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THE 1934 EDITION OF THE FEDERAL REVENUE ACT

By CHARLES L. B. LOWNDES*

Upon the eve of the tax year, with the ides of March impending, the fancy of the taxpayer turns inevitably, albeit not lightly, to thoughts of the latest version of the Federal Revenue Act. It is the 1934 edition or version of the Federal Revenue Act, rather than the 1934 Act. With the crystallization of the post-war system of federal revenues into their present molds, an analysis of the new act degenerates into a study in amendments to the old. A perplexing problem is the sequence in which these new developments should be presented. An alphabetical treatment by topics1 or a numerical approach by sections2 leaves rather appalling gaps. The major purpose of the new act is to equalize the tax burden by the prevention of tax avoidance. Possibly some continuity may be secured by ringing the changes effected by the new legislation upon this central theme. But concessions to artistry end here. A convenient arrangement is to consider the more noteworthy structural changes within the different taxes first, and then the minor amendments under some topical or chronological or sheer hodge-podge sequence. This is anticlimactic. It has the overwhelming advantage, however, of allowing the wearied reader to scan the major changes wrought by the new act rapidly. It also has the virtue of permitting him to desist entirely at almost any point, with the comforting reflection that the worst is still in store.

The measure of legislative achievement is the effectiveness of an enactment in approximating the legislative objectives. This is easier to judge in retrospect; although, it may be possible to forecast the probable success of a new revenue bill by a critical scrutiny of its provisions in the light of its declared purposes. The aim of the 1934 Act is a more equitable distribution of the tax burden by stopping the tax leaks in the old legislation. An evaluation of

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1See the yellow pages of a pamphlet entitled, The Revenue Act of 1934, published by Commerce Clearing House, Inc.

2See a clear, but deceptively summary, statement of the changes effected by the new act in a pamphlet issued by City Bank Farmers Trust Company entitled, Federal Revenue Act of 1934, pages 9 to 17.
the Congressional efforts in meeting this problem must embrace more than the current law. The leaks in the prior law must be scrutinized, and the alternatives which the new act rejected must be contrasted with those which met more favorable reception.

I. THE INCOME TAX

TAX RATE STRUCTURE, CREDITS, PERSONAL EXEMPTIONS

Under the 1932 Act a normal tax of 4 per cent. was imposed upon the first $4,000 of taxable net income and of 8 per cent. upon the balance. The surtax started at 1 per cent. on net income in excess of $6,000 and was stepped up through fifty-three brackets to 55 per cent., upon net incomes of one million dollars and over. The graduated normal tax is an added complexity. It is not necessary to preserve the ability to pay principle which is amply provided for by the progressive rates of surtax. The 1934 Act reverts to the practice of the first income tax laws by providing for a single normal tax. Under the new law there is one normal tax of 4 per cent. To recoup the loss in normal tax, the new surtax starts at 4 per cent. on net incomes in excess of $4,000 and is graduated up to 59 per cent. on incomes of one million dollars or more. The new rates are further simplified by limiting the number of surtax brackets to twenty-nine.

To compensate for the heavier surtax on small incomes, personal exemptions and credit for dependents, which remain unchanged in the new Act, are allowed against net income for surtax as well as normal tax purposes. The Treasury objected to this allowance against the surtax on the ground that a taxpayer in the surtax class should be able to pay without these advantages. But the provisions were retained in pursuance of a congressional policy against increasing the tax burden on small incomes.

Although theoretically the tax rates in the 1934 Act are substantially the same as those of the 1932 Act, the heavier surtax

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3Sec. 11, 1934 Act.
4Sec. 12 (b), 1934 Act.
5Sec. 25 (b), 1934 Act.
6Sec. 25 (b), 1934 Act.
7Statement of the acting secretary of the treasury regarding the preliminary report of a subcommittee of the committee on ways and means, (1934) 34 C. C. H. 6698.
8Report of the House Committee on Ways and Means 5, 6. Occasion will be found frequently to cite this report, which accompanied the introduction of the 1934 Bill in the House, in the course of this discussion. For the sake of brevity it will be cited simply as the House Report.
results in a slightly larger tax on dividends and partially tax-exempt interest, which are subject to the surtax but not to the normal tax.\(^9\) This will benefit the taxpayer with an earned income,—an incidental consequence of the new rates which was not unappealing to either branch of the national legislature.\(^10\)

The Revenue Acts for 1924, 1926, and 1928 contained a 25 per cent. tax credit for earned income, which was abolished by the 1932 Act. The 1934 Act provides for an earned income credit of 10 per cent.\(^11\) This credit is allowed, however, only for normal, not for surtax purposes. Moreover, the credit under the 1934 Act, unlike the prior laws, is a credit against net income, not a tax credit against the amount of tax.

The credit is to be taken against "earned net income," which is the "excess of the amount of earned income over the sum of earned income deductions."\(^12\) Income up to $3,000, however, is treated for the purpose of the credit as earned income, whether or not it is such in fact. However, in no case will earned net income be considered to be more than $14,000 for the purpose of the credit.\(^13\)

\section*{Capital Gains and Losses}

Probably the most interesting change in the new law relates to capital gains and losses. There is no more contentious ground in income taxation than the proper treatment of capital gains and losses. The British system is to ignore them entirely. This

\(^9\)Sec. 25 (a), 1934 Act. House Report 7; Report of the Senate Committee on Finance 10 (This report of the Senate which accompanied the introduction of the bill in that body will be cited hereafter as, Senate Report).

\(^10\)Supra note 9.

\(^11\)Sec. 25 (a) (4), 1934 Act. Earned income is defined by section 25 (a) (5) to include "wages, salaries, professional fees, and other amounts received for services rendered." But it does not include, "any amount not included in gross income, nor that part of the compensation derived by the taxpayer for personal services by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for personal services actually rendered." Finally, "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 as compensation for 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."

\(^12\)Sec. 25 (a) (5) (C), 1934 Act. "Earned income deductions means such deductions as are allowable by section 23, and properly allocable to or chargeable against earned income." Sec. 25 (a) (5) (B), 1934 Act.

