed in not more than 60 consolidated offices. There is a duplication of work in the mathematical verification of tax returns. There is a duplication in the numerous records that are required to be maintained. There is duplication in the correspondence and files. Other important elements on which savings will be effected are rentals of office space, telephones, consolidation of mechanical equipment, and traveling expense.

To accomplish this purpose it will be necessary that all employees in the field service be under the civil service. It is recommended that arrangements be made to continue in the service those employees who are now rendering efficient service to the Government regardless of their age. Many employees have rendered service for years without a civil-service status, and it is not believed wise to take any action by which the Government would lose the benefit of the experience already gained by these employees. They should be given a favorable opportunity to secure the proper civil-service status. The present turnover in the service is sufficient to take care of this situation without throwing out of employment a number of people who have given years to the service.

The reorganization, to be fully effective, should be carefully and tactfully worked out, and the numerous problems involved sympathetically considered and solved. As the result of our examination of the subject, in which we have been assisted by a collector detailed by the Treasury for the purpose, we are convinced that the consolidation is desirable, and we recommend that the Treasury be requested to submit detailed plans for carrying it 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.

6. Finally, it does not seriously affect the revenue. The present reduction in tax by the earned income credit amounts in round figures to \$25,000,000 per annum. It is estimated that the reduction by the proposed method will not be increased by more than \$4,000,000.<sup>1</sup>

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

<sup>1</sup> A later estimate, based on more accurate information, shows these figures to be too small. The correct amount is about \$14,000,000.

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.*

Another very important advantage of this method consists in the fact that the full benefit of the deduction could be secured by small

corporations, which are now at a distinct disadvantage in comparison with partnerships.

If such a deduction in respect of distributed income is approved, we recommend the repeal of section 220.

### 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 subpoena 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.

### EXPENSE OF TRANSFERS IN THE FIELD SERVICE

Under a construction of existing law the commissioner is denied the right, in some circumstances, to pay the expenses of transferring employees of the field service from one locality to another. Such transfers are desirable when congestion of work exists at a particular locality, and adequate provision should be made for necessary expenses.

## PART II. SIMPLIFICATION

### RECOMMENDATIONS

1. A rearrangement of the act (as shown in Volume II hereof) is recommended, whereby all provisions of general application and interest appear in 16 pages at the beginning of the act. More liberal use should be made of catchwords, headlines, different types, indentations, and other typographical improvements in printing the act. In this connection attention also is invited to the rearranged act in Volume II. Provisions relating solely to taxes under preceding acts are no longer necessary in each revenue law and should be omitted in the interest of simplification. The preceding act should remain in force for the purpose of administering the small number of cases pending for earlier years. It should be retained in force, subject to appropriate amendments, for the imposition and administration of the estate tax and other internal-revenue taxes and these titles should be omitted in the new law.

2. It is desirable to compile a code of Federal tax administration, to contain all statutory provisions defining the powers and duties of administrative officials and general administrative procedure. At the present time some of these provisions are in the revenue acts and some in the general statutes.

3. The root of complexity, however, is in the substance of the law. Simpler basic principles are needed. Simpler administration also is vitally necessary. Provision should be made for adequate study of both of these vital problems.

### DISCUSSION OF SIMPLIFICATION RECOMMENDATIONS

#### GENERAL SURVEY OF THE PROBLEM

The problem of simplification is to eliminate complications without creating uncertainty or hardship. It is only just to those responsible for the existing law to recognize that its complexities are due largely to efforts to meet states of fact previously unforeseen, to remove inequities, or to resolve doubts as to the intent of the law.

What the committee is required by section 1203 to do, is to consider methods and measures for simplification of the *income tax*. This includes more than attempting to simplify the *statute*. If the act must be supplemented by complicated regulations, or if as practical matter administration is slow and technical, little is accomplished by a simple law. Moreover, it is self-evident that a simple law may not mean simple returns. Simplification includes all these elements of tax determination.

#### THE NATURE OF THE PROBLEM

The income tax presents two essentially different problems. 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 is necessary to keep this dual nature of the problem constantly in mind in formulating policies either of legislative or administrative simplification and recommendations have been framed accordingly.

It is impossible to make the law as a whole simple in its application to the infinite variety of business transactions without real hardship. It should be possible to make its application to the simpler forms of income readily understandable and so to arrange its provisions that the great majority of taxpayers could glean from it all that relates to their own cases without becoming involved in the very complex provisions necessary to provide for complex business transactions. Simpler means may be found in some cases for handling the inherently complicated questions and states of fact which as a rule appear in the larger cases, but this can only be accomplished by inquiry and study of these matters over a period of time. The making of such inquiry and study is recommended.

Purely formal simplification of the act need not await further investigation of the kind described. Simplification measures directed chiefly to matters of form, such as arrangement of sections, phraseology, typography, etc., are discussed below.

#### REARRANGEMENT OF THE ACT

At no place in the law can the taxpayer find a simple statement of the principles which underly the income tax. At the beginning there are a dozen pages of definitions and special provisions. Though the principles of the corporation and the individual tax are much alike, they are expressed separately in Titles II and III. The elementary provisions as to gross income, deductions, net income, credits, the making of returns and payment of the tax are spread throughout the first 50 pages. The basic provisions which apply to all taxpayers ought to be collected together at the beginning of the act. This involves a rearrangement of the law, which has been made and will be found in Volume II.

The plan of rearrangement, recommended after much consideration, is to divide the provisions into two classifications: General Provisions and Supplemental Provisions. The general provisions, appearing at the outset, are intended to cover the ordinary transactions of the great majority of taxpayers. It is believed that about 75 per cent of the taxpayers will find in these comparatively few pages of general provisions practically all the sections of interest to them.

In the main, the supplemental provisions are those applicable only to special classes of taxpayers or to occasional transactions. The rearrangement simplifies the act for taxpayers regardless of income.

#### PROVISIONS RELATING TO TAXES UNDER PRIOR ACTS

It has been the custom with each new revenue law to repeal preceding acts and to write into the new act provisions for the settlement of all the old cases. Most of these provisions are complicated. The bureau is practically current in its work. The Revenue Act of 1926 should remain in force to settle taxes for all years preceding

the first year taxed by the new act. Necessary changes relating to earlier years may be made by amendments. This harmonizes with the suggestion for the compilation of a code of tax administration which will embody the administrative provisions relating to all years.

#### ESTATE TAX, EXCISE TAXES, AND MISCELLANEOUS TAXES

It is recommended for similar reasons that all the estate and miscellaneous tax provisions of the last law be continued in force, with necessary amendments for the purpose of imposing and settling all such taxes. The result will be to make the next law purely an income tax act, and it will be free of the complications due to these titles in which income taxpayers have no concern.

#### TYPOGRAPHICAL SIMPLIFICATION

A great deal can be accomplished by the liberal use of catchwords, indentations, and varied types in printing the act. Though not heretofore used in the revenue laws, these are well-known in older forms of legislation and are effectively employed in the new United States Code. The value of utilizing these typographical aids is demonstrated by a comparison of the act as set forth in Volume II, with past acts. It is suggested that the Joint Committee on Printing be requested to authorize their use as shown in the rearrangement.

#### ADMINISTRATIVE CODE

About three-fourths of the current returns are accepted as filed. Most of the remaining fourth are settled by the bureau. The average number of appeals to the Board of Tax Appeals is about 7,200 a year, a small fraction of the total returns. The great body of taxpayers have no particular interest in the procedure of the board nor in the other administrative provisions. As a rule they become important only where counsel have been employed to carry a case beyond the bureau to the board or the courts.

There is much to commend the compilation of a code of Federal tax administration, apart from the revenue acts. Stability of administration will be encouraged; the act will be made less bulky and more useful to the great number of taxpayers who are not concerned with the legal rights and duties of the commissioner or the statutory requirements of administrative procedure. To-day the administrative provisions are distributed at various places in the revenue acts and the general statutes. There is lack of uniformity as between the income tax, the estate tax, and other internal-revenue taxes. Some provisions duplicate or overlap others. Some antiquated sections ought to be adapted to modern conditions. This should be part of the work in compiling the code. The great benefit would be to collect for ready reference at one place all statutory provisions bearing on the administration of all internal-revenue taxes.

#### PHRASEOLOGY AND EXPRESSION

Obviously formal simplification also implies simple language, economy of words, the avoidance of technical terms, and the judicious employment of general phrases where practicable, to replace unneces-

sary detail. More must be done than to read the law and attempt to express it concisely and clearly. The meaning of legislation is not in the statute by itself. Court and board decisions, regulations, rulings, accepted administrative practices, and prior legislation must be consulted and each section must be examined by itself and in its relation to others. The undertaking is a large one and every precaution should be taken to guard against fresh uncertainties and ambiguities.

#### SIMPLIFICATION OF THE SUBSTANCE OF THE ACT

Plainly, the complicated character of the body of the law operates to limit the possibilities of simplification by merely formal measures. Simplification of the substance of the law is the only way to get at the root of complication. Some of these complexities of substance may be mentioned.

*The different bases for determining gain or loss.*—Several bases for determining gain or loss are prescribed in section 204 of the act. There is one rule if the property was purchased after March 1, 1913; a second if purchased before that time; a third if it is subject to inventory; a fourth if it was acquired by gift or transfer in trust after December 31, 1920; a fifth if it was acquired by gift or transfer in trust prior to December 31, 1920; a sixth if acquired by bequest, devise, or inheritance; a seventh if acquired by exchanges of certain types; an eighth if acquired by involuntary conversion and others. Intensive reexamination of the policies underlying section 204 is needed. It may prove possible to simplify these basic provisions. Mere formal simplification does not resolve this kind of complexity.

*Credit for foreign taxes.*—Several readings may be required to grasp the purport of sections 222 and 238, which deal with the credits for foreign taxes. Each section occupies more than a page of the act. Both involve mathematical formulæ like the following from section 238:

\* \* \* The amount of such credit shall in no case exceed the same proportion of the tax (computed on the basis of the taxpayer's net income without the deduction of any income, war-profits or excess-profits taxes imposed by any foreign country or possession of the United States) against which such credit is taken, which the taxpayer's net income (computed without the deduction of any such income, war-profits or excess-profits tax) from sources without the United States bears to its entire net income (computed without such deduction) for the same taxable year.

There are similar passages in other sections. Formal measures will not simplify statements of ratios and formulæ like these. The amount of credit allowable must be computed more simply or the complication must be accepted.

*The detailed list of deductions.*—Doubtless half the disputes between the taxpayer and the Government concern the deductions which by sections 214 and 234 the taxpayer is allowed to subtract from his gross income to arrive at net income. The deductions include interest payable, certain kinds of taxes and losses, bad debts, depreciation, obsolescence, depletion, gifts, contributions, ordinary and necessary expenses, and the like. The formidable list confronts all taxpayers and each must undertake to apply the list correctly, even though gross income may consist entirely of salary and the deductions amount to nothing. This is the case with thousands of small taxpayers. Formal simplification of the deductions does not

simplify the law for such people. Simplification must go to the substance of the law. Perhaps those with negligible deductions might be given a slightly lowered rate to be applied to the gross income if all deductions are waived. It is not possible to express the substance of sections 214 and 234 much more simply than they are now expressed.

*System of a normal tax and surtax inherently complicated.*—Individuals with net income of \$10,000 or more pay not one but two taxes, computed not on one but on two different bases. There is a flat normal tax and a graduated surtax. The surtax is imposed on net income, which is gross income less certain deductions. The normal tax is imposed on a different figure; i. e., net income less credits. The confusion of deductions with credits is inevitable. The system itself must be simplified (a difficult but perhaps not impossible undertaking) or the complexity must be viewed as inevitable.

Illustrations might be multiplied, including provisions relating to interest, limitation periods, nonresident aliens, recognition of gain or loss, procedure in case of a deficiency, and others.

#### SIMPLIFICATION OF ADMINISTRATION

The determination of taxes may be complicated, though the act is simple. Regulations may be restrictive, returns abstruse, or administration cumbersome and technical. Effective simplification means making tax determination simple.

Whether or not the return is simple depends both on the statute and on administration methods. Such provisions as the earned-income credit in its present form can not be accommodated to a simple return. So long as the normal and surtax are separate taxes on separate bases, returns for those subject to surtax will be more complicated than the normal tax return. A certain minimum of information is absolutely necessary to verify the correctness of any return. The more information on the return, the less need of requesting further data or of examining books and records. The problem is to strike a proper balance. Further examination of the law and administration is needed to form the basis of recommendations which will produce simpler returns.

The underlying factor of complication in administration is the element of personnel. Unless employees have the requisite judgment, impartiality, and executive ability, decisions become faulty, the disposition of cases is delayed, appeals to the board are multiplied, and there is great loss to the Government and taxpayers alike. The improvement of bureau personnel is indispensable to the solution of difficulties of the kind described.

Inquiry into methods of simplifying the administration of the tax laws has not been completed. A considerable amount of material is being assembled bearing on this difficult problem, and this will be analyzed for the purpose of making recommendations for improvement. Attention is invited to a survey of administration prepared by the Treasury Department for the joint committee and published herewith as Volume III. The recommendations with respect to earned income, section 1106 (b), section 280, and other subjects will tend to simplify administration.

## CONSOLIDATION OF FIELD FORCES

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.

A single organization will promote efficiency and convenience to taxpayers in the collection of taxes for the following reasons:

*Better service.*—Better service will be rendered to the taxpayers since there would be one directing head and one office in each collection district to which a taxpayer would correspond or personally visit in connection with the assessment, collection of his taxes, and audit of his return.

Under the present arrangement it is the exception rather than the rule when the office of the internal-revenue agent in charge and the collector of internal revenue both being in the same city are located in the same building. In many instances the collector of internal revenue occupies space in the Federal building, while the office of the internal-revenue agent is in rented quarters. The reverse may be true in some instances where the Federal space is inadequate to house the collector of internal revenue and it is occupied by the internal-revenue agent if the requirements of the agent's office are less than that of the collector.

It is obvious that in the same city taxpayers are confronted with the situation of going to two offices to effect adjustments of their taxes. In the agent's office the amount of tax due may be determined satisfactorily to the taxpayer and then he must go to the collector's office to make payment. Taxpayers, as a general rule, are not familiar with Government procedure and can not understand why one Government official can not determine the amount of tax due as well as accept payment. The situation is more complicated in those States where there is no internal-revenue agent's office. As an example, the States of Idaho, Montana, and Utah are combined in one internal-revenue agent's division, with the office of the agent in charge located at Salt Lake City, Utah. Taxpayers in Montana and Idaho must look to the agent in charge at Salt Lake City for a settlement of their taxes and then make payment to the collector of internal revenue at Helena, Mont., or Boise, Idaho, depending upon the residence of the taxpayer. Assessments made by the bureau are received by the collectors in Idaho and Montana and occasionally controversies arise, in which case the taxpayer must appeal to the internal-revenue agent in charge or to the bureau. The collector of internal revenue, not being charged by law for the assessment of taxes, has very little, if any, information to give to the taxpayer. Their returns are considered either in the office of the agent in charge at Salt Lake City or in the bureau. If there were one office in each State, the internal-revenue official in charge would be in a position to conduct the business of collecting the internal revenue far more expeditiously and with more satisfaction to both the Government and the taxpayer. The case of the agent's division, including the States of Utah, Montana, and Idaho, is a typical one.

There are 64 offices of collectors of internal revenue and 36 offices of internal-revenue agents in charge. Attention is invited to organization chart No. 1 at the end of Volume III herein. It would be economically unsound to establish an office of an internal-revenue

agent in charge in every collection district where there is a collector's office, due to the small number of returns received, but a combination of the two offices could easily take care of the entire situation.

The following incident illustrates fairly well what transpires under the present plan of organization. This is a typical incident. An internal revenue agent makes an examination of the return of a taxpayer residing in Des Moines, Iowa. The taxpayer appeals from the recommendation of the internal revenue agent, and it is then usually necessary for the taxpayer to make a trip to Omaha, Nebr., where the internal revenue agent in charge is located. During the conference with the internal revenue agent in charge it develops that a settlement can not be reached until first-hand information is obtained, which is available only at the office of the collector of internal revenue at Dubuque, Iowa, where the taxpayer originally filed his return and paid his taxes. There is delay, expense, and annoyance due to such situations in numerous districts throughout the country.

*Central control.*—The central office at Washington will be in closer and in more harmonious touch with its field organization, due to the fact that there will be one directing head in each field district with whom to conduct correspondence and to whom the bureau can look for settlement of any question that may arise. One supervisory organization operating from Washington could maintain a proper inspection of these offices. Two exist to-day. At present it is necessary to deal both with the revenue agent in charge and the collector of internal revenue before final action can be taken in the bureau. This is especially true in connection with bankruptcy cases, fraud cases, and claims for refund.

*Duplication of work.*—Under the present plan there is much duplication of work, such as—

1. Index cards.
2. Mathematical verification of returns.
3. Filing systems.
4. Disbursement clerks.
5. Correspondence.

As an example of the duplication of work in connection with correspondence the following is a typical case: The collector of internal revenue may address a letter to the bureau requesting information relative to some assessment that has been placed on his books for collection. The bureau upon receipt of the correspondence finds that the return giving the information desired is in the files of the revenue agent in charge. It is necessary for the bureau to address a letter to the internal revenue agent, who replies to the bureau, and then the bureau can intelligently answer the collector's question.

It is obvious that a substantial saving both in time and in money would be made if there were one supervisory official in each collection district with whom the bureau could correspond to bring about a satisfactory settlement of the various problems that arise in connection with the assessment and collection of the tax. It is difficult to realize the loss in time and the cost to the Government that this duplication of work brings about, but the magnitude can be readily realized when it is considered that there are approximately 5,000,000 income-tax returns filed each year that must be mathematically verified as to their accuracy, indexed, and filed.

*Better legal advice to taxpayers.*—Probably every taxpayer in the country knows the location of the office of the collector of internal

revenue within his district. Each year the collector of internal revenue gives advice to many taxpayers. Naturally when any question arises subsequently about a taxpayer's return he expects to receive an answer from the collector of internal revenue. The features of the internal revenue laws are so intricate that it is almost impossible for one man to master them all. The taxpayer may receive legal advice from one of the collector's employees or from the collector, which is given in the best of faith. The return is filed accordingly and is sent to the internal-revenue agent for audit. The internal-revenue agent assigned to the case may place an entirely different construction on the law, and as a result either increases or decreases the amount of tax. The matter, of course, is eventually settled, but it is difficult for the Government to explain to the taxpayer why he received advice from an employee of one branch of the Government which is not sustained by another branch of the same bureau. Under a consolidated plan of organization as herein proposed there would be assigned to each office a sufficient number of employees to give advice to taxpayers and more consistent advice would be given.

*Personnel.*—At present a large percentage of the employees in the offices of collectors of internal revenue are not appointed through the medium of the civil service. Deputy collectors are appointed by the collector of internal revenue, and as a result may or may not hold their positions during the tenure of office of the appointing officer and have no assurance of holding a position under a successor.

The employees in the offices of the internal-revenue agents in charge are selected from the civil service, and as a result the positions are more or less permanent; at least they are not subject to dismissal due to change of a supervisory official.

During the past three years there was a turnover in collectors' offices of approximately 3,000 employees, or 56 per cent of the present personnel. During the same period there were 993 resignations from internal-revenue agents' force, or 25 per cent of the present personnel.

It is estimated that the cost of training an employee is approximately one-third of the first year's salary, and therefore the cost to the Government in this turnover is slightly less than \$500,000 per annum.

It is believed advisable to require that all employees enter through the medium of the civil service. If such legislation is enacted, an undue hardship may be imposed on many employees who do not at present have a civil-service status, unless some arrangement is made to give them an opportunity to obtain a civil-service status by a non-competitive examination upon recommendation made by the supervisory officials or by a competitive examination in which they will be given due consideration for meritorious service and the special training they have received at Government expense.

It is also suggested that provision be made that the age limit usually required for civil-service examinations be waived as to applicants now in the collection service. The present turnover in the service is sufficient to eventually take care of the substantial reduction in personnel without throwing out of employment a number of people who have given years to the service. It would be unwise for the Government to lose the experience gained by these employees in the service, providing, of course, their work has been satisfactory.

In view of the enormous sums of money that employees attached to collectors' offices must handle, provision should be made for bonding civil-service employees either to the Government or to the supervisory officer in charge. The supervisory officer, however, should be bonded to the Government in such sum as the Commissioner of Internal Revenue may determine.

*Appointment of the collectors of internal revenue.*—In considering the appointment of collectors, attention is invited to four methods:

1. The appointment of collectors of internal revenue by the President, with the advice and consent of the Senate.

2. The appointment of collectors of internal revenue by the President, with the advice and consent of the Senate, the nomination to be made, however, by the President as the result of selection from the civil-service register or by the selection for promotion of an internal-revenue employee.

3. The appointment of collectors of internal revenue by the Commissioner of Internal Revenue without regard to civil service laws and regulations.

4. The appointment of collectors of internal revenue by the Commissioner of Internal Revenue, selection to be made from the civil-service register or by the selection for promotion of an internal-revenue employee.

*Estimated economies.*—There were in the internal-revenue field service on September 1, 1927, 9,048 employees.

There is a chart attached to this volume which indicates an ultimate reduction in personnel of 988 employees. This number will be composed of supervisory employees, telephone operators, janitors, disbursement clerks, messengers, file clerks, and other employees occupying positions that would be merged as a result of consolidation.

There will be a better utilization of space under a single organization, a saving in mechanical equipment, telephones, filing equipment, and a large number of other miscellaneous items.

By taking into consideration all the various elements that will enter into the consolidation plan, it is believed that a saving of approximately \$2,000,000 per annum can be effected.

The proposed change would increase the efficiency by securing unified personnel, management, and control. It would reduce turnover by giving employees the security of civil service and opportunity for advancement. It would promote uniformity of administration and procedure by placing all field forces under the Commissioner of Internal Revenue. It would permit the transfer of employees from one office to another to meet emergencies. It would save rent, equipment, and reduce pay roll. It would lessen clerical and supervisory work in Washington. The records would be collected in 64 cities instead of about 100. It would eliminate a vast amount of work necessary in two separate organizations, such as the preparation of transcripts of returns and tax accounts and the conduct of correspondence between the two agencies. It would mean infinitely better service to taxpayers.