\(^13\)Sec. 25 (a) (5) (C), 1934 Act. A further limitation on the earned income credit is that it must not exceed 10 per cent of the amount of net income. Sec. 25 (a) (5), 1934 Act.
THE FEDERAL REVENUE ACT

undoubtedly leads to a more stable revenue. In the past eleven years the maximum British revenue was only 35 per cent. above the minimum. In this country the percentage of variation was 280 per cent. 14

The real difficulty seems to lie in the fact that income cannot be taxed until it is realized. Occasionally an apparent capital gain may result from a depreciation in currency, rather than a genuine accretion to capital values. However, there have never been any constitutional difficulties in defining income to include capital gains. 15 Conceding that capital gains represent a form of income, the problem in taxing them arises from the fact that the gain need not accrue in the year in which it is realized for taxation. If land is purchased for ten thousand dollars and sold for twenty ten years later, the gain is realized and taxed when the land is sold. But the land has been gradually appreciating in value during the ten years it was held. It is manifestly unjust to tax income which it has taken ten years to produce under the ordinary normal and surtax rates, as though it were an annual accretion.

The prior laws met this difficulty in an arbitrary fashion by giving the taxpayer an election to pay a straight 12½ per cent. tax or the ordinary normal and surtaxes, upon gains from capital assets, which with certain exceptions were defined to be assets held by the taxpayer for more than two years. Capital losses were deductible from capital gains, and capital net losses—that is, the excess of capital losses over capital gains—could be deducted from ordinary income, but the effect of a capital net loss upon the tax payable was limited so that the tax of a taxpayer having such a loss should not be less than what his tax would have been but for the capital loss provisions of the law.

Under the 1932 Act, for the first time, losses from the sale of stocks and bonds were treated a little differently from ordinary losses. Losses of this character could only be deducted from like profits, where the securities were not held long enough to constitute capital assets. A carry over privilege, which was given under the original law, was abolished by the National Industrial Recovery Act; as, for that matter, were the carry over privileges in connection with capital net losses generally. If securities were held for more than two years, they came under the capital


net gain and capital net loss provisions of the act. Gains and losses from the sale of such securities were taxed like ordinary capital gains and losses.

The 1934 Act has a radically new set-up for taxing capital gains and losses. No distinction is made between securities and other capital assets. Capital gains are subject to the normal tax and the surtax like other income. A distinction is made, however, in the amount of the gain which must be included in net income, based upon the length of time for which the taxpayer held the capital gains. If the asset was held for a year or less, 100 per cent. of the amount of the profit must be included in net income; for more than one year but not more than two, 80 per cent.; for more than two years but not more than five, 60 per cent.; for more than five years but not more than ten, 40 per cent.; for more than ten years, 30 per cent. Capital assets are defined by section 117 (b) of the new act as

"property held by the taxpayer (whether or not connected with his trade or business)" excluding "stock in trade of the taxpayer or other property of a kind which could properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

Under the new act capital losses may be applied to reduce capital gains. To the extent of $2,000 a capital net loss may be deducted from ordinary income. A loss from a sale or exchange

16Sec. 117 (a), 1934 Act. Under section 117 (c) of the 1934 Act, if the capital asset upon which the gain was realized was acquired by the taxpayer in connection with a tax-exempt exchange, or by gift, or consisted of securities acquired under a tax-exempt distribution in reorganization or as the result of a wash sale, since the basis for computing gain or loss from the subsequent sale or exchange of such property is the basis of the property which was exchanged, the basis in the hands of the gratuitous transferror, or the basis of the securities in connection with which the tax-free distribution or the wash sale occurred, the taxpayer adds to the time during which he held the property, the period during which he or his transferror held the original property.

17Gains or losses from short sales (Sec. 117 (e) (1), 1934 Act) or which are attributable to the failure to exercise privileges or options to buy or sell property (Sec. 117 (e) (2), 1934 Act) are considered as gains or losses from sales or exchanges of capital assets. Moreover, "amounts received by the holder upon retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by a corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form shall be considered as amounts received in exchange therefor." Sec. 117 (f), 1934 Act.

18Sec. 117 (d), 1934 Act. But "If a bank or trust company incorporated under the laws of the United States or any state or territory, a substantial part of whose business is the receipt of deposits, sells any bond,
of a capital asset, however, is only recognized to the extent that a gain from the sale of a capital asset held for a similar length of time would be.\(^9\) That is, the percentages which are used in computing capital gains are invoked in determining allowable deductions for capital losses. It seems clear that capital losses from the sale or exchange of an asset held during one percentage period could be offset against a capital gain realized upon an asset held for another. For example, a loss from a sale of property held for more than ten years could be set off against a gain from a sale of a capital asset held for less than a year. Of course, in making this computation only 30 per cent. of the loss could be utilized, while the gain would be 100 per cent. taxable.

It is provided by section 115 (c) of the new act that the entire gain from distributions in complete or partial liquidations of a corporation shall be taxable, without reference to the length of time during which the stock, upon which the distribution was made, was held. However, losses from such transactions are subject to the limitations upon capital losses, and must be computed by the percentage method.

Capital gains of a corporation are taxable in their entirety without the benefit of the graduated reductions for the length of time capital assets were held.\(^20\) However, since no exception is made for corporations in section 117 (d), which limits capital losses, presumably a corporation cannot benefit from a capital net loss in excess of $2,000.

The new provisions for taxing capital gains and losses are less arbitrary than the old 12½ per cent. tax, in that they make a more flexible allowance for the period during which the capital asset was held, instead of imposing a rigid two year limitation. The limitations on capital losses are not particularly fair. They were dictated by the stern necessity of safeguarding the federal revenues in a period of diminishing capital values. When conditions improve, they should be relaxed.

There is one objection to the new system which may here be debenture, note or certificate or other evidence of indebtedness issued by any corporation (including one issued by a government or political subdivision thereof), with interest coupons or in registered form, any loss resulting from such sale (except such portion of the loss as does not exceed the amount, if any, by which the adjusted basis of such instrument exceeds the par or face value thereof) shall not be subject to the foregoing limitation and shall not be included in determining the applicability of such limitation to other losses.” *ib.*

\(^9\)Sec. 117 (a), 1934 Act.

\(^20\)Sec. 117 (a), 1934 Act.
partially valid. One of the principal objections to the old 12½ per cent. tax was that it encouraged taxpayers to hold capital assets for more than two years. One of the implications from this objection is that it stimulates an unnatural bullishness by upsetting the law of supply and demand by inducing an artificial restriction on supply. We could probably stand an injection of bullishness to-day. It has, moreover, never been convincingly demonstrated that taxpayers did postpone profit-taking in order to avail themselves of a lower rate on capital gains. If the old system had the vice suggested, however, it is certainly magnified by the new, which, with its incessantly diminishing rates on capital assets held for a longer time, puts a premium on holding property as long as possible.

Basis for Computing Gain or Loss

Closely related to the problem of taxing capital gains and allowing capital losses is the basis for computing gain or loss from the sale or exchange of property. Several important changes have been made in this respect by the new act.

What is claimed to be a clarifying amendment definitely specifies a substituted basis for property transferred to a partnership by a partner or distributed to a partner by the partnership. The basis for property acquired by the partnership from a partner is the basis which the property had in the hands of the partner from whom it was acquired. The basis for property which is distributed to a partner by the partnership is such "part of the basis of his partnership interest as is properly allocable to such property."

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22 Sec. 113 (a) (13), 1934 Act.
23 Sec. 113 (a) (13). "The result of the provisions of section 113 (a) (13) is that if property is purchased by a partnership, the basis of such property to the partnership shall be its cost; but if the property is paid in by a partner then the basis to the partnership shall be the cost or other basis to the partner. This provision simply makes specific the correct interpretation of the general provisions of the present law. Paragraph 13 further provides that if property is distributed to a partner, the basis to the partner shall be a proper proportionate part of the cost or other basis to him of his interest in the partnership. An example will make the operation of this proposal clear. Suppose that a partner, A, paid $10,000 for his interest in a partnership. Suppose that the partnership distributes to the partners property in kind representing one half of its assets. Irrespective of the value of this property at the time of its distribution, the basis to A of the property distributed to him will be $5,000, and he will be taxed on any amount for which he thereafter disposes of the property.
In addition to a substituted basis for partnership property, the new act follows the provisions of the 1932 law in specifying a substituted basis for property which is the product of a tax-exempt exchange or an involuntary conversion. However, in all three cases under the provisions of the present law, the substituted basis is required only with respect to property acquired after February 28, 1913.24

Under the prior law25 where property was acquired before March 1, 1913, the basis for computing gain or loss was the fair market value of the property as of that date, or its cost, whichever was greater. The privilege of using the larger figure enabled the taxpayer to minimize his profits and magnify his losses, and, for that matter, to create a loss for tax purposes where none existed in fact. For example, a taxpayer who purchased property for $10,000 in 1910, which had a fair market value of $20,000 on March 1, 1913, and which was sold later for $15,000, would have an actual profit of $5,000 but a tax loss in that amount.26

Section 113 (a) (14) of the new law provides:

"In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subsection adjusted (for a period prior to March 1, 1913) as provided in subsection (b), is less than the fair market value as of March 1, 1913 then the basis for computing gain shall be such fair market value."

The purpose of this provision is to prevent the taxpayer showing a loss where none exists in fact.27 Although he is still permitted to minimize his gains by invoking a greater March 1, 1913 value, since this privilege is no longer explicitly conferred in computing losses, the taxpayer will not be able to magnify his losses by using a higher March 1, 1913 figure; nor to show a tax loss, where none in fact exists.

The new act also prevents a taxpayer giving away a tax loss. When a donee sells or exchanges property, the gain or loss from this transaction under the prior law was in general computed upon the basis which the gift had in the hands of the donor. If a

in excess of $5,000." Editorial note, Federal Revenue Act of 1934, issued by City Bank Farmers Trust Company, at page 56.

24Sec. 113 (a) (6) (9) (12) (13), 1934 Act.

25Sec. 113 (a) (13), 1932 Act.

26To simplify the discussion, without losing sight of the essential principle involved, the necessary adjustments for depreciation and capital expenditures are omitted.

taxpayer had property which had greatly depreciated in value, he could sell it and realize a loss. But it might be that he had no income against which to apply such loss. In this situation under the prior law, the owner of the property could give it to a more fortunate friend who had an income. The donee would sell the property and realize a tax loss to absorb his income, since the loss was computed on the basis which the property had in the donor's hands. To put an end to this practice, the 1934 Act provides that where property was acquired by gift after December 31, 1920, in computing a gain or loss from a subsequent sale of the property the substituted basis, or the fair market value as of the time of the gift, must be used, whichever is lower.\(^2\)

Under the 1932 Act, \(^2\) where property was acquired by a taxpayer from a decedent by will or intestacy, in some cases the basis of the property was the fair market value at the date of the decedent's death; in others, the fair market value at the time of distribution to the taxpayer. The new act adopts, as the uniform rule for all cases, the fair market value at the time of acquisition,\(^3\) which has been construed to mean the date of the decedent's death.\(^1\) Section 113 (a) (5) of the 1934 Act also provides that "property passing without full and adequate consideration under a general power of appointment exercised by will shall be deemed to be property passing from the individual exercising such power by bequest or devise."

**Corporate Surtaxes**

One of the more obvious methods of tax evasion, as distinguished from tax avoidance, is the so called "incorporated pocketbook." A taxpayer with a large income creates a corporation to which he transfers his assets. The income from these assets is now taxed to the corporation under a straight corporate tax, and the taxpayer draws enough in dividends to meet his current expenses. Although there is the additional corporate income tax, the taxpayer's surtax is reduced by allowing the surplus income of the corporation to accumulate. Of course, if the corporate surplus is ever distributed, it will be subject to surtax; but such a contingency may be postponed indefinitely.

\(^2\)Sec. 113 (a) (2), 1934 Act.
\(^2\)Sec. 113 (a) (5), 1932 Act.
\(^3\)Sec. 113 (a) (5), 1934 Act.
The prior laws attempted to reach this device by heavy penalty taxes upon corporations accumulating a surplus to avoid surtaxes. These penalties ran as high as 50 per cent. in the 1932 Act, but they met with very limited success. It was difficult to prove that the corporation was accumulating a surplus to avoid surtaxes, rather than for some legitimate business purpose; and the heavy penalties made the tax officials reluctant to invoke these provisions.

The new law takes a fresh approach to the problem. A corporation which accumulates a surplus to evade surtaxes is still subject to a high rate of tax, although the penalties of the earlier laws have been diminished in order to stimulate more vigorous enforcement. A surtax of 25 per cent. is imposed in such a case upon the first one hundred thousand dollars of "adjusted net income;" there is an upper bracket for amounts in excess of one hundred thousand dollars of 35 per cent.32

"'Adjusted net income' means net income computed without the allowance of the dividend deduction otherwise allowable; but diminished by the amount of dividends paid during the taxable year."33

This tax may be avoided if the shareholders include in their return their pro rata share of adjusted net income of the corporation whether distributed to them or not.34 The amounts so returned by the shareholders are taxed as dividends, and when the corporate surplus is later distributed, these distributions will be tax-exempt.