There is no way to make field administration, which plays an important part in tax determination to-day, economical or reasonably efficient so long as the present scheme is retained.

## PART III. INVESTIGATIONS OF PARTICULAR SUBJECTS

### EARNED INCOME

(Section 209)

The present Revenue Act in section 209 provides for a tax credit, between certain limits, of 25 per cent of the tax which would be payable on the earned net income of the individual if such earned net income constituted his entire net income.

This provision has been investigated both as to the propriety of taxing earned income at a lower rate than other forms of income and also as to the possibility of simplifying the present method of computation.

The principal results of this investigation are set forth in the following synopsis, and public analysis and consideration of the data presented is invited.

#### SYNOPSIS

1. The principle of taxing earned income at a lower rate than other forms of income appears to be justified in our income tax law for the following reasons:

(a) Earned income is subject to more uncertainty than is the case with income derived from capital; further, the individual expends his energy and ultimately is worn out in the production of earned income, while the unearned income from capital leaves such capital unimpaired.

(b) The acquirement of earned income on the part of the individual places him in general under expenses not borne by the individual with unearned income, which expenses are not deductible as in the case of a corporation.

(c) Since relief is given taxpayers from full taxation on income from capital, through the capital gains tax and through depreciation and depletion deductions, justice requires a proper rate reduction on earned income.

(d) The principle of taxing earned income at a lower rate than other forms of income is recognized by such countries as Great Britain, France, Italy, Belgium, and Spain.

2. The earned income provision is not generally understood by the taxpayer and causes more errors in the computation of income taxes than any other provision of the act. Investigation reveals that at least 10 per cent of all individual returns are in error on account of the earned income feature, and 20 per cent of all individual returns over \$5,000 are in error from the same cause. From the above it results—

(a) That the clerical work in audit is increased, with consequent delay and expense.

(b) That many small refunds or additional collections are required.

(c) That taxpayers are often obliged to bear the expense of technical advice in the preparation of their returns, which would otherwise be unnecessary.

3. The errors made by the taxpayers, with the consequent administrative difficulties, do not show, as has been argued, that the principle of earned income should be eliminated. These facts do show an urgent need for simplification in the method of computing the tax.

4. A method (called Method No. 2 in this report) is suggested which allows 10 per cent of the earned net income as a credit from net income in arriving at net income subject to normal and surtax in lieu of the present 25 per cent tax credit. Earned net income is not to be allowed in excess of \$20,000 or in excess of the net income. It may be said with respect to this method—

(a) That it is very much simpler than the present method, resulting in reducing the number of entries required on the return by 13 distinct items and entries.

(b) That it results in practically the same net tax to the married man without dependents as the present law effects with the 25 per cent tax credit.

(c) That it results in a slight shifting of tax from the married person with dependents to the single person without dependents, but that this small shift in the tax burden is equitable and falls on those most able to pay.

(d) That the method is practical, as the same method is used in Great Britain with success.

5. The arbitrary 20 per cent limit placed on the earnings from a business where capital is a material income producing factor, which is assumed to represent earned income, is unjust in the case of small business men.

#### RECOMMENDATIONS

In view of the above and the discussion and facts presented later it is recommended—

1. That the principle of taxing earned income at a lower rate than other forms of income be retained in future Revenue Acts.

2. That simplification of the method of computing the tax under a Revenue Act, retaining the earned-income principle, be effected by the use of Method 2, described in this report, which proposes in lieu of the 25 per cent tax credit:

*A credit against net income in arriving at net income subject to normal and surtax, equal to 10 per cent of the amount of the individual's earned net income. If the taxpayer's net income is less than \$5,000, his earned net income should not be considered to be less than his net income, and if his net income is more than \$5,000 his earned net income should not be considered to be less than \$5,000. In no case should the earned net income be allowed in excess of \$20,000 or in excess of the taxpayer's net income.*

3. That in lieu of the 20 per cent limit on earned income, provided for in section 209 (a) (1), where capital is a material income-producing factor, it be provided that such limit be increased to 50 per cent.

## DISCUSSION OF RECOMMENDATIONS

The principle of allowing a reduced rate of tax on earned income was first included in the Revenue Act of 1924. The total tax reduction effected by section 209, which embodies this principle in the present act, was as follows:

<i>Total tax credit allowed on account 25 per cent earned income provision for year 1925</i> -----	\$24, 570, 183. 00
<i>Average earned income credit per individual taxable return 1925</i> -----	\$9. 82
<i>Average net tax per individual taxable return 1925</i> -----	\$293. 68
<i>Average tax reduction (per cent)</i> -----	3. 23

From the above it can be seen that the tax reduction allowed by the earned income credit does not very seriously affect the Government revenues. In fact, it affects only about one-fourth of the reduction caused by the capital net gain tax. It must not be concluded, however, that the relief given is of no consequence, for, as shown later, the 2,375,995 individuals who have net incomes less than \$20,000 receive a 15 per cent reduction in tax through the earned income provision.

There are many general arguments in favor of a lower tax on earned income than on income from capital. The acquisition of earned income is attended with uncertainties, such as loss of health and death, which do not affect the income from capital. Further, the individual expends and ultimately uses up his energy in the production of earned income. The income from capital does not impair the principal, or if it does it is subject generally to deductions for tax purposes. One of the most practical reasons for the earned-income principle from a tax standpoint can be stated as follows:

In the ordinary case an individual with earned income incurs necessary expenses in the acquisition of such income which are not borne of necessity by the individual with unearned income. Many of these expenses are not deductible in the case of an individual as they would be in the case of a corporation. On the basic theory of "ability to pay" it is reasonable, therefore, to make an allowance in the tax on earned income as distinguished from other forms, because with the same income the expenses of the two classes are different, and hence the net residue is greater in the unearned income class.

The propriety of the earned-income principle is recognized by such countries as Great Britain, France, Italy, Belgium, and Spain. While it might be argued that this does not necessarily prove its need in our law it confirms the justice of the principle.

It is apparent that an earned-income provision of some kind has a proper place in our income tax law, and we therefore pass to a consideration of the general difficulties encountered in the administration of the present provision.

The Treasury Department has secured for the committee the opinions of 41 internal-revenue agents and collectors in connection with the present earned-income credit. These agents and collectors, who are charged with the actual administration of this provision, are practically unanimous in recommending the elimination of section 209, the earned-income provision, from future Revenue Acts.

The first ground given for such recommendation is stated typically in the following:

Section 209 has resulted in more confusion to taxpayers in the computation of their income tax than any other section of the internal revenue law. It has produced an abnormally large percentage of errors in returns, resulting in a greatly increased amount of clerical work in the audit, and therefore a material increase in the cost of collection of internal-revenue taxes.

After a careful study of the above and similar statements, it appears that the above statement is correct as to the confusion in the minds of taxpayers as to the many errors made and as to the administrative difficulties. It is not believed, however, that the above is necessarily an argument for the elimination of the provision under discussion, although it is undoubtedly an argument for its simplification.

Investigation shows that at least 10 per cent of all taxable returns filed by individuals are incorrect as a result of the earned-income provision and that 20 per cent of all taxable returns showing a net income in excess of \$5,000 are incorrect from the same cause. Simplification is desirable.

Several of the revenue agents and collectors of internal revenue make statements, of which the following is typical:

It would be much simpler and more economical if in lieu of the earned-income provision a reduction was made in the normal and surtax rates.

While there is no doubt that the elimination of the earned-income provision and a corresponding reduction in the normal and surtax rates would be simpler, exhaustive computations reveal that it is impossible to adopt normal and surtax rates which would give even substantially the same result as the present earned-income credit. These computations indicate a difference of at least 15 per cent above or below the tax computed under the present act in fairly typical cases. In fact, such a method fails to give any weight to the present policy of according a lower rate on earned income than on unearned income.

One of the common objections stated in the reports from the revenue agents and collectors is quoted from one of the reports, as follows:

Section 209 appears to discriminate between an individual with dependents as against a single individual or married individual without dependents.

A typical case of this kind was stated as follows:

A man earning \$5,000 with three dependents is allowed \$1.13, while a man earning \$20,000 a year with no dependents is allowed a credit of \$191.25.

NOTE.—The above figure of \$191.25 is evidently slightly in error.

There is not much merit to the objection that an individual with dependents is inequitably treated in comparison with a single person. It is true that the amount of the credit would at first glance lead to this conclusion, but when it is remembered that the 25 per cent credit is superimposed on a graduated tax structure, and when a comparison is made of the percentage reduction in tax to each class of individuals, it will be found that no inequity of consequence exists.

Attention is drawn to a typical case quoted from a statement of a revenue agent where inequity is said to exist between the \$5,000 man with three dependents and the \$20,000 man with no dependents. We do not think this is an inequity, for both individuals get a 25 per cent reduction in the total tax, as shown below:

*Tax computation, \$5,000 net income; all earned; married person with three dependents*

Net income.....	\$5,000.00
Personal credits and exemptions.....	4,700.00
Net income subject to normal tax.....	300.00
Normal tax at 1½ per cent.....	4.50
25 per cent earned-income credit.....	1.13
Net tax.....	3.37
Reduction in tax by earned-income provision, 25 per cent.	

*Tax computation, \$20,000 net income; all earned; single person*

Net income.....	\$20,000.00
Personal credits and exemptions.....	1,500.00
Net income subject to normal tax.....	18,500.00
Normal tax at 1½ per cent, 3 and 5.....	705.00
Surtax on \$20,000.....	220.00
Total.....	925.00
25 per cent earned-income credit.....	231.25
Net tax.....	693.75
Reduction in tax by earned-income provision, 25 per cent.	

It is obvious from the above that while it may appear from a casual examination that a tax credit of \$1.13 to the first taxpayer and a tax credit of \$231.25 to the second is inequitable, nevertheless; when the final net taxes paid after these credits are, respectively, \$3.37 and \$693.75, and each individual has had a 25 per cent reduction in tax, the supposed inequity vanishes. The \$5,000 man in this case pays about one-fifteenth of a cent tax on each dollar of net income, while the \$20,000 man pays about 3½ cents tax on each dollar of his net income.

Some of the agents and collectors appear to have the opinion which is quoted verbatim from one of the reports:

The earned-income credit extended to taxpayers is insignificant.

The above statement that the earned-income credit extended to taxpayers is insignificant is not borne out by the facts, as shown by the following statistics for the income classes noted for the year 1925:

Income classes	Tax before deducting earned income credit	Earned income tax credit	Net tax	Per cent. reduction
Up to \$5,000.....	\$18,272,294	\$4,364,014	\$13,908,280	23.9
\$5,000 to \$10,000.....	23,523,927	4,374,750	19,149,177	18.6
\$10,000 to \$15,000.....	25,635,651	3,214,859	22,418,792	12.5
\$15,000 to \$20,000.....	27,965,392	2,875,453	25,089,939	10.3
Total.....	95,395,264	14,829,076	80,566,188	15.5

It is impossible to call the earned-income credit "insignificant" when it effects an average tax reduction of over 15 per cent in the taxes of 2,375,995 individual taxpayers out of a grand total of 2,501,166 individual taxpayers.

It seems obvious, therefore, that the suggestions advanced by the revenue agents and collectors, discussed briefly above, have merit in favor of simplification of the earned-income provision but little merit in favor of its elimination.

In view of the above, it has been recommended that the policy of taxing earned income at a lower rate than unearned income be retained in some form in future revenue acts.

It is proper, now, to turn from the consideration of the propriety of the earned-income provision to a consideration of methods by which the present provision may be simplified.

After testing several proposals, a method, called Method No. 2 to distinguish it from the present method, called Method No. 1, has been devised, which meets the test of simplification and also appears to meet the test of equity. The principle of this method may be stated as follows:

*A credit against net income should be allowed in computing net income subject to normal and surtax equal to 10 per cent of the amount of the earned net income. If the taxpayer's net income is less than \$5,000 his earned net income should not be considered to be less than his net income, and if his net income is more than \$5,000 his earned net income should not be considered to be less than \$5,000. In no case should the earned net income be allowed in excess of \$20,000 or in excess of the taxpayer's net income.*

For purposes of comparison, the rules for computing the earned-income credit under the Revenue Act of 1926 will be summarized as follows:

"1. In the case of an individual the tax shall \* \* \* be credited with 25 per cent of the amount of tax which would be payable if his earned net income constituted his entire net income. But in no case shall the credit allowed under this subdivision exceed 25 per cent of his tax under section 210 plus 25 per cent of the tax which would be payable under section 211 if his earned net income constituted his entire net income.

"2. If the taxpayer's net income is not more than \$5,000 his entire net income shall be considered to be earned net income, and if his net income is more than \$5,000 his earned net income shall not be considered to be less than \$5,000. In no case shall the earned net income be considered to be more than \$20,000."

For the purpose of securing a practical understanding of these two methods, the tax computations required in the same hypothetical case will be set forth for each of these methods.

*Hypothetical case A.*—Individual A has a salary of \$10,000 and interest from mortgages amounting to \$5,000. As he has no ordinary deductions, his net income under the present revenue act is \$15,000. A is unmarried and has no dependents.

The computation of tax for this same hypothetical case is shown on the following pages for the purpose of comparison in regard to simplicity.

*Tax computation case A, present method (No. 1)*

Item		
1. Total income	-----	\$15,000.00
2. Total deductions	-----	0.00
3. Net income	-----	<u>15,000.00</u>
4. Earned net income (not over \$20,000)	-----	10,000.00
5. Less personal exemption and credit for dependents	-----	1,500.00
6. Balance (item 4 minus 5)	-----	<u>8,500.00</u>
7. Amount taxable at 1½ per cent (not over first \$4,000 of item 6)	-----	4,000.00
8. Amount taxable at 3 per cent (not over second \$4,000 of item 6)	-----	4,000.00
9. Amount taxable at 5 per cent (balance over \$8,000 of item 6)	-----	<u>500.00</u>

Item		
10. Normal tax (1½ per cent of item 7)-----		\$60.00
11. Normal tax (3 per cent of item 8)-----		120.00
12. Normal tax (5 per cent of item 9)-----		25.00
13. Surtax on item 4-----		0.00
14. Tax on earned net income (total of items 10, 11, 12, and 13)-----		205.00
15. Credit of 25 per cent of item 14 (not over 25 per cent of items 13, 22, 23, 24)-----		51.25
16. Net income (item 3 above)-----		15,000.00
17. Personal exemption-----		1,500.00
18. Balance (item 16 minus 17)-----		13,500.00
19. Amount taxable at 1½ per cent (not over the first \$4,000 of item 18)-----		4,000.00
20. Amount taxable at 3 per cent (not over second \$4,000 of item 18)-----		4,000.00
21. Amount taxable at 5 per cent (balance over \$8,000 of item 18) --		5,500.00
22. Normal tax (1½ per cent of item 19)-----		60.00
23. Normal tax (3 per cent of item 20)-----		120.00
24. Normal tax (5 per cent of item 21)-----		275.00
25. Surtax on item 3-----		60.00
26. Tax on net income (total of items 22, 23, 24, and 25)-----		515.00
27. Less credit of 25 per cent of tax on earned net income (item 15) --		51.25
28. Balance (net tax)-----		463.75

*Tax computation case A, Method No. 2*

Item		
1. Total income-----		\$15,000.00
2. Total deductions-----		0.00
3. Net income-----		15,000.00
4. Earned net income \$10,000 credit 10 per cent <sup>1</sup> -----		1,000.00
5. Net income subject to surtax-----		14,000.00
6. Less personal exemptions-----		1,500.00
7. Net income subject to normal tax-----		12,500.00
8. Amount taxable at 1½ per cent (not over first \$4,000 of item 7) --		4,000.00
9. Amount taxable at 3 per cent (not over second \$4,000 of item 7) --		4,000.00
10. Amount taxable at 5 per cent (balance over \$8,000 of item 7) --		4,500.00
11. Normal tax (1½ per cent of item 8)-----		60.00
12. Normal tax (3 per cent of item 9)-----		120.00
13. Normal tax (5 per cent of item 10)-----		225.00
14. Surtax on item 5-----		40.00
15. Net tax-----		445.00

A comparison of the computations required by the two methods above set forth shows the greater simplicity of Method No. 2.

The "present method" required 28 separate items and entries. Therefore 13 items are eliminated from the return and the chance of error correspondingly reduced. A plan which will retain the earned-income principle and be much simpler is not likely to be found.

The following chart has been prepared, entitled "*Comparison of tax computed under present method of earned-income credit and as computed by proposed Method No. 2.*"

<sup>1</sup> Not allowed in excess of \$20,000 nor in excess of item No. 3.

This chart has been divided into two tables, both of which show the tax on incomes of \$2,000 up to \$30,000 under the two methods for dependents.

Table A is for individuals with *maximum earned income*.

Table B is for individuals with *earned incomes of not over \$5,000*.

The tables follow:

*Comparison of tax computed under present method of earned income and as computed by proposed method No. 2*

TABLE A.—INDIVIDUALS WITH MAXIMUM EARNED INCOME

Net income (present act)	Earned net income	Single person (exemption, \$1,500)			Married person (exemption, \$3,500)			Married persons with 3 dependents (exemption, \$4,700)		
		Tax, revenue act of 1926	Tax by method No. 2	Increase (+); decrease (-)	Tax, revenue act of 1926	Tax by method No. 2	Increase (+); decrease (-)	Tax, revenue act of 1926	Tax by method No. 2	Increase (+); decrease (-)
\$2,000.00	\$2,000.00	\$5.62	\$4.50	-\$1.12	\$0.00	\$0.00	\$0.00	\$0.00	0.00	\$0.00
3,000.00	3,000.00	16.88	18.00	+1.12	.00	.00	.00	.00	.00	.00
4,000.00	4,000.00	28.12	31.50	+3.38	5.62	1.50	-4.12	.00	.00	.00
5,000.00	5,000.00	39.37	45.00	+5.63	16.88	15.00	-1.88	3.37	.00	-3.37
6,000.00	6,000.00	56.25	58.50	+2.25	28.12	28.50	+.38	14.62	10.50	-4.12
7,000.00	7,000.00	78.75	84.00	+5.25	39.38	42.00	+2.62	25.87	24.00	-1.87
8,000.00	8,000.00	101.25	111.00	+9.75	56.25	55.50	-.75	37.12	37.50	+.38
9,000.00	9,000.00	123.75	138.00	+14.25	78.75	78.00	-.75	51.75	51.00	-.75
10,000.00	10,000.00	153.75	165.00	+11.25	101.25	105.00	+3.75	74.25	69.00	-5.25
11,000.00	11,000.00	198.75	200.00	+1.25	131.25	132.00	+.75	104.25	96.00	-8.25
12,000.00	12,000.00	243.75	253.00	+9.25	168.75	167.00	-1.75	134.25	131.00	-3.25
14,000.00	14,000.00	333.75	361.00	+27.25	258.75	261.00	+2.25	213.75	203.00	-10.75
16,000.00	16,000.00	438.75	473.00	+34.25	363.75	373.00	+9.25	318.75	313.00	-5.75
18,000.00	18,000.00	558.75	601.00	+42.25	483.75	501.00	+17.25	438.75	441.00	+2.25
20,000.00	20,000.00	693.75	745.00	+51.25	618.75	645.00	+26.25	573.75	585.00	+11.25
25,000.00	20,000.00	1,253.75	1,235.00	-18.75	1,158.75	1,135.00	-23.75	1,113.75	1,075.00	-38.75
30,000.00	20,000.00	1,853.75	1,825.00	-28.75	1,778.75	1,725.00	-53.75	1,733.75	1,665.00	-68.75

TABLE B.—INDIVIDUALS WITH EARNED INCOME NOT OVER \$5,000

\$2,000.00	\$2,000.00	\$5.62	\$4.50	-\$1.12	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
3,000.00	3,000.00	16.88	18.00	+1.12	.00	.00	.00	.00	.00	.00
4,000.00	4,000.00	28.12	31.50	+3.38	5.62	1.50	+4.12	.00	.00	.00
5,000.00	5,000.00	39.37	45.00	+5.63	16.88	15.00	-1.88	3.37	.00	-3.37
6,000.00	5,000.00	61.87	60.00	-1.87	31.87	30.00	-1.87	18.37	12.00	-6.37
7,000.00	5,000.00	91.87	90.00	-1.87	46.87	45.00	-1.87	33.37	27.00	-6.37
8,000.00	5,000.00	121.87	120.00	-1.87	69.37	60.00	-9.37	48.37	42.00	-6.37
9,000.00	5,000.00	151.87	150.00	-1.87	99.37	90.00	-9.37	67.87	57.00	-10.87
10,000.00	5,000.00	191.87	180.00	-11.87	129.37	120.00	-9.37	97.87	84.00	-13.87
11,000.00	5,000.00	251.87	235.00	-16.87	169.37	155.00	-14.37	137.87	119.00	-18.87
12,000.00	5,000.00	311.87	295.00	-16.87	219.37	195.00	-24.37	177.87	159.00	-18.87
14,000.00	5,000.00	431.87	415.00	-16.87	339.37	315.00	-24.37	283.87	255.00	-28.87
16,000.00	5,000.00	571.87	550.00	-21.87	479.37	450.00	-29.37	423.87	390.00	-33.87
18,000.00	5,000.00	731.87	705.00	-26.87	639.37	605.00	-34.37	583.87	545.00	-38.87
20,000.00	5,000.00	911.87	880.00	-31.87	819.37	780.00	-39.37	763.87	720.00	-43.87
25,000.00	5,000.00	1,451.87	1,405.00	-46.87	1,359.37	1,305.00	-54.37	1,303.87	1,245.00	-58.87
30,000.00	5,000.00	2,071.87	2,020.00	-51.87	1,979.37	1,920.00	-59.37	1,923.87	1,860.00	-63.87

The following observations can be made from a study of the foregoing Tables A and B:

*Table A.*—On net incomes of \$10,000 and under, Method No. 2 makes a slight increase in tax on the single man (except on a \$2,000 income, where there is a decrease); it makes practically no consequential change to the married man (except a deduction of \$4.12 to the man with a \$4,000 net income), and it gives a small deduction to the married man with three dependents.