Although the new tax is formally denominated a surtax in order to reach the interest from partially tax-exempt securities, it is really penal, since it is conditioned upon showing an accumulation of surplus to evade surtaxes. However, the new Act attempts to reach another type of corporation which is used to evade surtaxes, by a tax which is not dependent upon any illicit intention. This is the new provision for taxing personal holding companies.35

A personal holding company is any corporation (other than an exempt corporation, a bank or trust company, a substantial part of whose business is the receipt of deposits, or a life insurance or surety company) (A) eighty per cent. of whose gross income for

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32Sec. 102 (a), 1934 Act.
33Sec. 102 (c), 1934 Act.
34Sec. 102 (d), 1934 Act.
35Sec. 351, 1934 Act.
the taxable year is derived from royalties, dividends, interest, annuities and (except in the case of regular dealers in stock or securities) gains from the sale of stock and securities and (B) more than fifty per cent. of whose outstanding stock was, at any time during the taxable year, owned directly or indirectly, by or for not more than five individuals.\(^8\)

For the purpose of determining the ownership of stock in a personal holding company, stock owned directly or indirectly by a corporation, partnership, trust or estate is considered as being owned proportionately by its shareholders, partners or beneficiaries.\(^3\) In order to reduce the number of individuals owning more than fifty per cent. of the stock in a personal holding company to a minimum, an individual is considered as owning, directly or indirectly, the stock owned by his family.\(^3\) A family for purposes of the act includes brothers and sisters (whether by the whole or the half blood) spouses, ancestors and lineal descendants.\(^3\)

In addition to the regular corporate income tax, a surtax of 30 per cent. for the first one hundred thousand dollars, and 40 per cent. for the excess, is imposed on the “undistributed adjusted net income” of personal holding companies.\(^4\) “Undistributed adjusted net income” is computed from the “adjusted net income.” “Adjusted net income” is the net income of the corporation computed without the allowance of the dividend deduction otherwise allowable, less federal income, war-profits, and excess profits taxes paid or accrued, (but not including this surtax) contributions or gifts not otherwise allowed, but which could be taken as deductions by an individual under section 23 (o) and capital losses which could not ordinarily be deducted under the limitations imposed by section 117 (d).\(^4\) “Undistributed adjusted net income” is “adjusted net income,” less 20 per cent. of the excess of adjusted net income over the amount of dividends received from personal holding companies, (which are deductible for the purpose of the normal corporate tax) and reasonable amounts used or set aside to retire indebtedness incurred prior to January 1, 1934, and dividends paid during the taxable year.

\(^{8}\)Sec. 351 (b), 1934 Act.

\(^{3}\)Sec. 351 (b) (1) (C), 1934 Act.

\(^{3}\)Sec. 351 (b) (1) (D), 1934 Act.

\(^{3}\)Sec. 351 (b) (1) (E), 1934 Act.

\(^{4}\)Sec. 351 (a) (1) (2), 1934 Act.

\(^{4}\)Sec. 351 (b) (2) (3), 1934 Act.
THE FEDERAL REVENUE ACT

The new plan should work well. Most of the corporations which are relied upon to evade surtaxes are close family affairs which would fall under the description of a personal holding company. If there is some legitimate business purpose for the corporation, the additional corporate surtax can easily be avoided by distributing the corporate income which would be subject to the surtax to the shareholders. Since the new act allows a reasonable reserve for indebtedness incurred prior to January 1, 1934 and an accumulation of 20 per cent. of adjusted net income in excess of dividends received from other personal holding companies, the only corporations which should be struck by the new provisions are those designed for surtax evasion.

Reorganizations

The reorganization provisions of the prior laws undoubtedly played a major part in tax avoidance during more prosperous times, when some reorganizations were engineered for the sole purpose of distributing corporate profits exempt from tax. A broad proposal was made at the beginning of the deliberations on the new act to abolish the reorganization provisions entirely and let the courts work out a satisfactory solution. This was rejected, which seems just as well in view of the Supreme Court's performance in that direction in the past.

Although the reorganization provisions prevented the realization of taxable profits during the years of prosperity, they also prevented the realization of losses during the depression. At the present time when reorganization is more a necessity than a luxury, they prevent the realization for tax purposes of huge losses. The 1934 Act, therefore, retains the substantial principle of the earlier laws, contenting itself with several minor changes designed to eliminate the more obvious cases of tax avoidance.

Section 112 (g) of the 1932 law allowed a corporation in reorganization to distribute to its shareholders stock or securities in another corporation, a party to the reorganization, without any

42House Report 12, 13.
tax to the shareholder. Under this section if corporation A organized a subsidiary corporation, B, to which it transferred a part of its assets in return for all the stock of corporation B, and distributed this stock as a dividend to its stockholders, without the surrender by the stockholders of any of their stock, this dividend was exempt from tax. The effect of this provision then was to allow a corporation to distribute a dividend which was tax-exempt. It would seem apparent that if a dividend paid by a corporation in stock of another corporation is ordinarily taxable, the transaction described above, which is simply a dividend in kind under the saving tag reorganization, should not be immune. Under the present law section 112 (g) of the 1932 Act is deleted.

Section 112 (g) is gone, but not entirely forgotten. The present act provides that where there was such a tax-exempt distribution under a prior law before January 1, 1934 such a distribution shall not be considered as a distribution of earnings and profits in determining the taxability of subsequent distributions by the corporation. The significance of this provision can be appreciated by a glance at section 115 (b) of the 1934 Act, which also raises a point about tax-free dividends, which may as well be considered here, although it is not strictly in line with a discussion of reorganizations. Section 115 (b) follows the prior law in providing that dividend distributions from earnings and profits accumulated before March 1, 1913 shall be tax-exempt, although they go to reduce the adjusted basis of the stock. In order to determine what dividends are tax-free, distributions from earnings and profits are presumed to be made out of the most recently accumulated earnings or profits. Unless this presumption were explicitly negatived, where there was a tax-exempt distribution of securities under section 112 (g) of the 1932 Act, it would be possible for a corporation to reach its earnings or profits accumulated prior to March 1, 1913, without making any taxable distributions at all. The necessity for such a provision, in itself, shows the vice in section 112 (g) of the prior law, and the wisdom of the new Act in deleting it.