On net incomes from \$11,000 to \$20,000, the general effect of Method No. 2 is to make a moderate increase of tax to the single

man, a slight increase to the married man, and a slight decrease to the married man with three dependents.

On net incomes of \$25,000 and over there is a small decrease in tax, as in Method No. 1.

*Table B.*—In this special case Method No. 2 gives a moderate reduction in tax over the present method. On the whole, the reduction does not seem too great and is well distributed over the various classes.

A careful study of the Tables A and B and the above observations leads us to the conclusion that Method No. 2 secures results which give in general slightly more reduction in tax than the present method.

The changes made by Method No. 2 seem to be in accord with the idea of ability to pay and the earned-income principle.

For instance, in the general case shown in Table A we find Method No. 2 increasing the tax of the single man, not substantially changing the tax of the married man, and reducing the tax of the man with dependents.

It has been pointed out that the present method sometimes gives an earned income credit which cancels the tax liability. The latter part of the limitation upon the earned income credit which permits the credit to equal 25 per cent of the surtax that would be payable if the earned net income constituted the taxpayer's entire net income is responsible for this peculiar result. Because of it the credit may extinguish entirely the tax liability of an individual with earned net income over \$10,000. This is true because it permits the credit to be computed on an amount in excess of the statutory net income, since an individual, due to deductions, may pay no surtax and yet be entitled to a credit which not only equals 25 per cent of the normal tax (his only tax liability), but also that amount plus 25 per cent of the surtax which would be payable on his earned net income if it constituted his entire net income. It follows that if an individual has a small normal tax because of deductions and a large earned net income so that the 25 per cent of the hypothetical surtax on such earned net income is very large, the tax liability is canceled. This is illustrated by the following computation:

*Present method of computation*

COMPUTATION OF EARNED-INCOME CREDIT	COMPUTATION OF TAX
Earned income..... \$20,000.00	Salary..... \$20,000.00
Personal exemption and credit for dependents..... 1,500.00	Dividends..... 5,000.00
18,500.00	Total..... 25,000.00
Normal tax, statutory net income..... 52.50	Deductions..... 15,000.00
Surtax..... 220.00	Statutory net income..... 10,000.00
Total..... 272.50	Less dividends and exemptions..... 6,500.00
25 per cent..... 68.12	Statutory net income subject to normal tax..... 3,500.00
	Normal tax..... 52.50
	Earned income credit..... 68.12
	Tax..... None.

If Method No. 2 is applied to this same case, a tax of \$37.50 is found. It is thought that Method No. 2 sufficiently corrects this situation.

It is estimated under present conditions that the proposed Method No. 2 will decrease the revenue about \$4,000,000 more than the present method. This would give a total annual reduction in tax of \$29,000,000 instead of \$25,000,000 on account of the earned income provision.

To sum up the foregoing discussion of the present method and Method No. 2, it may be stated that—

1. Method No. 2 is simpler.
2. The changes in tax effected by Method No. 2 are slight and in the proper direction with respect to the principle of ability to pay.
3. That the revenue of the Government will not be seriously affected by the change.

It is recommended that Method No. 2 be incorporated into the law in lieu of the present method.

It is necessary to state one further point on which a recommendation is made. Section 209 (a) (1) is quoted in part as follows:

In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, a reasonable allowance for the personal services actually rendered by the taxpayer, not in excess of 20 per cent of his share of the net profits of such trade or business, shall be considered as earned income.

Suppose an individual taxpayer has a grocery store in which his average capital employed is \$30,000. His net profit is \$30,000. His earned net income is limited to \$6,000 under the present act. This allows an allocation of \$24,000 of the profit to a \$30,000 capital and only \$6,000 to personal service. If a fair return on capital is 10 per cent, then \$3,000 might be allocated to capital and \$27,000 allowed as earned income.

In view of the above, giving due regard to practicability, a change from the 20 per cent limit to a 50 per cent limit is suggested. Even after this change the commissioner should have the power to refuse this maximum limit in the proper cases. The effect can not be great in any case, the earned income feature being limited to a tax reduction of \$500.

*Conclusion.*—In concluding this report it is desired especially to emphasize the opinion of this committee that the earned-income principle is sound and that it should be retained or given greater effect.

If the taxes paid by individuals are compared, it will be found that the man with the \$100,000 salary pays a much larger tax than most of the individuals enjoying a \$100,000 income from capital.

Few statutory deductions can be taken against the \$100,000 salary. On the other hand depreciation and depletion deductions often distinctly benefit the man with the income from capital, especially when based on March 1, 1913, or discovery value. Moreover, income from capital in the case of capital net gains is taxed at a substantially lower rate than income from a salary.

Even the proposed method of computing the earned income deduction fails to equalize this inequity to any appreciable degree. It is recommended that further consideration be given to this difference with the purpose of adjusting the existing inequity.

## CAPITAL GAINS AND LOSSES

(Section 208)

Section 208 of the Revenue Act of 1926 provides for the taxation of capital gains at the rate of 12½ per cent and a corresponding deduction of 12½ per cent of the amount of capital losses in lieu of the inclusion of such gains and losses in net income calculations for the normal and surtax.

Three main questions with respect to the taxation of capital gains have been considered. These are:

(a) Should capital gains and capital losses be eliminated entirely from the scope of the income tax?

(b) Should such gains and losses be included in net income for the calculation of the normal and surtax?

(c) Should the present policy of taxing capital gains at a flat rate and the corresponding treatment of capital losses as expressed in section 208 of the Revenue Act of 1926 be continued?

It is thought that the first and second questions should be answered in the negative. With respect to the third question, the following recommendation is made:

## RECOMMENDATION

The present method of taxing capital gains and the corresponding treatment of capital losses should be embodied in the next revision of the income tax law.

## DISCUSSION OF RECOMMENDATION

*History of the provision.*—From 1913 to 1922 all gains from the sale of assets were subject to normal and surtax.

The Revenue Act of 1921 provided that, beginning with the year 1922, the net gain arising from the sale of property held for more than two years could, at the option of the taxpayer, be omitted from his ordinary net income and separately reported for the imposition of a tax at the rate of 12½ per cent. Under this act no reference was made to net losses from the sale of property held for more than two years.

“Capital assets” is the name given to property held for more than two years. It included any kind of property, whether or not connected with the trade or business of the taxpayer, except stock in trade or property properly included in inventory. “Capital gain,” “capital loss,” “capital net gain,” “capital net loss,” and “capital deductions” have the same specialized meaning in the statute—that is, they all refer to or appertain to the designated kind of property held for more than two years. These terms are used in their special sense throughout this report.

It should be noted that capital gains do not comprehend all gains from the sale of assets. Any profit on the sale of assets made within two years after purchase is not a “capital gain,” but comes under the term “ordinary net income.”

Under the Revenue Act of 1924 capital net losses were included in the same category as capital net gains. Such losses could not there-

after be deducted from ordinary or current income if the result was to reduce the normal and surtax otherwise payable by more than  $12\frac{1}{2}$  per cent.

The rule laid down in the Revenue Act of 1924 was carried over into the Revenue Act of 1926.

*Discussion of the provision.*—The rule relating to capital gains and losses may be stated as follows:

If the taxpayer holds certain property for more than two years it becomes a capital asset and he may elect to treat the gain on sale thereof either as subject to normal and surtax or as subject only to a tax of  $12\frac{1}{2}$  per cent. It follows that he will choose that course which results in the lowest amount of tax.

If in the same year he sells some of such capital assets at a profit and some at a loss he must offset one against the other and arrive at a net capital gain or a net capital loss. If the result is a net capital gain he may treat it as above stated; if it is a net capital loss he must do one of two things. He has no right to choose which of the two things he may do—it must be that thing which results in the larger tax. One of the things he must do is to deduct the capital net loss from his ordinary income and pay normal and surtax on the remainder; the other is to deduct  $12\frac{1}{2}$  per cent of the net loss from the amount of tax otherwise due from him.

In other words, if the taxpayer has a capital gain he may elect to report it in the way which will produce the lesser amount of tax; if he has a net loss he must report it in the manner which will have the lesser effect on the reduction of his tax.

This rule has the merit of placing capital gains and capital losses as nearly as possible on a parity so far as their effect on the tax of the seller of the property is concerned. In no case is the capital gain taxed at more than  $12\frac{1}{2}$  per cent, and in no case does the capital loss reduce the tax by more than  $12\frac{1}{2}$  per cent.

It has been suggested that the taxpayer should have the option to treat the capital loss as he pleases. Such right on the part of the taxpayer would result in a capital net loss always reducing the tax otherwise payable by  $12\frac{1}{2}$  per cent and, in cases of larger incomes, by as much as 25 per cent. There appears to be little in this suggestion to commend it.

It has also been pointed out that the taxpayer may legitimately obtain the benefit of a deduction of more than  $12\frac{1}{2}$  per cent of the loss on sale of property by selling immediately before the expiration of the two-year period, in which event the loss must be allowed as a deduction from net income, subject to normal and surtax. On the other hand, it has been pointed out, the same taxpayer may postpone selling his property until two years have elapsed in order to obtain the benefit of the lower rate of  $12\frac{1}{2}$  per cent in place of the combined normal and surtax rates.

There appears to be no data to indicate that any substantial amount of revenue is lost by reason of the alleged practices above stated. Even assuming the practices are followed to some extent, no method of correcting them presents itself. It is obvious that taxpayers can not be forced to take profits or refrain from taking profits in order to increase the revenue. In fact, it was partly from

recognition of this fact that Congress was impelled to extend a lower rate of tax in order to induce the taking of profits on transactions which might otherwise be postponed indefinitely.

Taxpayers who realize capital gains fall into two classes—(1) those who sell property not primarily purchased for purpose of resale, and (2) those who sell property purchased for the purpose of resale. In the former group fall a large number of persons who sell residences, factories, land, and investments often held for a period of many years. In the latter group fall those who buy stocks, bonds, and other property in the expectation of selling on a rising market.

From the viewpoint of the first group the capital-gains tax must be regarded as a very needful remedial provision. Their sales are often made under some degree of compulsion, such as the necessity of moving to a new neighborhood, retirement from business, settlement of interests of cotenants, etc. Where property has been held for 10 or 15 years and is then sold, the result may be the immediate conversion into cash of a relatively large profit accumulated over a long period of time. To tax that profit at graduated surtax rates, designed primarily to measure the tax on a single year's profit, is obviously unduly burdensome. If it were practicable to segregate such transactions, consideration might properly be given to their special treatment.

The second group might be divided into two subgroups—(a) those individuals who make occasional purchases of stocks or other property in expectation of increasing their capital, and (b) those who with more or less regularity buy and sell property for the purpose of making a profit; this group includes the stock-market trader, the real-estate operator, and the speculator, as well as many persons of moderate wealth or great wealth.

In considering the second group of taxpayers it should be noted that the "quick profit" made by a lucky venture where the purchase and sale take place within two years is taxed at the full normal and surtax rates. It is only where more than two years have elapsed that the lower rate of tax applies. That a lower rate of tax is proper in many cases is obvious; the lapse of time necessary before the profit is realized is the justification. On the other hand, if the taxpayer is in any event subject to a surtax in the highest bracket, year after year, the capital-gains tax is an obvious concession to him, irrespective of his ability to pay.

With respect to taxpayers of this class the capital-gains tax must obviously be regarded as an expedient provision, justifiable on the ground that it induces them to sell property which they are well able to hold for an indefinite period of time, perhaps finally to descend by bequest, devise, or inheritance without any tax having been imposed upon the increased value of the property. Such taxpayers are able to adjust their affairs to a great extent so that losses can be taken at favorable times and profitable sales postponed for long periods. As evidence of this the statistics of the Senate committee known as the Couzens committee are illuminating. The following table was compiled by that committee from the returns of 4,063 individuals who returned a net income in excess of \$100,000 each for the year 1916. The figures show the gains and losses from sales of property as reported for the years 1917 to 1924, both inclusive.

*Profits and losses on sale of assets reported by 4,063 individuals with a net taxable income of \$100,000 and over in 1916*

Year	Profits on sale of assets	Per cent profit to total income	Losses on sale of assets	Per cent losses to total deductions
1917.....	\$28,836,826	2.79	\$19,150,961	13.40
1918.....	7,937,991	.92	65,072,240	32.44
1919.....	36,687,447	3.99	124,253,174	45.90
1920.....	10,910,541	1.33	216,116,946	56.75
1921.....	10,596,216	1.57	160,121,432	48.76
1922.....	95,245,772	12.06	87,032,461	33.97
1923.....	78,345,775	9.99	101,958,153	36.71
1924.....	101,089,611	12.34	53,784,450	33.99

The following table is prepared from the returns of 75 individuals who reported a net income in excess of \$1,000,000 each for the year 1924. The table covers the years 1917 to 1925, both inclusive:

Year	Profits on sale of assets	Per cent profit to total income	Losses on sale of assets	Per cent losses to total deductions
1917.....	\$2,803,233	2.58	\$16,110,792	4.48
1918.....	1,723,990	1.87	23,955,447	22.47
1919.....	2,924,452	2.72	36,330,430	43.20
1920.....	1,243,069	1.22	42,964,016	58.00
1921.....	437,977	.44	41,459,237	49.54
1922.....	12,000,266	9.35	44,077,158	43.78
1923.....	14,732,561	11.27	40,761,119	32.39
1924.....	53,627,261	28.38	34,615,459	18.82
1925.....	62,822,952	31.07	45,230,895	19.05

The first table shows that from 1917 to 1920, both inclusive, 4,063 individuals reported gains in the aggregate amount of \$84,772,805 and losses aggregating \$424,593,321, the net result being approximately \$340,000,000 more of losses than gains. In the same period of time the 75 individuals of great wealth reported \$8,694,744 in gains and \$119,361,285 in losses.

These were years of high values and great activity in the sale of property, yet in each year the losses were greatly in excess of the reported gains. Undoubtedly the very high surtax rates forbade the taking of profits and encouraged the taking of losses. Beginning in the year 1922 a large increase in reported profits is discernible, which amounts in both tables to a substantial excess over losses in 1924, the first year in which the present method of taxing capital gains and treating capital losses went into effect. While some allowance must be made for the great prosperity enjoyed in 1924 and 1925, the statistics support the conclusion that the capital gains tax has removed the restraint exercised by the surtax rate on profit-taking.

The same trend in the relation of gains to losses is indicated in the following table prepared for this committee covering the returns of all individual taxpayers. Statistics of losses are not available and the losses stated below are estimated from selected actual figures:

*Actual profits and estimated losses on sale of assets regardless of time for which  
'such assets were held*

Year	Actual profits on sales of assets	Per cent profit to total income	Estimated losses on sale of assets	Approximate per cent loss to total deductions
1917.....	\$318,170,617	2.63	\$110,720,384	12.50
1918.....	291,185,704	1.64	571,468,120	31.38
1919.....	999,364,287	4.45	1,175,140,997	45.53
1920.....	1,020,542,719	3.82	1,680,304,149	56.87
1921.....	462,858,673	1.98	1,832,641,653	48.85
1922.....	991,351,580	3.99	1,251,989,891	35.41
1923.....	1,172,154,628	4.00	1,619,082,743	36.15
1924.....	1,513,714,092	5.12	896,906,462	22.45
1925.....	2,932,228,840	11.60	655,078,024	19.05
Total.....	9,701,571,140	-----	9,739,332,423	-----

It is pointed out that in all three tables set forth in the preceding pages the ratio of gains to total income shows a marked increase in each case beginning with the year 1922, coinciding with the introduction of the capital gains rate of tax. Although the full effect of this rise may not be attributable entirely to the reduction of the rate, it is significant that the remarkable activity of the stock markets did not take place until some time later. A fair inference may be drawn that the lowering of the rate largely contributed to bring activity in the sale of property.

The actual receipts from the capital gains tax attest to the importance of that tax in the revenue of the Government. The following table gives the figures for 1924 and 1925. For comparison the estimated receipts from the tax due to gains on property held for less than two years is included in this table:

## 1924

Actual net revenue from 12½ per cent tax on capital net gains, less 12½ per cent credit on capital net losses.....	\$39,567,328
Estimated net revenue from tax on profits from sale of assets held less than two years, minus tax reduction on losses on such sales..	20,996,000
Total, 1924.....	60,563,328

## 1925

Actual net revenue from 12½ per cent tax on capital net gains, less 12½ per cent credit on capital net losses.....	109,912,033
Estimated net revenue from tax on profits from sale of assets held less than two years, minus tax-reduction losses on such sales..	69,892,000
Total, 1925.....	179,804,033

Grand total net revenue, 1924 and 1925..... 240,367,361

The following table has been prepared for the committee to indicate the relative amount of capital net gains and capital net losses reported by taxpayers having incomes within specified ranges:

## YEAR 1924

Income classes	Number of returns	Capital net gain on sale of assets held more than 2 years	Capital net loss on sale of assets held more than 2 years	Per cent capital net gain to total income	Per cent capital loss to capital net gain
\$25,000 to \$50,000.....	47,061	\$35,595,894	\$16,112,664	1.93	45.27
\$50,000 to \$100,000.....	15,816	82,674,156	24,148,432	6.64	29.21
\$100,000 to \$150,000.....	3,065	48,649,375	10,783,568	11.07	22.17
\$150,000 to \$300,000.....	1,876	71,259,623	6,751,864	16.12	9.47
\$300,000 to \$500,000.....	457	46,101,298	5,357,512	22.60	11.62
\$500,000 to \$1,000,000.....	242	54,207,483	7,484,792	29.42	13.81
\$1,000,000 and over.....	75	50,660,650	1,647,056	26.62	3.25
Total.....	63,592	389,148,434	72,285,888	-----	-----

## YEAR 1925

\$25,000 to \$50,000.....	59,721	\$28,978,836	\$7,644,648	1.23	26.38
\$50,000 to \$100,000.....	20,958	145,191,060	14,445,432	8.93	9.95
\$100,000 to \$150,000.....	4,759	102,054,640	10,417,704	15.69	10.21
\$150,000 to \$300,000.....	3,223	164,404,256	11,949,640	22.02	7.27
\$300,000 to \$500,000.....	892	124,034,520	5,604,872	32.04	4.52
\$500,000 to \$1,000,000.....	479	139,367,194	5,436,384	37.77	3.90
\$1,000,000 and over.....	207	236,538,835	5,772,824	50.87	2.44
Total.....	90,239	940,569,341	61,271,504	-----	-----

Table I of the appendix to this volume sets forth further figures illustrating the incidence of the capital-gains tax and its effect upon the revenue.

No conclusions have been formulated based upon these figures. Several suggestions have been made and are taken under consideration with a view to further study of the problem. The problem of taxing capital gains and losses may find its ultimate solution in an elongation of the two-year period in which the property must be held. Four years has been suggested as a means of increasing the revenue from this source. But a four-year period may exercise a considerable restraint upon sales. Two transactions may now take place in approximately four years if the final profit after paying the 12½ per cent tax warrants it, while only one might be consummated if a four-year period were prescribed. The loss in revenue from the failure to make two sales might offset any other advantage.

Dividing the capital gain by the number of years during which the property was held and adding one part to the other income of the taxpayers for each of such years might bring about theoretical perfection but would raise insuperable administrative complications. Varying the rate in proportion to the maximum rate of surtax to which the taxpayer is subject on his ordinary net income seems impracticable. Therefore, notwithstanding that the present method of using a single rate results in no reduction below normal and surtax in the case of taxpayers reporting \$30,000 or less of net income and gives a constantly increasing reduction as the ordinary net income increases above \$30,000, its continuance is recommended as a practical, simple, and effective method of raising revenue until some other means not yet discovered appears with superior advantages.

It is suggested that the simplest method is to include capital gains in ordinary net income subject to normal and surtax, but that a return to this method should not be considered at this time. When the next substantial decrease is made in the combined rates of normal and surtax, consideration might be given to a return to the rule that

existed before 1922—that is, the inclusion of capital gains and losses in ordinary net income for the computation of the tax.

*Reasons for not exempting capital gains from income tax.*—The argument has been made that capital gains should not be subject to income tax. Because of the quite general impression that no tax should be imposed on gains of this character, it seems advisable to state the conclusions reached with respect thereto.

Three arguments are mainly advanced in support of the contention that no tax should be imposed. They are—

1. In principle the income tax should be confined to current income.
2. Capital gains are not taxed in Great Britain.
3. The revenue would be increased if capital gains were not taxed and capital losses not allowed as deductions.

These arguments will be considered in the order set forth above.

The principle of an income tax is set forth in the law imposing that tax. The United States has at times imposed tax only on annual income and at other times on gains of every kind. The constitutional question of the power to tax the increased value of capital and appreciation in assets when reduced to cash or its equivalent by sale or exchange has been settled by the United States Supreme Court. The principle of the existing statutes is to tax capital gains. Viewed from a theoretical or economic standpoint, many distinctions may be pointed out between current annual income and gains derived from the sale of the property producing that annual income. But no line of demarcation can be drawn so clearly as to justify taxing the income on one side and exempting from tax the gains on the other side. Some instances may be cited to illustrate this difficulty. Dividends are current income. Expected dividends are reflected in the market price of the stock. Should the profit on stock sold immediately before it goes ex-dividend be subject to no tax? Stock dividends are not taxable. Should the subsequent sale of such stock be subject to no tax? Should liquidating dividends be subject to tax on the ground that the liquidation is in part a distribution of current income? If so, should sales of stock made in anticipation of liquidation be subject to no tax? These are some of the difficult questions encountered in any discussion of exempting capital gains from tax.