In connection with tax-free distributions from earnings or profits accumulated prior to March 1, 1913, a proposal was made

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44 House Report 12, 13, 14; Senate Report 32.
45 Sec. 115 (h), 1934 Act.
46 Sec. 115 (b), 1934 Act.
by the House\textsuperscript{47} to eliminate this immunity, which could readily be done without encountering any constitutional objection.\textsuperscript{48} The Senate, however, reinstated it, for no better reason apparently than that it had existed since the 1916 law.\textsuperscript{49}

The reorganization provisions in the new act are further fortified against tax avoidance by a more stringent definition which limits reorganizations to statutory mergers and consolidations, transfers to a controlled corporation (control is defined as 80 per cent ownership) and changes in capital structure or form of organization.\textsuperscript{50} The definition of a "party to a reorganization" is also altered to conform to the new definition of a reorganization.\textsuperscript{51}

**CONSOLIDATED RETURNS**

The effect of consolidated returns on tax avoidance has been a matter of considerable dispute. The House retained the privilege, but provided for a 2 per cent. increase in the tax to be paid by taxpayers filing such returns.\textsuperscript{52} However, the consolidated return privilege was abolished in the Senate, except in the case of railroads.\textsuperscript{53} Railroad corporations are still allowed to file a consolidated return although they pay an additional 2 per cent. of tax for the privilege.\textsuperscript{54} For this purpose railroad corporations include corporations actually engaged in railroading and corporations whose assets consist primarily of stock in such corporations. If a railroad corporation leases its road to another common carrier by railroad, "the business of receiving rents for such railroad properties shall be considered as the business of a common carrier by railroad."\textsuperscript{55}

**DEDUCTIONS**

A. **Contributions.**—The deduction for contributions is limited under the 1934 Act by the provision that a contribution to a corporation, trust, community chest, fund, or foundation operated exclusively for religious, charitable, scientific, literary, or educ-

\textsuperscript{47}House Report 15.
\textsuperscript{49}Senate Report 36.
\textsuperscript{50}Sec. 112 (g) (1), 1934 Act. See Senate Report 16, 17.
\textsuperscript{51}Sec. 112 (g) (2), 1934 Act.
\textsuperscript{52}House Report 16, 17.
\textsuperscript{53}Sec. 141, 1934 Act.
\textsuperscript{54}Sec. 141, 1934 Act.
\textsuperscript{55}Sec. 141 (d) (3), 1934 Act.
tional purposes, or the prevention of cruelty to children or animals, is not deductible, if a substantial part of the activities of such a recipient consists of carrying on propaganda or otherwise attempting to influence legislation. The legislative sincerity in limiting the contribution to organizations like community chests and the S. P. C. A. is obvious. Section 23 (o) (3), which provides for the deductibility of contributions to posts or organizations of war veterans, contains no such qualification.

B. DEPLETION.—Under section 114 (b) of the new act, the taxpayer is given a fresh election in connection with coal, metal, and sulphur mines, to choose between the percentage of income method of depletion, specified by this section, or the regular method based upon cost or March 1, 1913 value. The election is binding in subsequent years and follows the property into the hands of successive taxpayers who must use a substituted basis with respect to it.

C. DEPRECIATION.—A provision which does not appear in the new law is an arbitrary deduction of 25 per cent. from depreciation allowances. Congress deleted this proposal upon the representations of the Treasury that the same amount of revenue would be saved by a more rigid administration of the existing provisions.

D. DIVIDENDS.—Dividends from a domestic corporation are ordinarily deductible from corporate net income. Dividends received by an individual from a domestic corporation are credited against net income for normal, but not surtax purposes. The theory behind this is that these distributions have already paid a corporate income tax and should therefore only be exposed to a surtax. The prior law allowed dividends from foreign corporations to be deducted from corporate income. Dividends from a foreign corporation, which during the preceding three year or applicable period earned more than 50 per cent. of its gross income from sources within the United States, were not subject to a normal tax in the hands of an individual recipient. In line with the

56Sec. 23 (o) (2), 1934 Act.
57See House Report 8; Senate Report 11, for a detailed discussion of the proposed depreciation limitation and Secretary Morgenthau's letter to the chairman of the House Committee on Ways and Means detailing the proposed changes in the departmental administration of depreciation allowances.
58But see the discussion of Corporate Surtaxes, supra.
59See the discussion of Tax Rate Structure, Credits, Personal Exemption, supra.
New Deal, however,—which has transmuted a somewhat passe 100 per cent. Americanism into an up to the minute planned national economy,—there is a provision in the new Act which denies any deduction or credit with respect to dividends received from a foreign corporation. Dividends from foreign corporations are taxed to corporate recipients and in the hands of an individual taxpayer are subject to both normal and surtaxes.60

Although it is scarcely pertinent in connection with deductions, there are several other interesting provisions in the new act, which emphasize the traditional Democratic policies of promoting free trade with other countries. The foreign tax credit, which was seriously impaired by the House,61 was restored by the Senate.62 However, section 103 of the new act contains a rather unique provision empowering the president to double the tax rates on citizens and corporations of foreign countries which are found to be imposing discriminatory and extra-territorial taxes upon our nationals. This power is limited to the extent that the rate which is imposed by this process must not exceed 80 per cent. of the taxpayer's net income, because it was felt that the tax should not be allowed to become confiscatory.63

Foreign taxpayers will also derive slight comfort from section 119 (a) of the new law which provides that interest from the United States, any territory or political subdivision of a territory, or the District of Columbia shall be treated as income from sources within the United States.64

A slightly more charitable international outlook occurs in section 119 (a) (2) (B). Although dividends from foreign corporations, 50 per cent. of whose gross income for the preceding three year or other applicable period was earned in the United States, are treated as income from sources within the United States, dividends from foreign corporations are treated as income from sources without the United States for purposes of the foreign tax credit.

E. EXPENSES INCURRED IN EARNING TAX EXEMPT INCOME.

60This is implied from section 23 (p) of the 1934 Act which limits the corporate dividend deduction to those received from domestic corporations, and section 25 (a)(1) which imposes a similar limitation on credits of individuals against net income for normal tax purposes.
61House Report 15, 16.
62Senate Report 39.
63Senate Report 31, 32.
64Senate Report 38, 39.
—Deductions, otherwise allowable, but which are incurred in connection with earning tax exempt income, are not deductible under the current law. An exception to this rule is made, however, in the case of expenses incurred in earning tax exempt interest. The reason for this exception was that the refusal to allow such deductions might interfere with the sale of federal and state securities, which the Senate Committee on Finance believed would be unfortunate during the present emergency.

F. INTEREST.—The new limitations upon deductible interest are directly connected with annuities. Under the prior laws annuity payments were exempt from income tax until the cost of the annuity had been recouped. When Congress was considering the current law, however, it was discovered that annuity payments not only represent a return of capital, but an allowance is made for a low rate of interest upon the sum expended in its purchase. Consequently the 1934 Act provides that even before the taxpayer recoups the cost of the annuity he must return each year out of annuity payments 3 per cent. of the cost or other applicable basis of the annuity.

Since annuity payments are no longer fully exempt until the capital expended for the annuity has been recovered, the provision of the 1932 Act, which excluded from the ordinary interest deduction interest paid or accrued by the taxpayer in connection with an indebtedness incurred or continued to purchase or carry an annuity, has been deleted by the current law. Interest of this type is now fully deductible.

In connection with the deduction for interest there was a rather interesting prenatal proposal to forbid the deduction of interest paid upon an indebtedness, if the proceeds of the indebtedness were used to purchase or carry tax-exempt securities. The purpose of this provision was to reach banks who invest a part of their deposits in tax-exempt securities and then proceed to deduct the interest paid to their depositors, without paying any tax upon the interest from the nontaxable securities. There was a good deal of logic in the suggested limitation, but at the instance of the banking interests it was deleted from the Act in its final form.

65Sec. 24(a)(5), 1934 Act.
66Senate Report 26, 27.
67Sec. 22(b)(2), 1934 Act.
68Senate Report 24.
69House Report 21, 22.
70See (1934) 57 Trust Companies 523.
The formal reason assigned by the Senate for failing to agree with the House on this point was that it might interfere with government financing during the present crisis.\footnote{Senate Report 24.}

H. Losses.—One of the prevalent forms of tax avoidance under the prior laws consisted of sales by one member of a family to another or between a taxpayer and a controlled corporation in order to establish a tax loss without letting the property actually pass beyond the taxpayer's control. This practice is terminated by section 24 (a) of the 1934 Act which provides that no loss will be recognized

"from sales or exchanges of property, directly or indirectly (A) between members of a family, or (B) except in the case of distributions in liquidation, between an individual and a corporation in which such individual owns, directly or indirectly, more than 50 per cent. in value of the outstanding stock."

An individual is "considered as owning the stock owned, directly or indirectly, by his family."\footnote{Sec. 24 (a) (6) (C), 1934 Act.} Family, for this purpose, is defined in the same way as family in connection with personal holding companies. It includes brothers and sisters (whether by the whole or half blood), spouses, ancestors, and lineal descendants.\footnote{Sec. 24 (a) (6) (D), 1934 Act.}

Another type of loss which is limited, though not entirely abolished, by the new act is wagering losses. The prior laws did not impose any limitation upon the deduction of gambling losses where such transactions were legal. However, the courts held that illegal gambling losses could only be used to offset gambling gains. The current act puts legal and illegal losses from wagering transactions upon the same footing, by providing that the losses from such transactions shall only be allowed to the extent of gains.\footnote{Sec. 23 (g), 1934 Act.}

According to the Report of the House Committee on Ways and Means

"under the present law [i. e., the Committee is referring to the 1932 Act] many taxpayers take deductions for gambling losses but fail to report gambling gains. This limitation will force taxpayers to report gambling gains if they desire to deduct their gambling losses."\footnote{At 22.}

I. Taxes.—Under the new law estate, inheritance, legacy, succession, and gift taxes are no longer deductible.\footnote{Sec. 23 (c) (3), 1934 Act.}
for the refusal to allow these deductions is that they do not constitute expenses which are incurred in the production of income; liability for them attaches regardless of whether there is any income; they are in fact merely charges imposed upon the transfer of capital.\textsuperscript{77}

J. Allocation of Income and Deductions.—Under the prior laws the Commissioner was given the power to allocate income and deductions between two or more trades or businesses owned or controlled directly or indirectly by the same interests, when this was necessary to prevent evasion of taxes or clearly reflect income. The commissioner’s power in this direction is either clarified or extended by the new act which adds “organizations” to “trades or businesses.”\textsuperscript{78}

Returns

A. Decedents.—Section 42 of the 1934 law provides in part, “In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period.”

Section 43 prescribes a similar rule for credits and deductions. The Report of the House Committee on Ways and Means explains these provisions:\textsuperscript{79}

“The courts have held that income accrued by a decedent on a cash basis prior to his death is not income to the estate, and under the present [1932] law, unless such income is taxable to the decedent, it escapes taxation altogether. By the same reasoning, expenses accrued prior to death cannot be deducted by the estate. Section 42 has been drawn to require the inclusion in the income of a decedent of all amounts accrued up to his death regardless of the fact that he may have kept his books on a cash basis. Section 43 has also been changed so that expenses accrued prior to the death of the decedent may be deducted.”\textsuperscript{80}

B. Execution.—Under the new law where there are two or more joint fiduciaries, a return by one of them is sufficient.\textsuperscript{81} Moreover, the chief accounting officer of a corporation may now execute a corporate return.\textsuperscript{82}

\textsuperscript{77}House Report 22.
\textsuperscript{78}Sec. 45, 1934 Act.
\textsuperscript{79}At 24.
\textsuperscript{80}See also Senate Report 28.
\textsuperscript{81}Sec. 142 (b), 1934 Act.
\textsuperscript{82}Sec. 52, 1934 Act.
C. PUBLICITY.—Under section 55 of the new act, taxpayers in addition to the usual return are required to file a statement taken from their return with their name and address, total gross income, total deductions, net income, total credits against net income for purposes of the normal tax, and tax payable. If the taxpayer fails to file such a statement, the collector is to file one for him and add $5 to the tax. These statements, or copies of them, become public records which are to be on public display for a period of not less than three years from the date they are required to be filed, in the office of the collector in which they are filed, in such manner as the commissioner with the approval of the secretary of the treasury may determine.

Section 148 (d) of the new act may also have some popular reverberations. This section provides that corporations shall submit to the secretary of the treasury a list of all officers and employees who receive compensation for personal services in any one year in excess of $15,000. The secretary of the treasury is to send an annual report containing this interesting information to Congress.