Exempting capital gains from tax would afford no simplification of such subjects as depreciation, depletion, and obsolescence or would require a complete change in our principles on which those subjects are treated. Under the English law depreciation is recognized only to a very limited extent and depletion is unknown. All of the proceeds from the production of ores are taxed as income to mine owners. The wasting away of the capital investment is not recognized for income tax. The net result is the payment of income tax on the return of the original investment of capital in the guise of current income. Our system gives careful consideration to the return of capital free of tax. The English system does not.

Nor in other respects is the English method of taxing income a satisfactory model for introduction into our system. The statement that Great Britain does not tax capital gains is only partly true. Whether or not capital gains are taxed depends upon the status of the taxpayer. A corporation may be subject to tax upon the sale of its assets, depending upon the objects for which it is incorporated. An individual is taxed on sales if he is a trader in the particular

property which is sold. The definition of a trader is impossible to state with precision. Much litigation on this point has taken place in England. The distinction between trader and nontrader is not a desirable one to incorporate into our law.

The statement has been made that capital gains tend to be equalized by capital losses over a period of time. The second table set forth above seems at first place to bear this out over a period of nine years, 1917-1925. We see no argument in this, however, for if we admit that conclusion, we are still confronted with the fact that the gains and losses of each individual do not equal each other over any period of time except in rare instances. The income tax is imposed on the individual, not on income. Every gain increases his ability to pay; every loss reduces it. Regardless of the trend of gains and losses on a national scale there is a real foundation for the recognition of such gains and losses in measuring the taxpaying ability of each taxpayer. National wealth may increase, remain stable, or decrease without affecting the proposition that individuals gain or lose as a result of individual circumstances and factors independent of the general trend in values.

The capital-gains tax has produced \$149,479,361 net in revenue for the two years 1924 and 1925. The figure represents the net amount of revenue after credit has been taken for capital losses. This very substantial receipt would be lost to the Government by abolishing the tax on capital gains.

To make up this loss in revenue it would probably be necessary to increase the rates on income from sources other than capital gains. Any such increase would fall more heavily on persons who had suffered losses than on those who had enjoyed capital gains, as is illustrated by the following computations, prepared for the committee, which are based on the most favorable situation, namely, the abolition of the capital-gains tax without an increase in rates:

## TYPICAL CASE

## 1. PRESENT LAW

<i>Individual No. 1 (married)</i>	<i>Individual No. 2 (married)</i>
Salary ----- \$100,000	Salary ----- \$100,000
Personal exemption ----- 3,500	Personal exemption ----- 3,500
<u>Net income (excluding capital net gain of \$50,000) ----- 96,500</u>	<u>Net income (excluding capital net loss of \$50,000) ----- 96,500</u>
Normal tax on first \$4,000 --- 60	Normal tax on first \$4,000 --- 60
Normal tax on second \$4,000 --- 120	Normal tax on second \$4,000 --- 120
Normal tax on balance at 5 per cent ----- 4,425	Normal tax on balance at 5 per cent ----- 4,425
<u>Total ----- 5,685</u>	<u>Total ----- 5,685</u>
Surtax on \$100,000 ----- 11,660	Surtax on \$100,000 ----- 11,660
<u>Total ----- 17,345</u>	<u>Total ----- 17,345</u>
Earned income deduction --- 206	Earned income deduction --- 206
<u>Total ----- 17,139</u>	<u>Total ----- 17,139</u>
Tax on \$50,000, at 12½ per cent ----- 6,250	Credit on \$50,000, at 12½ per cent ----- 6,250
<u>Total tax ----- 23,389</u>	<u>Total tax ----- 10,889</u>

## 2. UNDER CHANGE ELIMINATING TAX ON ALL PROFITS AND LOSSES FROM SALE OF CAPITAL ASSETS

<i>Individual No. 1</i>	<i>Individual No. 2</i>
Total tax----- \$17,139	Total tax----- \$17,139

Certain studies of the subject made for the committee by the Government actuary are contained in Table II and Table II-A in the appendix to this report. These tables show:

1. Comparing the sources of income returned for 1924 and 1925 capital gains increased 142 per cent and profits from the sale of assets held less than two years 94 per cent, while all other sources of income showed a substantial decrease or a very small increase.

2. The total income returned in 1925 was 14.56 per cent below that returned in 1924. If capital gains had been exempted from tax in 1925 the total income returned would have been 17.74 below that returned in 1924. If neither capital gains nor profits from the sale of realty, securities, etc., had been taxed in 1925 then the total income would have been 27.65 per cent below 1924.

3. The elimination of the capital gains tax in 1925 would have resulted in a reduction in total tax collected from individuals amounting to approximately 16 per cent.

## EVASION OF SURTAXES BY INCORPORATION

(Section 220)

Congress has recognized from the beginning of the system of Federal income taxation that some statutory provision was necessary to prevent evasion of individual income taxes through the formation or utilization of corporations to receive the income and accumulate profits without making distributions subject to tax in the hands of the individual stockholders. The Bureau of Internal Revenue has experienced great difficulty in administering the provisions which have appeared in the various revenue acts, and it is believed that it is advisable to abandon the present statutory provision (sec. 220) and substitute therefor a simple provision, easy to apply and administer, designed to encourage distributions by allowing corporations a deduction in computing net income of a portion of the amount distributed as dividends.

A summary of the main points will be found in the following synopsis.

## SYNOPSIS

1. Some provision to induce reasonable distributions by corporations or penalize the failure to make reasonable distributions is necessary to prevent evasion of proper taxation and inequitable discrimination between taxpayers through the unreasonable accumulations of profits in corporations.

2. Although provisions designed to accomplish this result have been included in every Federal income tax law beginning with the 1913 act, the amount of tax collected directly under such provisions has been negligible and their principal value has been in inducing distributions which might not have otherwise been made. In this indirect way the provisions have undoubtedly added materially to the

revenue, but there is no way of measuring or determining such indirect effect.

3. Up to October 1, 1926, but 78 cases had been considered by the Bureau of Internal Revenue in connection with these provisions. The number of cases has been small, partly because of the inadequacy of the statutory provisions, partly because of the extreme difficulty of administering the provisions, and partly because it has been the policy of the Internal Revenue Bureau to regard these provisions as deterrent to unreasonable accumulations rather than as provisions to raise revenue.

4. In the period from October 1, 1926, to June 25, 1927, 158 additional cases have been considered by the Bureau of Internal Revenue, and it appears that the present policy of the bureau is to enforce directly section 220 of the Revenue Acts of 1924 and 1926 at least on mere holding and investment companies with few stockholders.

5. There are few published rulings of the Bureau of Internal Revenue on section 220, and there have been no court decisions or Board of Tax Appeals decisions on this section. There is therefore a lack of authoritative information as to the validity of the statute and the possibility of its effective enforcement. Five cases involving section 220 are now pending before the United States Board of Tax Appeals.

6. The incentive to the taxpayer to reduce taxes by incorporation has been greatly lessened by reason of the lower surtax rates of the Revenue Act of 1926 and the higher corporation income-tax rate. This has made the problem less serious than it was in the past.

7. A change in the act is recommended which will automatically encourage reasonable distribution of dividends without causing unwise distributions and which will make the retention of section 220 unnecessary.

#### RECOMMENDATION

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.

#### DISCUSSION OF RECOMMENDATION

A provision to prevent the evasion of surtaxes through the use of corporations was first introduced in the Revenue Act of October 3, 1913, and was continued without substantial change in the Revenue Acts of 1916 and 1918. These acts provided for an addition to the dividend income of the stockholders of a corporation which for the purpose of evading surtaxes accumulated profits beyond the reasonable needs of the business, and the taxes of the stockholders were thus determined as if the distributions had actually been made.

In the Revenue Act of 1921 the section was revised to impose an additional tax of 25 per cent on the corporation in such a case, giving an option to the stockholders to avoid this additional tax by including in their individual returns the amounts which should have been distributed. In the 1924 act the rate was increased to 50 per cent of the net income, and it was provided that for this purpose the net

income of the corporation should include dividends from other corporations, this change making the section effective where the property held by the corporation was the stock of another corporation. Under this act the stockholders were given no option. The Revenue Act of 1926 changes the act of 1924 only by giving the stockholders the option to avoid the additional tax on the corporation by including in their individual incomes the profits which should have been distributed.

The purpose of these statutory provisions was to make it difficult for a corporation to be organized or availed of in such a manner as to permit the individual stockholders to escape the income taxes which they would pay if they owned the corporate property directly or the corporation made normal distributions of profits and to secure for the Government from either the stockholders or the corporation the amount of revenue which would have been received if the management of the corporation had not been influenced by tax considerations. The earlier statutes were designed to collect directly from the stockholder the surtaxes which he would have paid if normal distributions had been made. Because of grave doubts as to the constitutionality of such provisions, the more recent acts have imposed an additional tax on the corporation itself, but, except in the 1924 act, have given the stockholders the option of avoiding the additional corporation tax by including in their individual incomes the amounts which should have been distributed. Thus it appears that it has been the primary purpose of Congress to secure for the Government the proper amount of surtaxes from the stockholders of corporations.

The inclusion in the statute of the specific reference to mere holding or investment companies was for the purpose of making sure that such corporations would be subject to the operation of the statute. It was not for the purpose of excluding any other class of corporations which might also make unreasonable accumulations of profits.

A preliminary report has been made by the staff of the committee dealing with a considerable number of individual cases which seem to require consideration under section 220. This report has been printed for the use of the Members of Congress. This report shows that up to October 1, 1926, the Bureau of Internal Revenue had considered but 78 cases in connection with these provisions of the statute. It also shows that the provisions of the 1918 and 1921 acts did not cover many cases which probably were within the general purpose which the Congress had in mind in enacting these provisions. The amount of tax actually collected under these provisions has been so small as to be negligible. It appears that section 220 was considered by the Bureau of Internal Revenue as a provision primarily effective in inducing corporations to make distributions and thus avoid the application of the statute. This policy, coupled with the inadequacy of the provisions of the acts prior to the 1924 act, resulted in the direct application of these provisions in very few cases.

The Revenue Acts of 1924 and 1926, containing the specific reference to mere holding and investment companies, and requiring dividend income to be included in the corporation net income for the purposes of these sections, have made these provisions of the statute much more effective, and this is reflected in the increased activity under these sections of the Bureau of Internal Revenue. From October 1, 1926, to June 25, 1927, the Bureau of Internal Revenue

reports that 158 additional cases have been considered—that is, more cases have been considered by the Bureau of Internal Revenue in this recent eight months' period than were considered in the preceding eight years. These new cases appear to be fairly well divided between operating companies and mere holding and investment companies.

It is extremely difficult for the Bureau of Internal Revenue effectively to enforce the provisions of section 220.

The principal difficulty arises from the fact that section 220 is necessarily vague in its terms. The test of its application (except in cases of mere holding and investment companies) is whether the accumulations of income are beyond the reasonable needs of the business. The intent of the statute on this point is clear, but the difficulty of determining the facts in most cases is extremely great. The needs of a business depend largely on the intention of its owners in regard to its development. In deciding such cases long after the event, the commissioner is called upon to substitute his business judgment as to the prospective needs of an enterprise at a given date for the current judgment of those responsible for the conduct of the business. In some industries, such as banking, the reasonable needs of the business appear to be limited only by the imagination of the directors. A more specific definition of the test to be applied which will work out satisfactorily in all cases seems well-nigh impossible. Arbitrary rules setting up certain required percentages of distribution in relation to total income or total surplus are obviously unsatisfactory because of the fact that no two corporations are similarly situated. The problem is very much more difficult than determination of reasonable salaries, reasonable allowances for depreciation, and similar problems.

The second difficulty is the requirement that the Bureau of Internal Revenue find in all cases (except in those involving mere holding and investment companies) the existence of "a purpose to" evade surtax on the part of the taxpayer. This not only involves the determination of motive or purpose which is particularly difficult in the case of a corporation since corporate action is determined by the board of directors or the principal stockholders or some of them, but involves a consideration of the various purposes which may have influenced the judgment of the various individuals who determined the action of the corporation.

A third difficulty arises in determining what constitutes "a mere holding or investment company." An actual case considered by the Bureau of Internal Revenue will illustrate this difficulty. A corporation was organized in 1916 with an authorized capital stock of \$100,000; X transferred to the company stocks, bonds, and other securities worth approximately \$3,000,000 in exchange for its capital stock. He gave most of this stock to his wife and children. In the years 1919 to 1921, inclusive, this company had profits of \$820,183.02 and the cash dividends declared were but \$50,000. The company held nothing but stocks and bonds of various corporations and municipal and Government bonds. It claimed that it was necessary for it to invest additional funds in certain companies where its interest was large and made only normal charges in its investments. The Solicitor of Internal Revenue held that it was not "a mere holding company" and that its gains and profits had not been accu-

mulated beyond the reasonable needs of the business in any of the years in question.

A fourth difficulty in applying section 220 arises from the fact that the Bureau of Internal Revenue does not automatically receive the necessary facts to determine whether or not the section is applicable. The income-tax returns do not show the nature of the investments held by the company, nor do they show what the reasonable needs of the business are considered to be by the corporation management. This difficulty could be remedied to some extent by the use of a special questionnaire to be sent to taxpayers, but essentially every case is one requiring special investigation.

There is an entire lack of published rulings and decisions in regard to the application and interpretation of section 220. No cases on this subject have reached trial before the courts or the Board of Tax Appeals. Up to October 1, 1926, only two cases involving the question had been docketed with the Board of Tax Appeals and but three additional cases have since been docketed.

It is thus apparent that the administration of section 220 is an inherently difficult problem, and there appears to be no method by which these inherent difficulties can be satisfactorily overcome.

The present section imposes an additional income tax of 50 per cent on the corporations coming within its provisions. The maximum surtax on individual incomes is but 20 per cent, so that the maximum amount of additional revenue which the Government would have received if reasonable distributions had been made would be a 20 per cent surtax on the distributions to stockholders. The maximum individual normal and surtax rates combined aggregate 25 per cent. The corporation tax is  $13\frac{1}{2}$  per cent. The loss of revenue resulting from the receipt and accumulation of income by a corporation rather than by an individual can not, therefore, exceed  $11\frac{1}{2}$  per cent. The penalty on the corporation for unreasonable accumulation of income is thus out of proportion to the loss of revenue to the Government and takes on much of the aspect of a penalty rather than a tax provision. The lack of proportion between the penalty and the loss of revenue may as a practical matter lead to nonenforcement of the provision, and this is an additional objection to the retention of section 220 in its present form.

In recent years the opportunities for evasion of taxes through the use of corporations have been greatly diminished, first by reason of the reduction in surtax rates, and second, by the prevention of the opportunity of realizing the income unreasonably accumulated at a low cost in taxes. When the corporation income-tax rate was but 10 per cent and the maximum individual surtax rate was 65 per cent, there was a much greater inducement to make unreasonable accumulations of profits than there now is when the corporation income-tax rate is  $13\frac{1}{2}$  per cent and the maximum surtax rate is but 20 per cent. Furthermore, under some of the earlier acts the stock of a corporation could be given to a near relative and resold without tax, except on the difference between the value on the date of the gift and the amount realized on the sale, so that it was possible in effect to take over the unreasonable accumulated profits without substantial tax liability. Under the present act when property acquired by gift is sold the taxable income is measured by the difference between the cost of the stock to the donor, and its selling price and the accumu-

lated profits when realized by such a sale have been subjected to the corporation income tax of 13½ per cent, and in large cases to a tax at 12½ per cent on the capital gain, a total tax of 26 per cent, which exceeds the maximum normal and surtax rates on individual incomes. By reason of these changes in the statute there is a tendency on the part of some who in the past have formed personal corporations in order to save taxes to disincorporate for the same purpose, particularly where as in New York the State tax rate on corporate income is greater than on individual income. These changes in the relative burden of taxation on corporations and individuals have greatly reduced the seriousness of the problem which section 220 was designed to solve.

It may be helpful to consider the experience of Great Britain in connection with the subject of supertax avoidance by incorporation. The British finance act of 1922 included a provision somewhat similar to section 220 of the Revenue Act of 1918. It provided that any company organized after April 5, 1924, which was under the control of five persons or less and did not have more than 50 stockholders, and which did not make a reasonable distribution of profits, would lay its stockholders open to the imposition of the supertax as if such proper distribution had been made. This provision applied only to what is classified in Great Britain as "a private company." Mr. Mitchell B. Carroll, chief tax section, division of commercial laws, in an article entitled "British finance act of 1927 makes radical changes in the tax system," published in Commerce Reports of August 29, 1927, said:

The provision in the 1922 act proved ineffective because of the opportunities which it offered for circumvention.

Only 550 of the 40,000 companies subject to the 1922 act were subject to investigation during the last four years—an average of 135 a year. The inland revenue claimed surtax in 250 cases, and of that number 128 were appealed to the special commissioners. That body decided in favor of the taxpayer in 60 cases and against the taxpayer, in whole or in part, in 69 cases. Only 11 cases were carried to the board of referees, which decided 5 cases in favor of and 6 against the taxpayer.

The finance act of 1927 considerably broadens the scope of the act of 1922 and provides for a procedure of investigating the avoidance of supertax through incorporation, which is expected to be considerably more effective than formerly.

It can thus be seen that although Great Britain has considered twice as many cases on this point under its 1922 act as we have under all our acts, and has assessed and collected the tax in about 198 cases, as compared with a negligible number assessed by our Bureau of Internal Revenue, nevertheless Great Britain considers the provisions of the 1922 act unsatisfactory, and has taken means to make such provision more readily applicable in the present finance act.

Unfortunately, on account of the different classification of companies in England, and their different system of tax administration, investigation indicates that it is not possible for us to adopt the British system.

The British system can be summed up as follows:

1. The procedure is to tax stockholders as if the profits had been distributed, a procedure formerly embodied in our law but abandoned on constitutional grounds, which, of course, do not arise in Great Britain.

2. The provisions are restricted to a special class of companies, companies in which the public is interested being expressly excluded.

3. Notice of a proposed assessment must be given currently and the issue is then presented promptly to an independent board of referees, whose decision on the question whether there is a *prima facie* case under the statute is conclusive.

The problem in Great Britain is somewhat different from our problem. There the rate of tax on corporations and the normal rate on individuals are the same. Their surtaxes are higher than ours. Their capital gains are not taxed at all. The problem is, therefore, a much more serious one for Great Britain than it is for the United States.

The British plan has the desirable features of reasonableness of tax or penalty, expeditious determination of liability, and limited application to restricted and well-defined classes of companies, but there seems to be no way in which the British procedure could be adapted to meet our problem without departure from our present general scheme of administration.

In view of the inherent difficulty in enforcing section 220, the undesirability of having provisions in the statute which are not generally enforceable nor enforced and the decided change in the importance of the problem because of the reductions in tax rates and the special provisions of the statutes preventing realization on the unreasonably accumulated profits without payment of adequate taxes, it has been thought desirable to find some plan which would automatically encourage reasonable distributions on the part of corporations and discourage unreasonable accumulations and make it possible to repeal section 220.

The principal methods of accomplishing the desired result which have been considered are as follows:

*Undivided profits tax.*—One method of automatically accomplishing the desired result is the so-called "undivided profits tax." While this method has long been known and considered, it has been advocated in such various forms that a complete discussion can not be attempted here.

The general basis of such a tax is the imposition of a tax on the undistributed earnings of a corporation in addition to the usual income tax. Such a method may or may not contemplate the exemption from further tax of such earnings when ultimately distributed.

The most obvious objection to such a tax is the burden which it places on legitimate and proper business expansion. As a business expands not only does its plant and property increase but a larger working capital is required and it is desirable that reasonable accumulations of profits necessary for the expansion and stability of corporations should not be unduly burdened. A tax placed only upon the unnecessary accumulation of capital instead of upon the total accumulation involves many of the difficulties inherent in section 220 and is certainly an impracticable solution of the problem. It is believed that a tax on the total accumulation of profits by corporations is not desirable, because in many cases it might cause the making of unwise distributions and prevent the accumulation of a reasonable and proper surplus.

*Taxation of dividends to the recipient.*—Another method, which would prevent any large amount of tax evasion by incorporation,

would be to allow the corporation to deduct from taxable income the full amount of dividends paid during the taxable year in cash or in property and to tax such dividends to the stockholders at the full normal and surtax rates.

This would, of course, be a fundamental change in the structure of our present Revenue Act and should not be made without careful study. There might be noted as objections to such a method:

1. It would decrease the total revenue because much income now subject to the corporation income tax would be distributed to individuals paying a low rate of tax or no tax at all. Such a plan, therefore, requires a general readjustment of tax rates.

2. It would probably increase the difficulties of collection, since there would be many small sums to be collected from the many stockholders instead of large sums from the corporations.

3. It is open to the same general objection as an undistributed earnings tax since it might encourage unwise distributions.

There can be claimed as advantages for such a method:

It would be an automatic check on evasion of surtaxes by incorporation as there would be a tax, otherwise not payable, remaining on the income which the corporation did not distribute.

It would go far to make possible an important simplification of the tax law, for if dividends were taxed on the same basis as other income means might be found whereby the present normal and surtax rates could be combined into one graduated scale of rates for individuals.

*Partial deduction for corporations on account of cash dividends.*—

A third method, and the one which is recommended, is to 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 this computation no account should be taken of stock dividends. This method appears to be of such a nature that it can readily be applied to the present structure of our revenue act.

An illustration will show how this plan would operate:

If a corporation having a net income of \$1,000,000 distributes cash dividends of \$500,000, it will get a deduction of 20 per cent of \$500,000, or \$100,000. The taxable net income will then be \$900,000 instead of \$1,000,000, and the tax at 13½ per cent will be \$121,500 instead of \$135,000, a saving in corporate tax of \$13,500. The effect upon the corporation income-tax rate will, of course, depend upon the proportion of income distributed as dividends. Based on the present corporation income-tax rate of 13½ per cent, this would result as follows:

	Per cent
If total net income is distributed, the tax would be equivalent to that produced by a present tax rate of-----	10. 80
If one-half of the net income is distributed, the tax would be equivalent to that produced by a present tax rate of-----	12. 15
If no distribution is made, the tax would be equivalent to that produced by a present tax rate of-----	13. 50

This method would afford a means of relief to the small corporations owned by individuals with small incomes, which at present bear a burden which is very heavy as compared to the tax burden on similar enterprises which are unincorporated. The stockholders of

such corporations, by causing the entire profits to be distributed and reinvested if needed in the business, could secure the maximum benefits of the section.