REVOCABLE TRUSTS

Under the earlier laws income from a trust which was revocable by the grantor alone, or in conjunction with a person lacking a substantial adverse interest in the trust, or by such a person, at any time “during the taxable year” was taxable to the grantor. This raised a problem as to whether a trust which could only be revoked by a notice, given before the end of the calendar year, in the succeeding calendar year, was included under this provision. The present act removes all doubt upon this point by deleting “during the taxable year.”\(^\text{83}\) The income from a trust which is revocable by the persons described at the outset of this paragraph is apparently taxable to the grantor, regardless of the limitations in the way of notice to which the power of revocation is subject.

OMITTED PROVISIONS OF THE 1932 ACT; OTHER MATTERS

In addition to the provisions of the 1932 Act which were deleted by the current law and which have been previously mentioned, there are several other omissions which should be noted.

Section 102 of the 1932 Act which limited the surtax on the

\(^{83}\text{Sec. 166, 1934 Act.}\)
profit from the sale of oil and gas wells is omitted from the present law. This section provided that where the principal value of the property had been demonstrated by prospecting or discovery by the taxpayer, the surtax on the profit from the sale of the property should be limited to 16 per cent. of the selling price. Apparently this was inserted to encourage the development of new mines and oil wells. Both the House and the Senate felt, however, that in the present state of overproduction there was no longer any necessity to continue a system which taxed large profits from the sales of certain kinds of property on a different basis than that applicable to property generally.

Section 23 (o) of the 1932 Act relating to future expenses in case of casual sales of real property was omitted as surplusage, because the commissioner achieves this same result under other parts of the law in the case of any sale of real estate, regardless of whether it is casual or not.

The 1934 Act has a new method of treating fiscal years which are bisected by a new revenue law. Consequently, section 105 of the 1932 Act, which related to apportioning the tax under such circumstances, is omitted, because it is no longer necessary.

There is good news in the new act for agrarians, who will learn from consulting section 101 (12) that for the purpose of determining the exemption of cooperative agricultural associations, the business done for Uncle Sam will not be counted against them. However, the community chests, the S. P. C. A., and the other benevolent organizations, which are exempt under section 101 (6) will have to desist from devoting a substantial part of their activities to carrying on propaganda or otherwise attempting to influence legislation, if they wish to continue this immunity. This is the same limitation as that which was applied by section 23 (o) in order to limit the deductibility of contributions.

In cases of sales of realty and casual sales of personal property the right to report on the installment basis is limited by section 44 (b) of the 1934 Act to situations where the initial payments do not exceed 30 per cent. of the selling price, instead of the 40 per cent. provided for in the 1932 Act. However, this does not apply retroactively to sales consummated prior to January 1, 1934, the effective date of the new law.

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85 House Report 22, 23; Senate 25, 26.
86 See the discussion of the Effective Date of the Tax, infra.
Under section 44 (d) of the 1934 Act a gain or loss from dealing with an installment obligation is considered as a gain or loss "resulting from the sale or exchange of the property in respect of which the installment obligation was received." This is important in connection with the provisions concerning capital gains and losses.

The requirement of withholding in the case of tax free covenant bonds is limited by the current law to bonds issued prior to January 1, 1934, the effective date of the new Act.87

A revenue law is probably the last place in the world where one would look for humor, but the new bill is not without a subtle irony. A new definition added by section 48 (d) reads as follows:

"Trade or Business.—The term 'trade or business' includes the performance of the functions of a public office."

THE EFFECTIVE DATE OF THE TAX

The new bill reads, "The provisions of this title shall apply only to taxable years beginning after December 31, 1933."88 This means that taxpayers who account upon the basis of a fiscal year, different from the calendar year, will not be put to the inconvenience, which prevailed under the prior laws, of computing their tax under two different acts. If a fiscal year commenced before the effective date of the new law, the tax will be computed under the 1932 Act. Of course, if the taxpayer accounts on the basis of the calendar year, he will compute his tax for 1934 under the 1934 Act, and the tax for a fiscal year commencing after December 31, 1933 must be computed under the new law.

An exception to the general rule occurs in connection with partnerships. If the taxable year of a partner differs from that of the partnership, he will include in his return his distributive share of the partnership income for the taxable year of the partnership, ending in his taxable year, regardless of whether or not the taxable year of the partnership commenced before or after January 1, 1934.89 For the purpose of computing the net income of a partner for a taxable year beginning after December 31, 1933, however; the partnership net income for any taxable year beginning before January 1, 1934, is computed under the Revenue Act

87Sec. 143, 1934 Act.
88Sec. 1, 1934 Act.
89Sec. 188 (a), 1934 Act.
of 1932. The capital gain and loss provisions of the new act, with the exception of 117 (d), the new limitation on capital losses, however, are to be applied in making this computation.90

II. THE ESTATE TAX
JURISDICTION TO TAX

The earlier acts based jurisdiction to tax estates upon residence rather than citizenship. The present law has been amended to add an additional jurisdictional base of citizenship, in line with similar provisions in the income and gift taxes. An estate tax is imposed on citizens regardless of residence, as well as on residents irrespective of citizenship. The gross estate of nonresidents who are not citizens of the United States is subject to the tax to the extent that it is located in the United States.91

Although the prior laws explicitly provided that in the case of a tax imposed on the basis of personal jurisdiction over a decedent all of his property should be included in his gross estate, the commissioner excluded foreign real estate.92 The new act amends section 302 of the Revenue Act of 1926, to sanction this exclusion explicitly.93

RATES

The computation of the estate tax under the 1932 law was as cumbersome as anything that could well be imagined. First a tax was computed under the 1926 law. Then a tentative tax was computed under the provisions of the 1932 Act, and the taxpayer paid the 1926 tax plus the differential between that tax and the tentative tax computed under the 1932 law. The reason for this roundabout calculation was to preserve the 80 per cent credit which was allowed against the federal tax with respect to state estate and succession taxes. Provincial prejudice was too strong to delete the credit outright, so it was emasculated by limiting it to the tax computed under the 1926 Act. The new act continues the same system. A tax is still computed under the 1926 Act against which the 80 per cent credit for state taxes may be taken. The tentative tax rate schedule of the 1932 Act, however, is stepped up

90Sec. 188 (b), 1934 Act.
91Sec. 403, 1934 Act.
93Sec. 404, 1932 Act.
THE FEDERAL REVENUE ACT

considerably by an amendment of the 1934 law. Under the 1932 Act the tentative tax started at 1 per cent. on net estates over $50,000 and reached a maximum of 45 per cent. on net estates of more than $3,116,000. Under the amended rates provided for by the 1934 law the tax starts at 1 per cent. on net estates in excess of $50,000 and progresses up to a maximum of 60 per cent. on net estates over $4,316,000. There are twenty-six brackets in the amended schedule as against twenty-five in the original law. The exemption for purposes of the tentative tax still remains at $50,000. The 1926 Act allowed an exemption of $100,000 which is unchanged by the present law.