Stock dividends, which are not in fact distributions of income should not, of course, be a factor in computing the deduction. Only distributions in cash or in property should be used in determining the deduction.

Since dividends from domestic corporations are not included in corporate net income, it is necessary to provide that the deduction shall be based only upon the excess of dividends paid over dividends received and consideration should be given to excluding dividends paid to corporations.

By limiting the deductions to 25 per cent of the net income, corporations would be prevented from gaining undue advantage through making large distributions in years in which a large amount of income was received.

The advantages of the proposed method may be summed up as follows:

1. It would be an incentive to corporations to make a reasonable distribution of profits in order to reduce corporate taxes and would to that extent take care of the situation which the present section 220 is designed to meet.

2. While to a considerable extent of the same nature as a tax on undistributed profits, this method is unlikely to cause unwise distributions from a business standpoint if a reasonable rate of reduction on account of the dividends is provided for.

3. It would afford a means of considerable relief to the small corporations owned by individuals with small incomes which are now bearing a disproportionate tax burden.

4. It would remove any inducement to declare stock dividends for the purpose of avoiding the application of section 220.

5. This method sets forth a simple rule, easy to apply and administer.

It is recommended that this method be adopted and that section 220 be eliminated from the statute.

The following information in regard to the net income and cash dividends of corporations reporting taxable incomes for 1925 is important in the consideration of this problem:

Net income.....	\$9, 583, 683, 697
Dividends paid in cash.....	4, 817, 301, 320
Accumulated income.....	4, 766, 382, 377

It thus appears that in 1925 approximately one-half of the net income of corporations was distributed to stockholders in cash or property. The accumulated income retained in the business was undoubtedly necessary for the expansion of the business or other reasons in the great majority of cases, but raises a doubt as to whether section 220 has in fact been fully effective.

*Conclusion.*—The conclusion has been reached that the present section 220 is obscure and inherently difficult of administration and largely ineffective. It is therefore desirable to replace this provision by some method which will automatically prevent tax evasion by means of incorporation and which will be easy to administer. Such a method is suggested in this report and is believed to be sound.

## INSTALLMENT SALES

(Section 212(d) and 1208)

Investigation of the installment sales provisions of the Revenue Act has been made on account of certain criticisms of these sections by taxpayers rather than on account of any apparent difficulties in the way of the effective administration of the present statute.

## SYNOPSIS

1. There has been a widespread increase in installment sales during the past few years until such sales are now estimated at the amount of \$6,000,000,000 per annum. In connection with such installment sales, it came to be realized that the ordinary merchant's system of accounting failed to properly reflect the true net income, due to the fact that the sales price is not even approximately the equivalent of cash for the year of sale and that certain expenses in connection with these transactions are postponed to a year subsequent to the year of sale. To fill this apparent need in accounting systems, the installment method of reporting income was evolved and has now become recognized throughout the country as a proper method of reflecting the true net income from this type of transaction.

2. An investigation of individual cases shows that while there have been some technical disputes, on the whole the present provisions have caused no serious administrative difficulty.

3. The principal criticisms which have been directed at the provisions appear to be based on considerations of equity, and may be classified and briefly discussed.

(a) *Double taxation.*—The double-taxation feature, while not strictly equitable is justifiable. In the first place, the installment basis has always been optional with the taxpayer. In the second place, the change appears generally to have been beneficial to the taxpayers in spite of the double-taxation feature. Finally, the difference in rates applicable to the taxable years in the past gave the taxpayer an unreasonable advantage when by changing his basis in a high tax year he was enabled to reduce his taxable income to a figure far below his true income computed on any consistent basis. This was the effect of the regulations with double taxation eliminated.

(b) *Inequity in closed cases.*—While, as stated, considerable advantage generally accrued to the taxpayer in changing from the accrual to the installment basis, even with the double-taxation feature included in the regulations, those to whom the regulations without this feature were applied derived an additional benefit which was often of great magnitude. They were not equitably entitled to this additional benefit, and there is no reason why a similar benefit should be extended to those who in the past were denied it. On the other hand, it is undesirable now to open up cases in which the benefit was granted in accordance with regulations in force at the time. To open up a large number of closed cases is no more required in this instance than it would be in hundreds of cases closed on bases at variance with later Board of Tax Appeals and court decisions. Retroactive legislation and reopening of cases must be avoided if the

bureau is to accomplish the much-to-be-desired object of disposing finally of old cases.

(c) *Twenty-five per cent limitation on real-property sales.*—There are essential differences in the business and accounting methods of the personal-property dealer and of the real-property dealer which make the 25 per cent limitation reasonably appropriate in the one case though not in the other. There are, however, certain types of real-estate sales in which it is unreasonable to tax as income the whole difference between cost and selling price, even though 25 per cent of the latter has been collected. These cases can best be dealt with by a reasonable extension of the principle of applying proceeds against cost until the latter is recouped, leaving the whole of further receipts to be taxed as income.

(d) *Arbitrary definition of "initial payments."*—From the standpoint of logical classification of sales it is obvious that a definition based on terms of the contract would be more correct than the existing rule based on the payments within the taxable year. It seems necessary, however, if evasion is to be prevented, to treat payments made within a limited period of the sale as initial payments, and there is probably little to be gained by rescinding the existing rule and substituting another which must still be arbitrary.

#### RECOMMENDATIONS

In view of the above and of the discussion which follows the following recommendations are made:

(1) No retroactive legislation should be attempted in regard to installment sales except to validate settlements made under regulations in force at the time of settlement.

(2) The 25 per cent limitation on the purchase price should be retained in case of casual sales and sales made by dealers in real property.

(3) Specific authority should be granted to the commissioner to determine the taxable income on the basis of applying receipts against the basis of property sold until that basis has been recovered, and tax all further receipts as income in any case in which he finds that obligations received on the sale have no fair market value determinable with reasonable certainty by the application of standards customarily accepted in business practice.

#### DISCUSSION OF RECOMMENDATIONS

Selling on the installment plan, though only of recent prominence and present wide usage, is, nevertheless, long established as a manner of doing business. Building and loan associations have had a recorded and prosperous existence of at least 75 years. This type of association deals largely in extending credit facilities to purchasers of real property on the installment plan. Items of personal property have been offered for sale on the installment plan at a time even antedating real property sales on the same basis. Indeed the origin of the system of installment buying along modern lines may be traced to personal-property sales. For instance, pianos, encyclopedias, and other commodities having durability and life for

a sustained period of at least several years have been sold on the installment plan for practically an entire century.

Until recent years installment selling constituted but a small fraction of the business of the country. When, in the period between 1910 and 1915, the automobile industry evolved a plan of selling automobiles on the installment basis a new era began. Growth was phenomenal. It was found an expedient method of selling after the World War, in so far as it stimulated business at a time when plant facilities for the making of automobiles were in excess of the existing demand for them.

The character of goods bought on the installment plan, in the order of volume of sales of each as taken from the best obtainable sources for the years 1925 and 1926, is as follows:

- |                         |                             |
|-------------------------|-----------------------------|
| 1. Automobiles.         | 8. Jewelry.                 |
| 2. Household furniture. | 9. Clothing.                |
| 3. Pianos.              | 10. Tractors.               |
| 4. Sewing machines.     | 11. Gas stoves.             |
| 5. Phonographs.         | 12. Electric refrigerators. |
| 6. Washing machines.    | 13. Vacuum cleaners.        |
| 7. Radio sets.          | 14. Farm equipment.         |

To-day it is estimated that approximately \$6,000,000,000 of goods are sold at retail annually on the installment plan. This amount constitutes about 15 per cent of all goods bought at retail. As a result of separate investigation by the economic policy commission of the American Bankers' Association, the National Association of Credit Men, and the National Association of Finance Companies, it has been quite reliably established that at the present time the amount of the installments outstanding at any date is probably \$2,750,000,000. Of this figure, \$1,500,000,000 constitutes the outstanding indebtedness on automobile sales. A clearer visualization of the extent of installment buying in certain industries may be obtained from the fact that 75 per cent of all automobiles (considered with respect to value) are sold on the installment plan, 85 per cent of all furniture, 80 per cent of all phonographs, 75 per cent of washing machines, 65 per cent of vacuum cleaners, and at least 25 per cent of all jewelry, pianos, clothing, radios, and electric refrigerators.

Enough has been said to indicate the importance of the installment method of doing business; it is also quite clear that in the ordinary case of an installment sale the obligation of the purchaser is not the equivalent of cash. It follows that on such a sale there is not a gain realized equal to the difference between the cost of the goods sold and the nominal sale price. A method of accounting which would avoid the error of treating the difference between the cost of the goods sold and the nominal sale price as income at the time of sale was, therefore, imperatively called for by section 212 of the act of 1918, which provided that returns should be made on such a basis as would clearly reflect income. The view sometimes expressed that Congress in the 1918 act recognized two and only two methods of accounting finds no support in the language of the act. On the contrary, the intent of Congress was clearly to give the commissioner proper latitude to accept standard methods of accounting which resulted in a fair reflection of the income of the taxpayer. This intention has been recognized in all regulations since issued (art. 28

of Regs. 45, 62, and 69), but has frequently been ignored or overridden in practice and in some decisions of the Board of Tax Appeals.

Recognition of the propriety of a special method of accounting for the installment sale business had been given by the commissioner prior to the passage of the 1918 act, in a Treasury decision and in Regulations 33, revised, promulgated January 2, 1918. Article 42 of Regulations 45, issued April 17, 1919, laid down the rules to be followed under the 1918 act, and, except as regards the accounting in the period of transition to the prescribed method, that regulation has remained substantially unaltered.

The validity of the main features of that regulation does not seem open to serious question. The Board of Tax Appeals, however, in the case of *B. B. Todd, Inc.* (1 B. T. A. 762), used language that suggested that the board held the contrary view, and section 212 (d) of the act of 1926, and section 1208, applying the rule retroactively, were inserted in the law to eliminate any uncertainty. The chairman of the Senate Finance Committee, speaking for the committee in the Senate, said:

While the committee believes that the 1919 installment regulations were a proper interpretation of the existing law in determining net income, because of the confusion now existing, it is deemed advisable to make the amendment precise in the interest of certainty.

The *Todd* case, above referred to, arose under the 1921 edition of Regulations 45, which differed materially from the regulations of 1919 in respect to the accounting in the period immediately following the transition. The regulations issued in 1919 presented a method of determining income that was consistent in its treatment of transactions in course of completion at the beginning and at the end of the year, but was open to the objection that it resulted in the taxation of income which had already been taxed. The 1921 regulations, under which the *Todd* case arose and which were criticized by the board in that case, involved no double taxation, but admittedly did not result in a consistent treatment of items overlapping from one year into another, or in a correct reflection of income in the period immediately following the adoption of the new method.

Taxpayers concerned have strenuously insisted that the 1921 regulations should be adhered to, and that consistency in the computation of income should be sacrificed, if necessary, in order to avoid double taxation.

In considering this question from the broad standpoint of equity it is important to note that the right to adopt the installment method has always been optional, and existed in 1917, the first year of high war taxes. It is also pertinent that changes to that basis were freely made while double taxation was a feature of the regulations governing the accounting in the transition period. It appears also that the exclusion from taxation in the year of transition of both gross income reported on the old basis in the prior years and gross income which would have been reported on the old basis in the current year left the remaining gross income in many cases so small that the transition year showed a loss and the taxpayer thus entirely escaped taxation for that year, which was usually a year of high war taxation. No consideration of equity seems to require or even to justify such an extremely favorable treatment.

The question was presented to Congress when the revenue bill of 1926 was before it, and though neither section 212 (d) nor section 1208 dealt specifically with the question whether the regulations of 1919 or those of 1921 were to be applied, the report of the conference committee to the Senate contains the explicit statement that—

In the application of this provision it is intended that the installment provisions of Regulations 45, promulgated on December 25, 1919, will be substantially followed in settling all cases under prior acts and under this bill.

The House conference report is to the same effect. We see no reason for a change in this position. It may be said that with taxes reduced and more nearly uniform the objection to giving relief from double taxation is lessened. Equally, however, the need for any option or change of method is lessened. There is little reason why corporations should to-day be contemplating a change to the installment basis unless their installment business is new or for the first time assuming real importance, and in such cases the double taxation will not be serious and there will still probably be a tax advantage in the change in spite of it. Corporations which have been in the installment business for a number of years should have made their election before now and certainly should not be offered a substantial inducement to adopt a method they have hitherto declined to adopt. We see no reason, therefore, to change the existing rules covering the period of transition either for the past or for the future.

There are a number of cases in the bureau which had been closed on the basis of the regulations as revised in 1920 by the elimination of the double-taxation feature, and the bureau appears to feel that it is its duty under the act of 1926 to reopen these cases and redetermine the tax. It is very clear that such reopening is inexpedient and unnecessary and it is suggested that in the next revenue act proper provision should be made that where returns were filed and accepted under regulations in force and the cases have been closed the cases should remain closed and no attempt should be made to collect additional sums from the taxpayers in respect of the years covered by such returns. The war taxes were bound to operate with some inequitable results, and it is impossible now to remedy all such inequities. The need now is to dispose finally of cases for those years, and the bureau should not, in general, be required, nor should it undertake except in case of fraud, to reopen cases once disposed of in accordance with existing regulations.

Section 212(d) of the Revenue Act of 1926 sets up a distinction between dealers in real property and dealers in personal property, in so far as granting them the installment basis is concerned, to the effect that while the installment basis is allowed dealers in personal property without consideration of the extent of initial payment, it is allowed dealers in real property only if the initial payment does not exceed 25 per cent.

Considerable criticism has been leveled against this restriction as affecting real property dealers on the grounds of (1) inequality, in that the basis should not be different for dealers in real property and dealers in personal property, and (2) hardship, in that the denial of the installment basis, because of the 25 per cent limitation, produces a situation where cash is not available with which to pay taxes on the completed sales.

A distinction between the ordinary dealer in real estate and the ordinary dealer in personal property is clearly warranted, and, in fact, necessary to the effective administration of the income tax law. The vendor of real estate who takes 25 per cent of the sale price in cash is usually fairly assured of the ultimate collection of the balance and apart from tax considerations can afford to allow the balance to be secured by mortgage and paid over a long period of years. If at any time he should desire to turn the deferred obligation into cash, he would be in a position to do so at relatively small sacrifice. If he were given the added incentive that by so postponing the collection he could postpone payment of tax on his profit, the result would inevitably be that collection and payment of tax would be deferred in a large percentage of cases. In the case of the ordinary installment-sale dealer in personal property, however, the risks are usually such that the taxpayer can not afford to lengthen the period over which collections would be spread in order to postpone the tax.

There are, however, certain classes of real-estate transactions which are subject to as great uncertainties as installment sales of personal property, and, indeed, to even greater uncertainty. Examination of cases relating to speculative land projects, such as some undertaken in recent years in Florida or in the Muscle Shoals region of Alabama, shows that the gross profit, if the proceeds of sale are collected in full, frequently runs from 50 per cent to 200 per cent, or even 300 per cent. The sales are consummated on what is ordinarily known as open-sales contracts, requiring some payment down and the balance over four to six years in periodic installments. In the case of the Muscle Shoals dealers, no mortgages were taken, the contract of sale merely providing that payments were to be made at stipulated times, and that in the event of default the property could be taken back by the vendor.

In such cases it is clear that the obligations received from purchasers are not equivalent to cash in the amount of their face value any more than are such obligations received from the purchaser of personal property sold on the installment plan. The remedy, however, does not appear to be the elimination of the 25 per cent limitation for all real-estate dealers, nor even for dealers in this highly speculative class. It is apparent, for instance, that the application of the installment method of accounting to many Florida real-estate ventures would result in the taxation of profits which were never in fact realized.

The conclusion has been reached that the most effective and just form of relief in such cases would be the adoption of a rule under which the proceeds of sale may be applied first against the cost until the cost has been recouped, all subsequent receipts being treated as income. Such a method of accounting is recognized in article 46 of the existing regulations, but in that article it is made applicable only where obligations received have no fair market value, and in practice the regulation has been given a very limited application. The bureau has, in general, insisted that obligations received (unless they are worthless) have some value and must therefore have a fair market value.

In earlier statutes Congress recognized that property may have a value and yet not have a fair market value that is determinable with a sufficient degree of certainty to warrant making it the basis for

the computation of a tax, and laid down rules for taxation to meet such cases. In the act of 1918 it provided that property received in exchange should be treated as the equivalent of cash to the amount of its fair market value, *if any*; in the 1921 act provision was made that on an exchange no gain or loss should be recognized unless the property received in exchange had a "readily realizable market value."

It seems to us that these provisions properly applied would have afforded any necessary relief in the more speculative class of real-estate transactions, and we recommend the reinsertion of provisions of somewhat the same general import in the new revenue law. In order to overcome the apparent reluctance of the Treasury to apply such methods, we suggest that the language employed should be amplified; specifically, it is proposed that the commissioner should not treat obligations received from the sale of property as the equivalent of cash unless such obligations have a fair market value ascertainable with substantial accuracy by the application of standards customarily accepted in business practice. Such a rule would avoid the absurdity not infrequently encountered under the existing law of the commissioner contending that property has a fair market value but claiming at different times widely differing figures as the amount of that fair market value.

### CONSOLIDATED RETURNS

(Section 240)

The Revenue Act of 1926 in section 240 continues the policy inaugurated during the war period which permitted affiliated corporations to file returns of their consolidated net income. The interpretation of this section, as well as its administration, is still the subject of much controversy and difficulty. A study of the operation and effect of the consolidated-returns provision has therefore been made and the results are submitted herewith.

#### SYNOPSIS

1. The primary purpose of the Congress, in enacting this provision in the Revenue Act of 1918, was to provide a "sound, equitable, and convenient" method of taxation for both the taxpayers and the Government. The secondary purpose was "to prevent evasion of taxes."

2. The consolidated-returns provision appears to have been justified under the excess-profits tax partly for the reason that invested capital computations were required and net losses were not permitted to be carried forward to subsequent years.

3. Under present conditions this section does not entirely prevent tax avoidance and gives to the affiliated corporations different treatment in some respects than that given to separate corporations.

4. A consolidated-returns provision which permits benefits other than the mere right to offset the loss of one corporation against the gain of another no longer appears to possess advantages sufficient to offset the many difficult problems of law and administration to which it gives rise.

## RECOMMENDATIONS

1. The statute should be so framed as to treat affiliated corporations the same as separate corporations, except as to the right to offset the operating loss of one corporation against the gain of the other in the same taxable year.

2. Class B affiliations (the class in which 95 per cent of the stock of two or more corporations is owned by the same interests) should be abolished.

## DISCUSSION OF RECOMMENDATIONS

*Purpose of the consolidated provision.*—The purpose for which section 240 was inserted in the income tax laws is disclosed by the following extract from the report of the Finance Committee on the Revenue Bill of 1918:

Provision has been made in section 240 for a consolidated return in the case of affiliated corporations for purposes both of income and profits taxes. A year's trial of the consolidated return under the existing law demonstrated the advisability of conferring upon the commissioner explicit authority to require such returns.

So far as its immediate effect is concerned, consolidation increases the tax in some cases and reduces it in other cases, but its general and permanent effect is to prevent evasion, which can not be successfully blocked in any other way. Among affiliated corporations it frequently happens that the accepted intercompany accounting assigns too much income or invested capital to company A and not enough to company B. This may make the total tax for the corporation too much or too little. If the former, the company hastens to change its accounting method; if the latter, there is every inducement to retain the old accounting procedure, which benefits the affiliated interests, even though such procedure was not originally adopted for the purpose of evading taxation. As a general rule, therefore, improper arrangements which increase the tax will be discontinued while those which reduce the tax will be retained.

Moreover, a law which contains no requirement for consolidation puts an almost irresistible premium on a segregation or a separate incorporation of activities which would normally be carried as branches of one concern. Increasing evidence has come to light demonstrating that the possibilities of evading taxation in these and allied ways are familiar to the taxpayers of the country. While the committee is convinced that the consolidated return tends to conserve not to reduce the revenue, the committee recommends its adoption, not primarily because it operates to prevent evasion of taxes or because of its effect upon the revenue but because the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and to the Government. (Senate Rept. No. 617. 65th Cong., 3d sess., pp. 819.)

This report of the Finance Committee indicates that Congress enacted section 240 for a dual purpose—to prevent tax evasion and to provide a sound, equitable, and convenient method of taxation. It is apparent that its primary purpose was to provide for a sound, equitable, and convenient method of taxation. The bureau has had an experience of nine years in the application of this provision. The results obtained in the past and the difficulties encountered should reveal the necessity for its retention or disclose a basis for its revision. The revision made in this section in the Revenue Acts of 1924 and 1926 eliminated only a few of the difficulties in the prior statutes and added provisions that are perhaps equally objectionable and difficult of application.

*Difficulties of interpretation and administration.*—A complete discussion of all the difficulties encountered in the interpretation and

administration of the various consolidated returns provisions would require a voluminous and technical report. The following questions indicate the principal difficulties which have arisen. Some of these questions have been partly answered by the Board of Tax Appeals while others are still in controversy:

1. What is meant by "substantially all the stock"?
2. When does "control" exist?
3. What are "closely affiliated interests"?
4. What are "the same interests"?
5. What constitutes an election to file a consolidated return and when must it be made in order to be effective?
6. What are "related trades or businesses"?
7. When are such "related trades or businesses" "owned or controlled by the same interests"?
8. How shall accounts be "consolidated"—i. e., to what extent, if at all, shall the principles of a consolidated return apply?
9. What constitutes an agreement as to allocation of tax and when must one be made to be effective?
10. Where tax has been allocated and paid according to agreement, and it is later discovered that one or more of the group which paid none of the tax was actually nonaffiliated, but had income, how shall credit or refund be made?
11. Where tax was allocated and paid, as in 10, and prior to running of statute of limitations, one of the affiliated corporations passes to other interests and claims a refund, who is entitled to refund?
12. Where tax is allocated by agreement to an insolvent member of the affiliated group, how shall the tax be collected?
13. Where the tax has been assessed erroneously against one member of the group, may part of such assessment be credited to a member of the group which paid no part of the tax?

In addition to the above specific difficulties other general difficulties arise from the method of consolidation employed. The most important of these are as follows:

1. Application of net-loss provisions, especially when there has been a change in affiliation status during the years affected by those provisions.
2. Effect on consolidated net income of the liquidation of one or more members of the affiliated group.
3. Treatment for income-tax purposes of profits or losses resulting from sales of stock of members of the group to nonaffiliated interests.
4. Basis to be used for computing depletion, depreciation, and gain or loss on sale or other disposition of assets where cost or other basis to subsidiary is different from cost of latter's stock to the parent. Almost impossible situations have occurred in this connection, especially where minority interests are involved.
5. Complicated accounting problems in eliminating intercompany transactions.

It results from the interpretation now placed on section 240 in regard to the above questions and the method of consolidation employed, that affiliated corporations often receive substantially different treatment from separate corporations. One hypothetical case based on the principles of recent Board of Tax Appeals decisions will make this clear.

Suppose corporation A acquires 95 per cent of the stock of corporation B in 1918 at a price of \$1,000,000. It sells the stock in 1925 at the price of \$2,000,000. Corporation A is not taxed on the profit of \$1,000,000.

The consolidated provision was necessary during the war period in order to prevent tax avoidance and the injustice which would have resulted to many taxpayers. The elimination of the excess-profits tax removed for the most part the reasons for this provision. The insertion of the net loss provisions further lessened the injustice that would have resulted in a tax law which did not recognize affiliation.

It appears that under present conditions, sufficient relief would be granted affiliated corporations if the operating loss of one company could be offset against the gain of another for the same taxable year. This can be done in a manner which will recognize the separate entities of the corporations and eliminate many of the present difficulties of interpretation and administration.

*Method of affiliation recommended.*—The method of affiliation proposed for the elimination of the difficulties already outlined may be described as follows:

1. The consolidated return, as such, should be abolished.
2. An affiliated group is a group of corporations which are connected through a stock ownership of not less than 95 per cent.
3. The operating loss of any member of such a group may be offset against the net income of one or more members of the group if they mutually agree thereto.

The treatment of the corporations as separate corporate entities in the above manner appears to eliminate the most troublesome features of the present law, and at the same time retain what would appear to be the meritorious principle, namely, the right to offset operating losses in the case of companies operated as a business unit.

## FEDERAL TAX LIENS

### RECOMMENDATIONS

(1) The commissioner should be authorized to release a tax lien on the giving of a bond with satisfactory sureties, to be approved by the commissioner, in an amount not more than double the amount of the tax.

(2) The commissioner should be authorized to place a lien upon specific property where the security is ample. The law to-day extends the lien to all the taxpayer's property and rights to property.

(3) The commissioner should be authorized, on the release or discharge of an income-tax lien, to issue a certificate to that effect.

### DISCUSSION OF RECOMMENDATIONS

*Release on giving of bond.*—If the taxpayer has no resources from which to pay the tax other than the property to which the lien has attached, payment can be made only by sale or mortgage of that property, or by sale on distraint, or by proceedings under Revised Statutes 3207 (sec. 1127 of the 1926 Act). The two methods last named are slow and harsh. Where there is reason to believe that, but

for the lien, the taxpayer could raise money to pay the tax by mortgaging or selling the property subject to lien, he ought to be given this opportunity of paying. The Government is amply secured by the bond required to be given. It is thought that the fixing of the bond should be left to the commissioner, who should have the right to delegate his duties in this respect to proper field officers.

*Restricting lien to particular property.*—The present form of section 3186 of the Revised Statutes makes it plain that the lien attaches to all property, real and personal, and to all rights in property. This is unnecessarily broad. A taxpayer may own five separate parcels of real estate, each worth more than \$5,000, and the tax may be \$2,000. It ought to be possible to file the lien against any one tract, if it affords ample security. A lien not filed against specific property should cover all property and property rights.

*Certificate of release.*—The commissioner is specifically empowered by statute in estate-tax cases on the release of a lien to issue an appropriate certificate to that effect. While the commissioner doubtless has the same power as to income-tax cases, it seems desirable to provide specifically therefor by statute. The certificate is convenient in proof of title and provision should be made authorizing its issuance on the release of a lien for income taxes.

## TRANSFEREES OF PROPERTY

(Section 280)

If a taxpayer has transferred his property under such circumstances as to give rise to liability on the part of the transferee it may become necessary to proceed against the transferee for payment of the tax. Prior to the 1926 act suit was brought against the transferee in the lower Federal courts. This was the exclusive remedy where a tax lien had not attached to the property prior to the transfer. Section 280 does not purport to affect the transferee's liability, but it does substitute another method of collection. In substance, it subjects him to the same proceedings as though he were the taxpayer. A deficiency letter is sent to him; he may appeal to the Board of Tax Appeals; if he does not appeal, the tax may be collected by distraint and he is subject to jeopardy assessments. There have been numerous complaints about the operation of the section on the ground that it deprives transferees of important rights and advantages and that it is an unnecessarily harsh method of enforcing liability, especially in the case of a transfer in the ordinary liquidation of a corporation or distribution of an estate. In *Owensboro Ditcher and Grader Co. v. Lucas*, 18 Fed. (2d) —, a Federal district court in Kentucky held section 280 unconstitutional.

## RECOMMENDATIONS

1. Proposals have been received to eliminate section 280 from the next revenue act. After considerable study, it appears that though the section is capable of harsh application it serves a useful purpose when properly employed, particularly in cases of colorable transfers, and should not be stricken from the statute. Consideration should be given to the question whether the commis-

sioner should not have the alternative right to proceed by suit in the courts.

2. The transferee should have the same rights as the transferor with respect to bureau hearings, copies of returns, protests, and other documents and general administrative procedure. Legislation should be provided if necessary to assure these rights.

3. A transferee who has appealed to the board should have the right by subpoena or other process, to compel the transferor or other custodian of the transferor's books and records to produce such evidence for his inspection prior to the trial. This right should be conditioned on satisfying the board that the evidence is necessary and that it would not be an undue burden to the transferor, or other custodian to produce it at the time and place designated.

4. Careful consideration should be given to the matter of more nearly approximating under section 280 the benefits of Federal equity procedure, particularly as to parties, orders, and other remedial measures appropriate to the determination of primary and secondary liabilities and rights to contribution and reimbursement. A study of several proposed methods of doing this is being made and the results will be submitted in a supplementary report.

5. At present, no change is recommended as to limitation periods respecting enforcement of the transferee's liability, except that the liability of an executor under Revised Statute 3467 should be assessable prior to the last of the following two dates: (1) One year after the liability arose, or (2) the expiration of the period for collecting the additional tax.

#### DISCUSSION OF RECOMMENDATIONS

The enforcement of transferee liability presents varied and difficult problems. The transfers range from *bona fide* corporate liquidations or distributions of estates made at a time when taxes were thought to be settled, to colorable transfers made for the purpose of evading payment of the tax. One transferee or a hundred or more may be involved in a single case. Some may be out of the jurisdiction, bankrupt, deceased, or for other reasons unable to respond, or not subject to suit or proceedings under section 280. The liability ordinarily sought to be enforced is a somewhat indefinite common-law liability. Moreover, most cases may ultimately involve questions of secondary liabilities, contribution, reimbursement, and the like. This is the kind of a controversy for an equity court; and the transferee's liability as a rule was enforced by equity proceedings prior to the 1926 act.

On the other hand, equity suits proved inadequate where there were successive transfers, delay was great, and the amount decreed often could not be collected; the efficient cooperation of several governmental agencies was necessary in the prosecution of the suit, and as a net result comparatively little tax was actually collected from transferees. The ideal solution, of course, would be to combine, as far as possible, the flexibility of the equity suit with the advantages to the Government of section 280.

Complaints have been received about the operation of section 280 and suggestions for its elimination from the act. It may be employed with unfortunate, harsh results to transferees. Wisely

employed, it can be made to facilitate collection without undue hardship and it should not be stricken from the law. The commissioner to-day, however, has no choice but to proceed under section 280. It may appear advisable to restore procedure by suit as an alternative, to be used in cases where collection is not jeopardized thereby, and where the application of section 280 would clearly prejudice the transferee. This would enable the commissioner to lessen somewhat the hardships of section 280 by electing in appropriate cases to bring suit. The suggestion may be particularly desirable if the constitutionality of the section is not free from doubt.

*Benefits of bureau procedure.*—Until recently the transferee was not given the same opportunity as the taxpayer of presenting his case before the bureau. He was proceeded against by distraint or 60-day letter without an opportunity to show that the transfer was made under circumstances such as not to make him liable for the tax and he had no opportunity to show that the tax was not due him from his transferor. The transferee was not given copies of returns, protests, or other papers which would be available to the transferor. It appears desirable to give the transferee the same rights as the transferor in these particulars. The bureau now accords to the transferee most of these rights. If legislation is necessary to assure all the rights specified, its enactment is recommended.

*Preliminary examination of transferor's books and records.*—There is no provision in existing law whereby the transferee, prior to the hearing before the board, may have access to the books of the transferor, though this evidence may be essential to his case. Ordinarily the facts as to tax liability are not within his control. The transferor has the evidence on the question. If the case is to be properly presented, the transferee must prepare *in advance* of the trial. The board should be authorized to order a preliminary inspection at a time and place convenient to the parties. The order might be enforceable as a subpoena. The transferee should first show that the evidence is necessary to his defense; that it is not available except by an order and that an examination can be had without hardship to the transferor or other custodian.

*Flexibility in proceedings under section 280.*—It is desirable to find means of minimizing litigation on issues of reimbursement, contribution, etc., where one transferee is made to pay more than his share of the transferor's tax. The Federal court has a marked advantage over the Board of Tax Appeals in the flexibility of equity procedure, which permits the settlement of claims involving primary and secondary liabilities in a single proceeding. Since the board is not a court, it may not be possible or desirable to give it general equity powers with respect to parties and orders in transferee cases. It does seem desirable to take such steps as may be practicable in this direction, as far as transferee cases are concerned. The matter is under study, and a supplemental report on it will be made.

*Limitation periods.*—Revised Statutes 3467 provides that if an executor or administrator pays any debt before he satisfies Federal taxes, he incurs thereby a personal liability for the tax. The liability may not arise until after the period of limitations on assessments against him has expired. An amendment is suggested which extends the period for assessment against the executor under such circumstances.

MATTERS AS TO WHICH NO RECOMMENDATIONS FOR LEGISLATION ARE MADE

*Lien for taxes.*—Under existing law the tax, together with all interest, penalties, and other additional amounts, becomes a lien on the real and personal property of the taxpayer when the assessment list is received by the collector. This lien is valid against transferee except mortgagees, purchasers, or judgment creditors. Where a lien is perfected prior to the transfer, the Government is amply secured. Where there is a lien, assessments ought to be prorated among the transferees in proportion to the property received by each, and jeopardy assessments should not ordinarily be made unless the security is plainly inadequate. It seems clear that some hardship under section 280 may be alleviated if the commissioner will take full advantage of liens attaching to the property prior to the transfer. This does not appear to call for legislation.

*Jeopardy assessments against a transferee.*—There has been much criticism with respect to the commissioner's right to make jeopardy assessments against a transferee. The right to do so was given in the Revenue Act of 1926. The indiscriminate use of jeopardy assessments may produce intolerable hardships. On the other hand, the jeopardy assessment ought to be available in some cases—for instance, where property is the subject of successive transfers to evade tax and thus gives rise to actual jeopardy. It is not believed practicable by legislation to limit jeopardy assessments to cases of tax evasion and actual jeopardy.

*Statutory definition of liability.*—In certain aspects it might be beneficial to incorporate a provision in the law defining the kinds of transfers which create liability under section 280. It is not, however, believed to be desirable as a practical matter. Procedure under section 280 should be available where property is transferred to evade tax. If evasion by itself were the test, it would make the jurisdiction of the board depend on proof of that fact, and the section would become unworkable.

*Sixty-day letters.*—The form of the 60-day letter can do much to assist the transferee in preparing a petition. It should be sufficiently complete within itself so as to show the amount of tax originally paid by the transferor and each adjustment which gives rise to the deficiency. It is important in transferee cases that the letter be made sufficiently definite to inform the transferee what has been done in the case and what is the reason for the deficiency. This appears to be a matter primarily for administrative action.

## THE BAR OF THE STATUTE OF LIMITATIONS

In a broad sense the statute of limitations may be said to present two problems: First, what effect should be given to the expiration of a limitation period; second, what periods of limitation ought to be imposed on the assessment and collection of taxes and the making of refunds or credits to the taxpayer?

### RECOMMENDATIONS

(1) Any payment of internal revenue tax should be considered as an *overpayment* if the assessment was made after the period of

limitations had run on assessments, or if it was paid after the period of limitations for collection by distraint or proceeding in court had expired. The rule should be applied regardless of the manner of collection and whether payment was under duress or threat, on demand or voluntary. An exception to the above general rule should be made in the case of amounts collected under judgment of a court or under a final decision of the Board of Tax Appeals, or an amount paid under a section 1106(b) agreement. Claims and suits for refund or credit of the overpayment (as above defined) should be filed within the applicable period of limitations. The rules above stated should be applied in the case of all such overpayments made after February 25, 1926, and any credit or refund coming within these rules which has been disallowed by the commissioner or the Board of Tax Appeals or any court between the date of the 1926 Act and the new act on account of section 1106(a) of the 1926 Act, should be promptly allowed.

(2) Any refund to the taxpayer after the period for filing claims should be recovered by the United States unless claim for refund was filed by the taxpayer before the expiration of the period of limitation for filing claims. Any amount refunded after the expiration of the period for filing suit therefor by the taxpayer, should be recovered by the United States if suit was not brought within the period. An exception to the general rule above stated should be made in the case of amounts refunded as a result of a judgment of a court or on a final decision of the Board of Tax Appeals, or of an agreement made under section 1106(b). The right of recovery should be exercised by suit to be filed within two years after the making of such refund.

(3) As to amounts paid by the taxpayer before the expiration of the period of limitations on collections by the Government, no refund or credit should be allowed unless the amount paid is in excess of the correct tax. If the taxpayer within the proper period brings suit for a refund, the Government should have the right, if it can prove that a deficiency is owing for the taxable year or years in question, to obtain judgment therefor.

(4) The United States should not collect any deficiency unless the amount already paid is less than the correct tax. In any proceedings before the board or in the courts by the Government to collect additional taxes, the taxpayer should be permitted to obtain a judgment or order for any refund or credit in his favor.

#### DISCUSSION OF RECOMMENDATIONS

*Payments by taxpayer after limitation period.*—The purpose of the statute of limitations does not relate to the determination of a case on its merits. The purpose is to put an end to controversy. It is, in other words, a statute of repose. In recent revenue laws various time limits have been placed on the assessment and collection of taxes by the Government. Prior to the enactment of the 1926 act there was some doubt as to the effect of the expiration of these time limits on assessment or collection. Section 1106 (a) of the Revenue Act of 1926, which deals with the subject, has not completely resolved these doubts. Further legislation seems necessary. The problem may be illustrated by a concrete case. Assume that a taxpayer has filed

his return, paid the proper tax in full, and that after the period for assessing additional taxes has expired the Government wrongfully collects a further sum from him by distraint. The taxpayer should clearly be permitted to recover the excessive amount thus collected.

The case may be slightly changed to illustrate another aspect of the matter by supposing that the amount collected after the expiration of the period would have been due and owing within the period, and that its collection within the period would have been proper. If the statute of limitations against the Government is to be effective the taxpayer must nevertheless be permitted to recover the amount taken from him after the expiration of the period. Otherwise the Government could legally collect by distraint and retain all barred taxes.

Consideration has been given to the possibility of drawing a line between voluntary payments and involuntary payments made in either case after the Government was barred from collecting the amount in question. Such a distinction is undesirable. A somewhat similar rule with respect to interest under the 1921 act gave rise to much confusion and difficulty. Consequently, it is recommended that the taxpayer be entitled to recover any payment made by him after the period, whether voluntary or involuntary and whether or not under duress.

It will be seen, therefore, that the first recommendation in substance is that any amount paid by the taxpayer after the Government is barred from collecting additional amounts for that particular year should be considered as an overpayment, regardless of the correct amount of the tax or the manner of securing payment. The overpayment should be credited or refunded the same as any other overpayment, subject to the same limitation period.

The exceptions referred to in the recommendation in connection with decisions of a court or the Board of Tax Appeals are self-explanatory. The fact that the statute of limitations may not have been raised before the court or the board should not impair the validity of its decision. If the question was raised and the court or board decided it wrongly, the proper way to correct it is by an appeal, not by a new proceeding. Once a closing agreement under section 1106 (b) has been made and additional taxes have been paid pursuant thereto the matter should be definitely closed, even though the payments prove to have been made after the statutory period.

The foregoing rules appear to express the intention of Congress in enacting section 1106 (a) of the 1926 act, and hence it seems proper, despite the recognized objections to retroactive legislation, to make these rules apply to all overpayments of the nature above discussed which are made after February 25, 1926, and further to provide that any refund coming within these rules which has been disallowed by the commissioner, the board, or any court solely on account of section 1106 (a) of the 1926 act, should be promptly allowed.

*Refunds by the Government after the limitation period.*—The revenue acts provide that no refund to a taxpayer may be made unless claim therefor is filed within a specified time. It does not often happen that the Government makes a refund after the expiration of this period. In the occasional case where this occurs, a situation is presented which is the converse of that discussed in preceding paragraphs, though it is of relatively far less importance. Provision should be made for the recovery by the United States of amounts

refunded after the expiration of the period for filing claims. The general rule should not be given retroactive effect. The same exceptions should be made as in the case of payments by the taxpayer after the period. It is suggested that the right of recovery be exercised by a suit by the United States to be filed within two years after the making of such refund.

*Limitation periods.*—As above indicated, recent revenue acts have provided various periods of limitation, against both the Government and the taxpayer. As a result of the operation of these provisions it may happen that a case is barred as to refunds and open only for additional assessments, or, conversely, that it is barred as to additional assessments and open only for refunds. The tax for a given year is a unit. The determination of the correct tax is more or less like an accounting between the Government and the taxpayer and until the case is finally determined it may not be possible to tell to whom the balance will be owing. It seems desirable to provide so far as practicable that where an administrative determination of the case satisfactory to both parties can not be made and where as a consequence it becomes necessary either for the Government to institute proceedings to collect a deficiency or for the taxpayer to bring suit for a refund, that the case having thus become the subject of litigation should be decided on its merits without restriction, whether the net result is in favor of the one party or the other. This is the effect of the third and fourth recommendations submitted. The operation of the rules suggested may be illustrated:

If, within the proper limitation period, the commissioner sends the taxpayer a deficiency letter and an appeal to the board is taken, the board should ascertain the correct tax liability for that year. If the board finds that there is an underpayment, it should be collected in the same manner as under the 1926 act. If, on the other hand, the board finds an overpayment, the taxpayer should be entitled to a recovery without restriction as to amount. The determination on the merits thus made by the board would be final and binding on both parties unless reversed or modified on appeal.

If the taxpayer received the 60-day letter and chose to pay the tax with a view of bringing a suit for refund rather than to appeal to the board, he should be given a short period thereafter (perhaps not more than a year, or even a lesser period) within which to file a claim for refund and the same length of time after the rejection of the claim as he is now given for bringing suit. Once the case is thus brought before a court, there should be an adjudication of the case on its merits, and judgment should be given for the taxpayer or the United States in accordance therewith without any restriction as to time, dates of payment, or other restriction.

If a taxpayer believes that he has overstated his tax on the return and that the amount originally paid is excessive, he should be given the right to file a claim for refund within the period now provided by law and, if it is denied, to bring suit for a recovery. In that suit the court should decide the case on its merits and render judgment for the taxpayer or the Government as the case might be.

Particular attention is invited to the fact that in all these instances the case has already become the subject of litigation. It is not perceived that any useful purpose is served by restricting the litigation only to one party—that is, by allowing one party to recover in case

the evidence shows he is entitled to a recovery but not allowing the other party to recover if the evidence is in his favor. The suggested rule appears to operate justly both to the Government and to the taxpayer. An important consequence of the adoption of these recommendations will be to discourage the beginning of proceedings either by the taxpayer or by the Government in cases where the moving party is not confident as to the correctness of his position.

## BASIS FOR GAIN OR LOSS ON SALE BY AN EXECUTOR

### RECOMMENDATIONS

1. The basis for gain or loss on an executor's sale should be the value at the decedent's death of the property sold. Consideration should be given to making this rule retroactive in so far as it may be practicable to do so without hardships to taxpayers or undue loss of modified on appeal.

2. In the interests of uniformity the same rule should be applicable in determining gain or loss on the sale of property by a beneficiary or other person acquiring the same by bequest, devise, or inheritance.

### DISCUSSION OF RECOMMENDATIONS

None of the revenue acts have specifically provided the basis to be employed in computing gain or loss on a sale of property by an executor or administrator. Nevertheless, for years prior to the recent decision of the Court of Claims in the McKinney case, the regulations issued by the department have provided that the basis should be the fair market value of the property at the decedent's death. The McKinney case holds that the basis for the executor or administrator is the same as the basis for the decedent, and following the denial of certiorari by the United States Supreme Court in that case, Treasury Decisions 4010, 4011, and 4012 were promulgated, changing the old rule so as to provide that the basis should be the same as the property would have had if the decedent had sold it.

When property is sold by an executor or administrator, the benefit of any gain or the detriment of any loss, as the case may be, rests finally on the beneficiaries of the estate, not on the decedent. For this reason it seems best to regard the personal representative as acting for and on behalf of the beneficiaries in making the sale, and as a consequence the basis for determining gain or loss when the representative sells the property should be the same as the basis when the beneficiary sells the property.

This rule is particularly desirable in view of the difficulty which may be encountered by executors and administrators in ascertaining what the decedent paid for the property, especially where it had been held by him over a long period of time.

It may be argued that in a substantial sense the rule of the McKinney case results in taxing as income the value of property acquired by bequest, devise, or inheritance, a result which is contrary to specific provisions relating to gross income in practically all of the revenue acts. The rule above suggested preserves intact the full force of section 213 (b) (3) of the Revenue Act of 1926 and similar parts of preceding acts.

Section 204 (a) (5) of the 1926 act provides that the basis for determining gain or loss when the property is sold by beneficiary or other person acquiring it by bequest, devise, or inheritance shall be the value "at the time of such acquisition." Some doubt exists as to the meaning of "acquisition." It seems advisable to provide specifically that the date of acquisition shall be the date of death.

## INTEREST ON OVERPAYMENTS AND UNDERPAYMENTS

### RECOMMENDATION

In the case of *overpayments* adjusted by a refund, it is recommended that interest be payable to a date not more than 30 days prior to the payment of the refund. Under existing law interest terminates on the date the refund is "allowed," which may be weeks or months prior to the issuance and delivery of a check.

### DISCUSSION OF RECOMMENDATIONS

As already stated, the interest period on a refund stops at the date of *allowance* and the refund, with the interest, is ordinarily paid about 33 days later. The period between the date of allowance and the date of payment was formerly about 63 days, and it does not appear that any further appreciable reduction is feasible at this time. Nevertheless, it is considered feasible to limit the period of loss of interest to the taxpayer to 30 days. Computation of interest to a date later than the date of allowance is administratively practicable and could be made at the same stage of the procedure at which it is now made. The several steps in the route of a schedule of over-assessments are indicated below to account for the present period between the date of allowance (i. e., the date of the commissioner's signature of the schedule of overassessments) and the date of payment of the refund:

	Days
To the collector and return.....	21
In claims control section (for computation of interest, etc.).....	6
In General Accounting Office (for approval of disbursement).....	2
In accounts and collections unit (for charge against appropriation).....	1
Incidental travel.....	3
Total.....	33

It is apparent that the computation of interest in the claims control section to a current date instead of to the date of allowance would in no way complicate the procedure. It is also apparent that the remaining stages in the procedure would ordinarily be of a perfunctory character and the time necessary therefor could be estimated quite accurately; the variation in the total time (averaging 33 days) required in a specific case would lie in the first stage (the average 21-day period "to the collector and return"). While the last three stages require but 9 days in the ordinary case, it is recommended that the Government be permitted to make payment within a 30-day period after the case reaches the claims-control section without additional interest in order to obviate recomputation of interest in the cases where the final steps may take longer.

Of major importance in connection with the proposed change in the law regarding the interest period on a refund is the delay in payment of the refund due to circumstances outside of bureau control. The delays consequent upon the exhaustion of the appropriation for refunding have been as follows:

From—	To—	Period
Oct. 10, 1922.....	Jan. 24, 1923.....	3 months 14 days.
Dec. 20, 1923.....	Apr. 5, 1924.....	3 months 15 days.
Nov. 20, 1924.....	Jan. 22, 1925.....	2 months 2 days.
Dec. 1, 1925.....	Mar. 6, 1926.....	3 months 5 days.
Nov. 4, 1926.....	Mar. 3, 1927.....	4 months.

We are concerned in this report with the relation between the date of payment and the date to which interest shall run. Equitable treatment of the taxpayer demands that the dates be separated only by the time necessary to allow for the Government bookkeeping and accounting. Interest burdens incident to exhaustion of the refunding appropriation should be borne by the Government rather than the taxpayer. No provision is recommended to force the Government to expedite the payment of a refund by the imposition of an increased rate of interest or compound interest in the event of a delay in refunding, although the taxpayer is subject to such additional burden when he is delinquent.

The adoption of the above recommendation regarding the interest period on a refund made by the commissioner would raise the question as to the advisability of amending section 1117 of the Revenue Act of 1926, providing for interest on judgments. Considerations of the same general nature obtain for adopting a provision allowing interest to within 30 days of payment rather than to the date of entry of a judgment.

Under the existing revenue laws the provisions imposing liability for interest upon the Government in the case of overpayments and on taxpayers in case of underpayments are numerous and are to be found in several different places in the act. It is believed that the convenience of all who use the act would be promoted by collecting these provisions at one place. It is customary to audit the returns for several years at the same time, and in considering the result of such an audit the taxpayer and the representative of the Government must check the interest computations on underpayments and overpayments for several different years. This would be facilitated if all the interest provisions were together in the statute.

There are some difficulties in connection with the determination of interest in cases of affiliated corporations, trusts, and beneficiaries and marital communities. In some of these cases, particularly that of affiliated corporations, the interest periods may operate, particularly with respect to the 1918 and earlier acts, so that the Government pays interest over a term of several years on a refund to the parent when it is able to collect interest only since the passage of the 1926 Act on amounts found to be due from a subsidiary. This results from practical considerations, and possibly even from constitutional considerations, which determined the policies of the last three revenue acts with respect to interest on deficiencies. It is not believed wise at the present time to undertake the making of further

changes in the provisions for interest on deficiencies under these early laws, nor is it believed to be sound economically or legally to treat corporations with stockholders in common or parent corporations and subsidiaries as one unit for the purpose of computing interest on deficiencies. Study of the subject should be continued, however, to develop if possible means for making the determination and computation of interest in certain cases more equitable to taxpayers and to the Government and less difficult from an administrative standpoint.

### CONGESTION AND DELAY IN THE SETTLEMENT OF TAX CASES

Congestion of cases within the bureau at the present time is not so serious a problem as it has been in past years. The accumulation of cases on the docket of the Board of Tax Appeals, however, has been steadily growing and requires thoughtful consideration. The board can not control the volume of cases coming to it. It can only control the rate at which cases are disposed of, and even this is possible only within comparatively restricted limits. The problem of congestion, therefore, past and future, is not primarily a board problem. It is a problem of the bureau and the general counsel's office. Attention is invited to the data presented in the survey of administration prepared by the Treasury for the committee and printed as Volume III herein.

### RECOMMENDATION

1. There should be a special body in the Bureau of Internal Revenue charged with the closing out of cases and with curtailing appeals to the Board of Tax Appeals. Legislation is recommended if necessary to the existence of such a body.

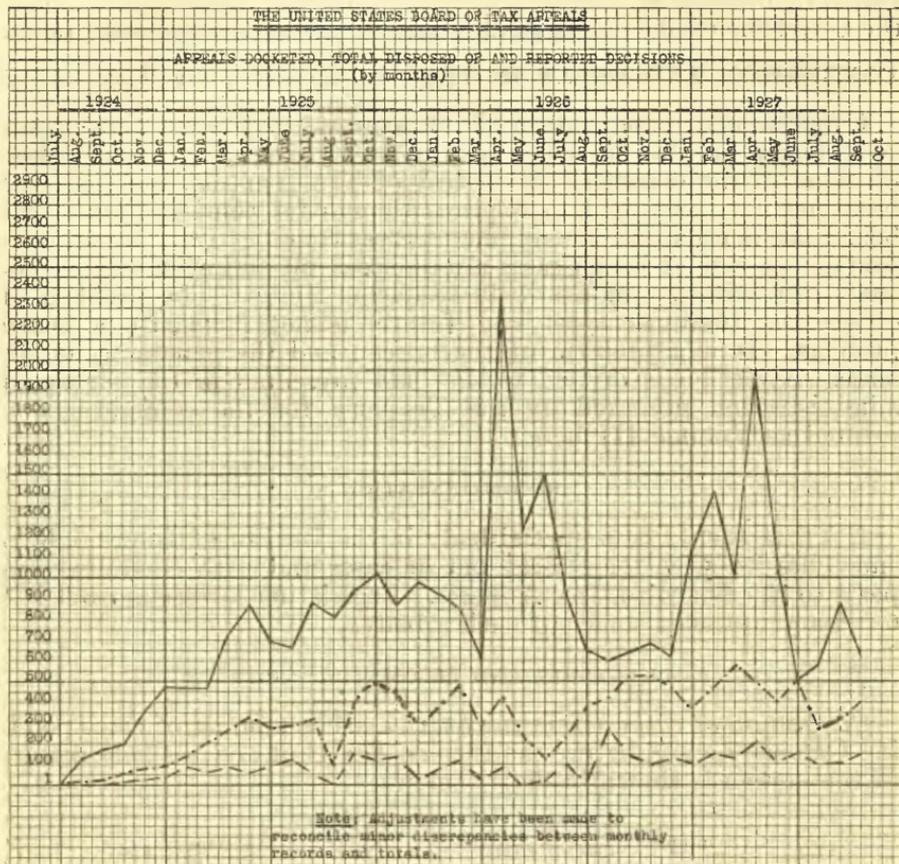
### DISCUSSION AND RECOMMENDATIONS

*Congestion of cases before the bureau.*—The number of cases pending October 7, 1927, before the Income Tax Unit and the field officers of the bureau is shown in detail below:

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

Much progress has been made during the past two years in the way of bringing the bureau's work to a current basis. The closing out of the few remaining cases for 1923 and prior years is a slow process, due in some measure to the taxpayer's right to file a claim for refund within three years after the payment of an additional tax. It is important that the cases for these early periods be definitely closed out as rapidly as possible. It seems clear that, except for the relatively few cases for earlier years, the problem of congestion has been shifted from the bureau to the Board of Tax Appeals and the general counsel's office.

*Congestion of cases before the Board of Tax Appeals.*—A major problem as above stated is the accumulation of undecided appeals before the Board of Tax Appeals and the flow of incoming petitions to that body. Attention is invited to the following chart, which shows the appeals docketed, the total number disposed of, and the reported decisions, by months, from July, 1924, to September, 1927:



#### EXPLANATION OF CHART

The continuous line indicates appeals docketed; the line composed of dots and dashes indicates total cases disposed of; and the line consisting of broken dashes indicates the reported decisions.

The following table shows the condition of the board's work as of June 30, 1927:

	Number of cases	Per cent	Amount of additional tax claimed by the Government
Closed by final board decision fixing the amount of the tax.....	10,951	37	\$119,132,437.06
Decided by written findings of fact and opinion, and awaiting the filing by the parties of a recomputation of the tax.....	371	1	10,203,550.12
At issue and pending on the Washington calendar, circuit calendar, and the reserve calendar.....	14,270	48	420,770,011.57
Not at issue.....	2,491	9	39,856,000.00
Heard and submitted for preparation of findings of fact, opinion, and decision.....	1,542	5	82,060,083.25
<b>Total.....</b>	<b>29,625</b>	<b>100</b>	<b>672,022,084.00</b>

Certain outstanding facts may be noted. In the 35 months between August 1, 1924, and June 30, 1927, the board disposed of deficiencies at the average monthly rate of three and one-half millions of dollars. The monthly average of cases was 323 and the average tax proposed in each case was \$11,440. The chart shows that of the appeals disposed of, only about one-third required written findings of fact or opinion. Two-thirds were disposed of by dismissals, stipulations, or otherwise. *This indicates the very limited possibilities of relief by speeding up the rate of formal decisions. Relief must be looked for, primarily, in curtailing the flow of cases to the board.* On June 30, 1927, there were pending undecided 18,313 appeals, which is 62 per cent of the appeals filed during the life of the board. More than \$542,000,000 were involved in pending cases, which is more than 80 per cent of the total amount involved in all appeals docketed from August, 1924, to June, 1927.

*Responsibility of the Bureau of Internal Revenue.*—It is impossible to discuss the problems of the board apart from the work of the Bureau of Internal Revenue. Attention is invited to a survey of administration prepared for the committee by the Treasury Department and published herewith as Volume III. The department has submitted in this survey a frank analysis and statement of its problems. There can be no doubt of the fact, set forth in the survey, that personnel difficulties and other problems within the bureau have resulted in transferring to the board many cases which call for administrative rather than judicial determination.

*Jeopardy assessments and jeopardy cases.*—The great increase in cases coming to the board each spring, as shown in the chart, commands attention. During that time of the year the period of limitation on assessments by the commissioner expires in a great many cases. The statute of limitations ceases to run during the pendency of the appeal. Many of the appeals filed during the spring months are cases in which the statute of limitations rather than any determination on the merits has been the reason for sending the cases to the board. The commissioner is not at fault in all cases for not having disposed of them sooner. Sometimes a case is held by the bureau as an accommodation to the taxpayer. When the statute is about to run, the commissioner's alternatives are to secure waivers or to send the case to the Board of Tax Appeals. It is no longer possible, as a general matter, to file claims in abatement of assessments and hence the commissioner can not assess the tax and complete his consideration of the case on the claim in abatement. The situation results in sending to the board a mass of undigested or partially digested tax cases. An obvious remedy is for the commissioner to make provision whereby all cases of this kind automatically become eligible for continued consideration within the bureau after the appeal is filed. The board might establish a special calendar of "jeopardy" cases, so called, so that they could be identified as cases which, *prima facie*, have not received adequate administrative consideration.

Reference is made elsewhere in this report to a "special advisory committee" recently established in the Treasury. The special advisory committee should be able to perform valuable service in disposing of "jeopardy" appeals. If it does not do so, a special

body capable of handling the situation should be created in the bureau. The responsibility of the bureau for assisting the board in the matter of "jeopardy" appeals is clear.

*Tendency to force taxpayers to the board.*—There is a tendency on the part of some bureau employees to construe board decisions narrowly and to force taxpayers to take unnecessary appeals. There is little evidence of a disposition to settle cases according to the standards by which private litigants settle theirs. The duty of this administrative body to administer the law without sacrificing substantial justice to technical considerations is sometimes lost sight of. It is the opinion of experienced practitioners that one who is looking for the disputable points can find them in almost any tax case. The creation of the Board of Tax Appeals was not intended in any way to relieve the bureau of its responsibilities to reach correct administrative settlements. The bureau should shoulder this responsibility anew. The board should be resorted to only when question of substantial importance can not be disposed of otherwise.

*General counsel's office.*—The general counsel's office acts as the legal adviser to the bureau and members of the general counsel's office represent the bureau in litigation before the board. It is commonly said that the trial lawyers of the general counsel's office fail to cooperate with the board and with the taxpayer in the manner customary in civil litigation. It is stated that members of the general counsel's office unduly press technical points during the course of the trial; that they force taxpayers to comply with technical rules of evidence not ordinarily applied in litigation and that they are unwilling to stipulate as to incidental matters commonly the subject of stipulation in courts.

There can be no doubt that to some extent the situation complained of exists. The result is to delay the trial of cases and to consume the time of the board needlessly, as well as to cause inconvenience and expense to taxpayers. A major underlying cause is to be found in personnel difficulties in the office. Each trial lawyer has charge of something like 450 board cases. He is assisted by a bureau employee delegated from the Income Tax Unit. The general counsel finds it difficult to obtain the services of men qualified by experience, training, and temperament to represent the Government as trial lawyers. As a result of these circumstances, the general counsel's office is literally swamped with work.

There is a system of review in the office which does not conduce to the making of stipulations. The trial lawyer in charge of the case is not relied upon to make the stipulation by himself. It is reviewed by another, and the reviewer is so pressed with work that he has insufficient time within which to consider the stipulation and the facts of the case. As a practical result, the stipulation may be rejected when it ought to be entered into.

The general counsel is the commissioner's lawyer in every appeal before the board. As such it is peculiarly his duty to assist the board and to cooperate with the opposing attorney in handling cases efficiently and expeditiously. This duty can not be performed by unbending insistence on trial technicalities or unreasonable refusals to stipulate.

There are few problems which deserve more thoughtful consideration in connection with the improvement of income-tax administration to-day than the outstanding problem of personnel in the general counsel's office. The several aspects of this problem may be noted briefly: In the first place, the general counsel is forced to compete with law firms and other organizations for the retention of qualified lawyers in his office. Often the salaries offered are greatly in excess of the amount which the general counsel is authorized to pay. The result is that the general counsel loses a disproportionately large percentage of the attorneys who have been trained and qualified to do the work of the office. The office should be something more than a training ground.

Another difficulty arises from the fact that the work to be done is specialized and requires a high order of legal ability. A considerable period of time, often more than a year, is required for a new attorney to become reasonably familiar with the legal principles with which he has to deal and the organization and procedure of the bureau and of the Treasury Department. Consequently, immediate relief could not be expected, even if it were possible to secure on short notice the services of a number of qualified lawyers on the outside.

The answer appears to be to select carefully new lawyers for the office and to find means of retaining those in the office who have proved their ability to do the work required.

*Bringing bureau work to a current basis.*—The vast accumulation of returns and cases arising under the war revenue acts were not touched until months after the war. The organization of the Bureau of Internal Revenue necessarily occupied considerable time. Since 1921 the bureau has directed every effort to the disposition of accumulated cases for earlier years, as well as to the auditing and closing out of current returns. The table below shows the status of cases at the end of the last fiscal year (June 30, 1927), not including cases pending in the general counsel's office or before the board.

Return years	On hand June 30, 1923	On hand June 30, 1924	On hand June 30, 1925	On hand June 30, 1926	On hand June 30, 1927	Total audited to date	Per- centage remain- ing open June 30, 1927
1917.....	28,916	8,773	3,417	1,372	622	1,321,980	0.05
1918.....	84,323	19,364	6,002	1,877	861	1,275,134	.07
1919.....	103,198	61,327	12,155	2,628	1,184	1,498,590	.08
1920.....	458,205	166,484	90,746	7,121	2,081	1,642,268	.13
1921.....	1,190,902	353,781	171,221	8,192	2,020	1,471,218	.14
1922.....	1,167,000	719,702	380,045	141,084	5,136	1,552,925	.33
1923.....		1,100,624	372,200	154,329	35,316	1,236,945	2.77
1924.....			975,298	170,786	107,607	1,024,486	9.51
1925.....				253,402	289,275	573,679	33.52
1926 <sup>1</sup> .....				1,949	30,433	1,413,147	2.11
Total.....	3,032,544	2,430,044	2,011,084	742,740	474,535	13,001,372	3.52

<sup>1</sup> This tabulation does not include the total returns filed for the year 1926, since many of them had not on June 30, 1927, been received in the Income Tax Unit.

The bureau is approximating a current status. As the work becomes more current the volume of board cases may diminish. The board's docket may be as congested now as it will be at any time in

the future. It should be said, however, that there is no tangible evidence as yet to show that this factor is operating to decrease appeals.

The major element in relieving congestion is an adequate recognition by the bureau and the general counsel's office of their duties in this connection, and the exertion of vigorous efforts by both to accomplish the reduction of congestion. That the Treasury is fully aware of the situation will be apparent from the data submitted in Volume III. Without whole-hearted cooperation between the bureau, the general counsel's office, and the board, the task will be difficult. By itself the board is powerless either to diminish incoming appeals or greatly to increase the present rates of production while maintaining the quality of its decisions.

*Key cases.*—It often happens that several cases within the bureau and before the board rest ultimately on a single proposition of law which is the subject of dispute between the department and several taxpayers. There were recently more than 1,000 cases on the board's docket, all resting primarily and some wholly on a single issue. There should be a way in which to secure a speedy hearing on a typical case so that others will not continue to encumber the docket, and so that the bureau may dispose of those in its hands without issuing deficiency letters. A motion to advance might accomplish the result. It is felt that there can be no doubt of the board's right under existing law to entertain such a motion, and its use under circumstances of this kind is suggested.

*Improved form of 60-day letters.*—It is the experience of board members that the taxpayer and the bureau do not always know the points of difference between them. This is inexcusable. In part it is due to the bureau's failure to tell the taxpayer at conferences the position which it has taken with respect to his case, the exact point at issue, and the particular details which give rise to difference of opinion. He may be told that the evidence is "insufficient," when in fact it is sufficient if understood and rightly interpreted by the conferee. Some bureau letters are vague, simply stating that the taxpayer's contentions can not be accepted. The taxpayer should at all times know in what particular the bureau does not agree with his views of the case. If during the progress of each case through the bureau both parties knew exactly the contentions of the other party, more adjustments would be reached and there would be fewer 60-day letters. The 60-day letter ought to show completely on its face the cause of the deficiency. It should not merely incorporate prior letters.

The bureau has under consideration means of improving the form of the 60-day letter in these respects.

*Plea in the nature of a demurrer.*—The suggestion has been made that the Board of Tax Appeals can not consider questions of law in advance of questions of fact. It is believed that the act does not restrict the board in this respect. There is ample authority to make rules for the disposition of law questions at preliminary hearings. It is suggested that the board make suitable provision by rules to take care of such cases.

## CLOSING AGREEMENTS

## Section 1106 (b)

## RECOMMENDATION

It is recommended that section 1106 (b) be modified so as to permit the execution of agreements thereunder as soon as the settlements in a given case has been reached between the Government and the taxpayer, without waiting for the assessment and collection of the amount of tax due (if any), the actual making of an abatement, refund, or credit, or the determination in detail of interest or penalties. The making of the agreement under section 1106 (b) should not be restricted to years for which original or additional taxes are determined to be due and unpaid.

## DISCUSSION OF RECOMMENDATIONS

A frequent criticism in connection with the administration of income taxes has been the reopening of closed cases. Taxpayers complain when cases once thought to be settled are reopened by the Government. On the other hand, the bureau points out the circumstance, that one of the chief obstacles to bringing its work to a current basis is the reopening of old cases by taxpayers on claims for refund or credit. In both instances the moving party (taxpayer or Government) is raising for fresh consideration a case which therefore has been considered adjusted and closed.

An effective way of attaining the desired end of preventing the reopening of cases is by agreements between the Government and the taxpayer to regard a given decision as final. The execution of such an agreement is authorized by section 1106 (b) of the Revenue Act of 1926. There were somewhat similar provisions in the acts of 1924 and 1921.

Facilities should be provided for executing such agreements more promptly and more generally than has been done in the past. A case should not be subjected to an intensive reaudit on the taxpayer's application for such an agreement. This, though formerly the practice, appears to have been abandoned. It is true of many tax cases that one bureau employee may decide the case one way and another employee, equally honest and competent but disposed to the a different view of the facts or the law, may review the same case and reach a different answer. This process may go on indefinitely. It is of utmost importance that this be discouraged. Once a case has been considered and a fair adjustment has been reached the disposition should be final.

One difficulty in the way of executing agreements under section 1106 (b) is the wording of that section, which requires that the tax or penalty be not only determined but that it also be assessed and paid before the agreement can be signed. As a practical matter this is too cumbersome. The effectiveness of the section is lost. The taxpayer or his representative has conferred with a representative of the Government. The facts have been developed and an agreement has been reached at or shortly after the conference. It should be possible to execute an agreement *when the settlement is reached*, without

waiting for assessment and payment of the tax or determining the liability for interest or penalties. If advisable, these items may be specifically excepted from the agreement. The same is true as to the making of an abatement, refund, or credit determined to be proper for that year. These matters can follow in usual course. Neither the Government nor the taxpayer has anything to lose by executing the agreement without delay and both have much to gain.

Applications for 1106 (b) agreements have been made where no tax is due either because all amounts have previously been paid or because for the year in question the taxpayer had a loss, or because the particular individual or corporation was exempt from tax. The present wording of the section may be construed impliedly to prohibit closing such cases by agreement. It does not seem desirable to distinguish these cases from other cases so far as closing agreements are concerned. The desirability of putting an end to controversy about a particular tax year is just as strong as in ordinary cases. While the agreement should not bind the Government or the taxpayer as to any year not included in it, the execution of the agreement should be open to the parties.

In no case should the agreement be entered into prior to the expiration of the taxable period to which it relates.

The execution of agreements under section 1106 (b) in tax cases generally is strongly recommended.

#### MISCELLANEOUS SUBJECTS

*Deductions of estate and inheritance taxes.*—Estate, succession, legacy, or inheritance taxes are deductible from gross income in computing net income. In some States the tax is imposed on the right to transmit property at death, while in others it is a tax on the right to receive property at the death of another person. Difficulties have been encountered in deciding who is entitled to deduct taxes of the nature above mentioned. Under the present regulations the deduction is taken by an estate or by the beneficiary, accordingly as it is imposed on the right to transmit or on the right to receive. The distinction is almost unworkable and much too technical. To provide a definite and uniform rule, it is suggested that the estate be allowed the deduction in all cases unless the beneficiary can show that he actually paid the tax and that he was under liability to make such payment.

*Extensions of time for payment of deficiencies.*—Section 274 (k) of the Revenue Act of 1926 provides that the commissioner may extend the time for payment of a deficiency in cases where payment on the date prescribed for payment thereof would result in undue hardship to the taxpayer, but the extension can not be made for a period of more than 18 months. Experience has shown that under certain circumstances this period of time is inadequate to permit the taxpayer to liquidate his assets sufficiently to make payment of the tax. In cases where the taxpayer is unable to pay after an extension of 18 months, it may happen that to force payment would put the taxpayer in bankruptcy and the Government would recover less than the amount of the tax. Frequently the full amount can be collected by forbearance for a slightly longer period. Accordingly it is recommended that in exceptional cases the commissioner be permitted to extend the time for a further period of 12 months.

District	Collectors—Authorized Location of collector's office	Number of offices the records of the Justice Department	Estimated increases and decreases necessary for proposed consolidation				
			Estimated number of employees necessary under proposed organization	Field		Office	
				Increase	Decrease	Increase	Decrease
Alabama	Birmingham	56	52		4		
Arizona	Phoenix	25	22		3		
Arkansas	Little Rock	55	47		8		
First California	San Francisco	336	314		10		12
Sixth California	Los Angeles	253	282		10	39	
Colorado	Denver	107	84		10		13
Connecticut	Hartford	158	142				16
Delaware	Wilmington	23	23				
Florida	Jacksonville	138	129		9		
Georgia	Atlanta	95	76		13		6
Hawaii	Honolulu	28	23		3		2
Idaho	Boise	28	30			2	
First Illinois	Chicago	525	525				
Eighth Illinois	Springfield	112	96		6		10
Indiana	Indianapolis	173	156		15		2
Iowa	Dubuque	124	121		8	5	
Kansas	Wichita	92	74		14		4
Kentucky	Louisville	123	96		16		11
Louisiana	New Orleans	117	95		15		7
Maine	Augusta	50	43		7		
Maryland	Baltimore	246	225		12		9
Massachusetts	Boston	510	400		55		55
Michigan	Detroit	255	245		5		5
Minnesota	St. Paul	173	145		21		7
Mississippi	Jackson	35	33		2		
First Missouri	St. Louis	151	138		8		5
Sixth Missouri	Kansas City	76	74		7	5	
Montana	Helena	49	47		4	2	
Nebraska	Omaha	122	82		20		20
Nevada	Reno	11	12	1			
New Hampshire	Portsmouth	40	34		6		
First New Jersey	Camden	69	75		6	12	
Fifth New Jersey	Newark	238	226				12
New Mexico	Albuquerque	18	20	2			
First New York	Brooklyn	313	285		17		11
Second New York	Custom house, New York City	719	425		207		87
Third New York	250 West Fifty- seventh Street, New York City	185	260	68		7	
Fourteenth New York	Albany	131	131				
Twenty-first New York	Syracuse	95	87		8		
Twenty-eighth New York	Buffalo	188	165		7		16
North Carolina	Raleigh	108	93		8		7
North Dakota	Fargo	26	26				
First Ohio	Cincinnati	123	100		14		9
Tenth Ohio	Toledo	63	58		5		
Eleventh Ohio	Columbus	48	50			2	
Eighteenth Ohio	Cleveland	232	220		9		3
Oklahoma	Oklahoma	122	100		11		11
Oregon	Portland	73	70		6	3	
First Pennsylvania	Philadelphia	396	342		34		20
Twelfth Pennsyl- vania	Seranton	80	80				
Twenty-third Pennsylvania	Pittsburgh	309	300		7		2
Rhode Island	Providence	53	48		5		
South Carolina	Columbia	56	46		10		
South Dakota	Aberdeen	38	33		5		
Tennessee	Nashville	108	85		15		8
First Texas	Austin	103	120		1	18	
Second Texas	Dallas	158	115		20		23
Utah	Salt Lake City	57	45		6		6
Vermont	Burlington	30	25		5		
Virginia	Richmond	117	110		4		3
Washington	Tacoma	171	140		16		15
West Virginia	Parkersburg	104	90		12		2
Wisconsin	Milwaukee	194	185		6		3
Wyoming	Cheyenne	21	24	3			
Total		5,032	8,044	74	735	95	422
Total estimated					74		95



District	Collectors—Authorized office and field forces of collectors of internal revenues as of Sept. 1, 1927			Internal revenue agents—Authorized office and field forces of the 36 internal revenue agents' divisions as of Sept. 1, 1927			Estimated increases and decreases necessary for proposed consolidation			
	Location of collector's office	Total salary authorized office force, Sept. 1, 1927	Total salary used field force, Sept. 1, 1927	Total salary	Location of internal revenue agents in charge	Total salary office force	Total salary field force	Total number of collectors in field force necessary under present organization	Field	Offices
Alabama.....	Birmingham	24	\$48,940	16	\$34,120			55	52	
Arizona.....	Phoenix	12	27,080	10	19,800	San Francisco		22	22	3
California.....	San Francisco	92	188,420	53	108,280	San Francisco	60	47	8	8
Florida.....	San Francisco	12	25,800	10	18,200	San Francisco	10	10	10	10
Illinois.....	Chicago	95	174,240	69	107,860	New Haven	66	194,700	10	30
Indiana.....	Indianapolis	25	54,500	23	47,400	New Haven	25	54,500	23	23
Iowa.....	Des Moines	55	94,540	33	65,460	New Haven	33	65,460	33	33
Kansas.....	Topeka	10	24,420	8	8,260	New Haven	8	22,200	9	9
Michigan.....	Ann Arbor	31	65,320	15	35,700	Albany, N. Y.	15	35,700	15	15
Minnesota.....	Minneapolis	18	33,860	7	15,860	Honolulu	7	11,400	3	3
Missouri.....	St. Louis	203	440,720	01	177,940	Chicago	59	95,520	92	92
Montana.....	Helena	43	85,000	23	53,280	Chicago	23	18,800	112	66
Nebraska.....	Omaha	39	59,880	24	38,840	Indianapolis	13	31,820	124	124
Nevada.....	Reno	55	99,570	34	78,840	Indianapolis	01	183,500	124	124
New Hampshire.....	Manchester	40	59,880	24	38,840	Indianapolis	28	83,700	92	74
New Jersey.....	Trenton	34	68,820	24	44,880	New Orleans	49	144,800	15	15
New Mexico.....	Albuquerque	22	48,900	10	28,100	New Orleans	17	27,780	49	44
New York.....	Albany	203	440,720	01	177,940	New Orleans	25	80,800	59	43
North Carolina.....	Raleigh	42	88,900	30	56,900	Baltimore	30	60,800	50	43
North Dakota.....	Fargo	203	448,640	08	145,000	Baltimore	25	81,800	50	50
Ohio.....	Columbus	11	22,620	6	12,680	Baltimore	05	40,200	25	24
Oklahoma.....	Oklahoma	62	117,220	35	70,800	Baltimore	37	74,800	35	35
Oregon.....	Portland	187	315,740	58	131,460	Baltimore	121	205,100	715	425
Pennsylvania.....	Philadelphia	177	301,800	67	132,840	Baltimore	23	39,460	82	206,000
Rhode Island.....	Providence	17	36,600	18	37,880	St. Louis	20	31,800	67	107,300
Tennessee.....	Memphis	6	14,620	4	9,700	Omaha	11	12,120	12	12
Texas.....	Austin	18	37,780	11	23,660	Omaha	44	44	34	44
Vermont.....	Montpelier	15	61,280	17	83,000	Newark	28	47,480	28	28
Virginia.....	Richmond	65	126,620	6	12,680	Newark	35	64,600	18	20
Washington.....	Seattle	206,221	187	315,740	58	131,460	Newark	121	205,100	715
West Virginia.....	Charleston	176,486	117	201,800	67	132,840	New York	340	1,692,900	715
Wisconsin.....	Madison	67	113,000	45	89,260	New York	181	131	131	131
Wyoming.....	Cheyenne	46	79,220	28	58,820	Buffalo	29	51,980	188	165
Alabama.....	St. Louis	116,677	71	131,640	34	72,840	Buffalo	21	41,980	72
Arizona.....	St. Louis	46,706	41	78,440	25	43,640	Greensboro	31	93,400	108
California.....	St. Louis	19,000	13	26,600	8	17,200	Greensboro	31	93,400	188
Florida.....	St. Louis	30,980	36	38,440	17	20,000	Greensboro	26	26	26
Illinois.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Indiana.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Iowa.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Kansas.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Michigan.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Minnesota.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Missouri.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Montana.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Nebraska.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Nevada.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
New Hampshire.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
New Jersey.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
New Mexico.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
New York.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
North Carolina.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
North Dakota.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Ohio.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Oklahoma.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Oregon.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Pennsylvania.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Rhode Island.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Tennessee.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Texas.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Vermont.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Virginia.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Washington.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
West Virginia.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Wisconsin.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Wyoming.....	St. Louis	33,764	22	48,800	9	13,600	Greensboro	43	58	43
Total.....		941	1,571,980	2,830	\$,762,500		941	1,571,980	9,022	5,044
Total estimated decrease.....									74	95
Collectors (64)									74	95
Offices force (3,888)									74	95
Field force (1,789)									74	95
Total (4,271)									74	95

Revenue agents, office force (941)

Revenue agents, field force (2,830)

Total (3,833)

\$38,609

3,716,739

10,282,860

Total (4,271)

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\$1,571,980

\$,762,500

10,334,450



## APPENDIX TO VOLUME I

TABLE I.—Approximate loss in tax to the Government by the 12½ per cent provisions on capital gains and losses and reduction in tax to individuals, classified by net incomes

Classification of incomes	12½ per cent tax on capital net gains	12½ per cent credit on capital net losses	Approximate loss in tax	Per cent reduction of tax to group	Number of taxpayers in group	Average saving in tax to each individual
<i>Year 1922</i>						
\$30,000 to \$40,000.....	\$428, 251		\$368, 314	0.72	14, 283	\$25.78
\$40,000 to \$50,000.....	1, 283, 500		1, 591, 540	3.43	7, 970	199.69
\$50,000 to \$60,000.....	1, 685, 695		2, 764, 539	6.80	4, 700	588.19
\$60,000 to \$70,000.....	1, 476, 399		3, 012, 343	8.23	3, 030	994.17
\$70,000 to \$80,000.....	1, 171, 749		2, 859, 064	9.34	1, 944	1, 470.71
\$80,000 to \$90,000.....	1, 082, 665		3, 103, 168	11.12	1, 401	2, 214.96
\$90,000 to \$100,000.....	1, 133, 349		4, 800, 507	19.24	925	5, 189.73
\$100,000 to \$150,000.....	3, 246, 842		11, 298, 007	13.67	2, 171	5, 204.05
\$150,000 to \$200,000.....	2, 095, 644		7, 460, 492	12.47	763	9, 777.84
\$200,000 to \$250,000.....	1, 753, 636		6, 492, 431	19.83	350	18, 549.80
\$250,000 to \$300,000.....	1, 451, 431		5, 283, 205	20.72	210	25, 158.12
\$300,000 to \$400,000.....	1, 825, 449		6, 644, 533	20.49	205	32, 412.35
\$400,000 to \$500,000.....	1, 287, 463		4, 685, 999	20.92	104	45, 057.68
\$500,000 to \$750,000.....	2, 654, 882		9, 663, 768	26.40	122	79, 211.21
\$750,000 to \$1,000,000.....	1, 600, 262		5, 824, 910	33.38	39	149, 356.66
\$1,000,000 and over.....	6, 849, 140		24, 930, 869	33.48	67	372, 102.52
Total.....	31, 066, 357		100, 783, 689		38, 284	
<i>Year 1923</i>						
\$30,000 to \$40,000.....	980, 550		384, 375	.89	16, 441	23.32
\$40,000 to \$50,000.....	1, 304, 400		886, 975	2.46	8, 472	104.69
\$50,000 to \$60,000.....	1, 592, 951		1, 561, 091	5.05	4, 945	315.69
\$60,000 to \$70,000.....	1, 396, 033		1, 786, 912	6.74	3, 060	578.28
\$70,000 to \$80,000.....	1, 069, 474		1, 689, 770	7.67	1, 981	1, 851.99
\$80,000 to \$90,000.....	1, 122, 286		2, 109, 900	10.22	1, 435	1, 470.31
\$90,000 to \$100,000.....	913, 568		1, 991, 556	11.08	1, 001	1, 989.56
\$100,000 to \$150,000.....	3, 400, 099		8, 024, 206	12.59	2, 329	3, 430.61
\$150,000 to \$200,000.....	1, 837, 762		4, 447, 385	13.02	750	5, 929.84
\$200,000 to \$250,000.....	1, 569, 622		3, 892, 639	17.15	348	11, 186.74
\$250,000 to \$300,000.....	1, 342, 623		3, 329, 679	19.67	203	16, 402.36
\$300,000 to \$400,000.....	1, 752, 851		4, 347, 068	18.34	216	20, 125.31
\$400,000 to \$500,000.....	1, 458, 617		3, 617, 080	22.77	111	32, 590.81
\$500,000 to \$750,000.....	1, 929, 298		4, 784, 633	22.92	103	46, 452.74
\$750,000 to \$1,000,000.....	807, 144		2, 001, 701	17.53	38	52, 676.34
\$1,000,000 and over.....	6, 709, 346		16, 639, 157	31.73	74	224, 853.47
Total.....	29, 186, 624		61, 494, 127		41, 537	
<i>Year 1924</i>						
\$30,000 to \$40,000.....	1, 680, 824	\$855, 401	310, 355	.65	19, 464	15.98
\$40,000 to \$50,000.....	2, 468, 166	823, 774	1, 118, 141	2.73	10, 165	109.99
\$50,000 to \$60,000.....	2, 555, 782	682, 943	1, 932, 768	5.26	6, 019	321.11
\$60,000 to \$70,000.....	2, 436, 163	714, 763	2, 272, 248	6.72	3, 978	571.20
\$70,000 to \$80,000.....	2, 065, 817	560, 667	2, 468, 446	8.40	2, 579	957.13
\$80,000 to \$90,000.....	1, 645, 168	549, 324	2, 112, 786	7.69	1, 912	1, 105.01
\$90,000 to \$100,000.....	1, 066, 740	510, 857	2, 481, 061	10.25	1, 328	1, 868.26
\$100,000 to \$150,000.....	6, 075, 812	1, 347, 946	11, 535, 984	12.00	3, 065	3, 763.78
\$150,000 to \$200,000.....	3, 749, 623	371, 892	7, 753, 649	14.69	1, 084	7, 152.81
\$200,000 to \$250,000.....	3, 061, 375	180, 313	7, 260, 277	19.03	542	13, 395.34
\$250,000 to \$300,000.....	2, 083, 183	91, 778	4, 933, 799	21.99	250	19, 735.19
\$300,000 to \$400,000.....	3, 687, 338	557, 776	8, 100, 745	21.75	320	25, 314.82
\$400,000 to \$500,000.....	2, 073, 744	111, 913	5, 133, 245	22.93	137	37, 468.94
\$500,000 to \$750,000.....	5, 046, 510	538, 009	12, 082, 780	27.84	192	62, 931.14
\$750,000 to \$1,000,000.....	1, 716, 844	397, 590	3, 535, 590	24.40	50	70, 711.80
\$1,000,000 and over.....	6, 332, 587	205, 882	16, 419, 589	25.72	75	214, 927.85
Total.....	48, 285, 616	8, 700, 828	89, 451, 463		51, 160	

TABLE I.—Approximate loss in tax to the Government by the 12½ per cent provisions on capital gains and losses and reduction in tax to individuals, classified by net incomes—Continued

Classification of incomes	12½ per cent tax on capital net gains	12½ per cent credit on capital net losses	Approximate loss in tax	Per cent reduction of tax to group	Number of taxpayers in group	Average saving in tax to each individual
<i>Year 1925</i>						
\$30,000 to \$40,000.....	\$1,158,826	\$471,276	\$93,507	0.19	24,732	\$3.73
\$40,000 to \$50,000.....	2,463,401	484,305	680,809	1.54	13,067	52.10
\$50,000 to \$60,000.....	3,551,430	381,373	1,699,151	4.31	7,868	215.96
\$60,000 to \$70,000.....	4,102,498	414,012	2,685,218	7.58	5,108	529.69
\$70,000 to \$80,000.....	4,083,827	360,460	3,127,628	10.56	3,586	872.18
\$80,000 to \$90,000.....	3,165,807	354,912	2,586,023	9.27	2,507	1,031.52
\$90,000 to \$100,000.....	3,245,252	294,922	2,714,304	10.78	1,889	1,436.90
\$100,000 to \$150,000.....	13,006,830	1,302,213	11,704,617	12.84	4,759	2,459.47
\$150,000 to \$200,000.....	8,325,524	855,735	7,469,789	13.88	1,758	4,249.02
\$200,000 to \$250,000.....	6,691,485	391,407	6,300,078	15.99	928	6,788.88
\$250,000 to \$300,000.....	5,533,523	246,563	5,286,960	18.30	537	9,845.36
\$300,000 to \$400,000.....	8,018,866	468,781	7,550,085	19.22	562	13,434.31
\$400,000 to \$500,000.....	7,485,449	231,828	7,253,621	23.22	330	21,980.67
\$500,000 to \$750,000.....	10,114,990	460,902	9,654,088	21.96	340	28,394.33
\$750,000 to \$1,000,000.....	7,055,909	218,646	6,837,263	26.10	139	49,188.94
\$1,000,000 and over.....	29,567,354	721,603	28,845,751	30.14	207	139,351.45
Total.....	117,570,971	7,658,938	104,488,892	-----	68,317	-----

NOTE.—The above compilation made from figures obtained from "Statistics of Income" as published by Bureau of Internal Revenue.

TABLE II.—Capital gains tax

	1923	1924	1925
Total income returned.....	\$29,318,927,803	\$29,578,996,575	\$25,272,034,691
Total profits from sales of property.....	1,172,154,628	1,513,714,092	2,932,228,840
Amount of these sales not taxed as capital gains.....	866,760,860	1,124,565,685	1,991,669,499
Amount of these sales taxed as capital gains.....	305,393,768	389,148,434	940,569,341
Total net tax returned.....	663,651,505	704,265,390	734,555,183
Capital gains tax returned.....	29,186,624	48,803,064	117,570,971
Other tax returned (sur and normal).....	634,464,881	655,462,326	616,984,212
Capital gains tax in percentage of total tax per cent.....	4.40	6.93	16.01

TABLE II-A.—Source of income returned

	1924	1925	Reduction	Per cent
Wages and salaries.....	\$13,617,662,626	\$9,742,159,865	\$3,875,502,761	28.46
Business.....	4,755,483,091	3,688,804,463	1,066,678,628	22.43
Partnership.....	1,810,013,740	1,827,025,490	<sup>1</sup> 17,011,750	.94
Rents and royalties.....	2,009,716,478	1,471,332,463	538,384,015	26.79
Interest and investments.....	2,281,703,361	1,814,402,206	467,301,155	20.48
Dividends.....	3,250,913,954	3,464,624,648	<sup>1</sup> 213,710,694	6.57
Fiduciary.....	310,143,901	305,805,537	4,338,364	1.40
Interest on partially taxed United States securities.....	29,645,332	25,651,179	3,994,153	13.47
Profits from sale of realty, securities, etc.....	1,513,714,092	2,932,228,840	<sup>1</sup> 1,418,514,748	93.71
Capital gains (included above).....	389,148,434	940,569,341	<sup>1</sup> 551,420,907	141.70
Total.....	29,578,996,575	25,272,034,691	4,306,961,884	14.56

<sup>1</sup> Increase.