GROSS ESTATE

Section 302 (d) of the 1926 Act provided for the inclusion in the gross estate of a decedent of any property which he had transferred in trust or otherwise which was "subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend or revoke." The new act amends this section by providing that the power shall be considered to exist at the decedent's death "even though the exercise of the power is subject to a precedent notice or even though the alteration, amendment or revocation takes effect only on the expiration of a stated period after the exercise of the power, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised."

In other words, there is no longer any possibility of escaping the estate tax by the creation of a revocable trust where the exercise of the power is dependent upon a precedent notice, or the revocation is not to become effective until the expiration of a certain period after the power is exercised.

DEDUCTIONS

Section 303 (a) (2) and 303 (b) (2) of the 1926 Act are amended by section 402 of the 1934 Act to limit the deduction for prior taxed property to a situation where the property was not only included in the gross estate of the prior decedent, but his estate was not entitled to a deduction with respect to it. Thus if A died and left Blackacre to B, and B died within five years of A's death, leaving the property to C, B's estate is entitled to a

94Sec. 405, 1934 Act.
95Sec. 401, 1934 Act.
deduction with respect to Blackacre. But if C dies within five years of B's death, under the 1934 amendment, his estate may not take a deduction on account of Blackacre, since this was allowed as a deduction to B's estate.

The limitation against allowing contributions to the organizations enumerated in section 23 (o) of the 1934 Act, a substantial part of whose activities consist in carrying on propaganda or otherwise attempting to influence legislation, to be deducted from the income tax, is applied by section 406 of the new Act to deductions for estate tax purposes.

III. GIFT TAX

Rates

The gift tax is designed as a supplement to the estate tax. Consequently to continue the policy of the 1932 Act, the gift tax rates are increased to about three-fourths of the new estate tax rates.96

The new rates only apply to gifts made in the calendar year 1935 and subsequent years. They are not applicable to gifts made in 1934, even after the enactment of the new act.97

Deductions

The new limitation on deductions for contributions or transfers to organizations, a substantial part of whose activities consist in carrying on propaganda or otherwise attempting to influence legislation, which was applied to the income and estate taxes, is extended to the organizations to whom tax-exempt gifts may be made by the 1934 Act.98

Omitted Provision

Section 501 (c) of the 1932 Act explicitly provided that the relinquishment by a donor of a power to revest title to property transferred in trust in himself was a taxable gift. After the enactment of that provision, the Supreme Court99 reached the

96Sec. 520, 1934 Act.
98Secs. 505 (a) (2) (B), 505 (b) (2) and 505 (b) (3) of the 1932 Act as amended by Sec. 517, 1934 Act.
conclusion that such relinquishment constituted a taxable gift in connection with the 1924 Act, which contained no such explicit provision. Section 511 of the 1934 Act therefore has deleted section 501 (c) of the 1932 Act as surplusage.

IV. **Capital Stock and Excess-Profits Taxes**

The combination of a capital stock tax and an excess-profits tax is an ingenious device to impale the corporate tax evader upon the horns of a seemingly inescapable tax dilemma. The capital stock tax is based upon the adjusted declared value of capital stock. The excess-profits tax is imposed on profits in excess of 12½ per cent of the adjusted declared value of capital stock. If the taxpayer seeks to reduce his capital stock tax by declaring a low value, he runs into a high excess-profits tax. If he seeks to reduce his excess-profits tax by setting a higher figure for capital stock, he encounters a stiff capital stock tax.

The capital stock tax under section 215 of the National Industrial Recovery Act and the excess-profits tax imposed by section 216 of that enactment were supposed to be temporary, their termination being conditioned upon the repeal of the eighteenth amendment. The last capital-stock tax return which was required was for the year ending June 30, 1934. The last excess-profits tax was for the taxable year ending prior to December 1, 1934. The House Bill contained no provision for continuing these taxes, beyond the dates they were originally limited to terminate. The Senate, however, decided that they should be continued indefinitely in view of the satisfactory manner in which they had worked and the condition of the federal finances.100

The rates and provisions of the new taxes are substantially the same as those of the prior law. The capital stock tax is one dollar for each $1,000 of adjusted declared value of the capital stock.101 The excess-profits tax rate is also the same as that previously provided; 5 per cent. of the amount of net income in excess of 12½ per cent. of the adjusted declared value of the capital stock.102

The new capital stock tax applies to the taxable year ending on or before June 30, 1934, and allows a new declaration of value for the first return under the new law. To avoid conflict with the

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100 Senate 5, 6, 7.
101 Sec. 701, 1934 Act.
102 Sec. 702, 1934 Act.
prior law, section 217 (d) of the National Industrial Recovery Act is amended so that the tax imposed under that act only applies to a year ending June 30, 1933.\textsuperscript{103} Section 703 of the new act also amends section 217 (e) of the National Industrial Recovery Act so that the excess-profits tax imposed by that enactment shall not apply to any taxpayer in respect of any taxable year ending after June 30, 1934.\textsuperscript{104}

**Conclusion**

The most illiterate objection that can be levelled against a tax system is that it is complicated. Every worthwhile tax is complicated. The unfortunate paradox of taxation is that the simplest taxes are the most oppressive. Justice in taxation, as elsewhere, consists of detailed concessions to unique situations. As long as a tax does not become so involved that it cannot be administered effectively, complexity is not a valid objection.

Moreover, even a complicated tax becomes familiar with time. The new revenue bill is the most technical and involved of all the modern federal revenue acts. But it proceeds on familiar principles and deals with familiar problems. The current law can and will be administered as effectively as its predecessors.

It is impossible to be associated with the modern federal tax system for very long without experiencing a genuine admiration for the scientific genius and planned intelligence behind a new revenue act. The new act is no exception. It is a task of no mean dimension to design a comprehensive tax measure which will equalize the tax burden by stopping tax avoidance; effect a more equitable distribution of wealth by a discreet emphasis on the ability to pay principle; further other social policies; provide for a more definite and facile administration; increase the federal revenues; and, still preserve the delicate economic balance of a society organized upon a traditional capitalistic basis. The reports of the various committees which sponsored the bill and some of the deliberations on the floors of both Houses showed an acute Congressional consciousness of these problems. For the most part they were met sincerely and with courageous intelligence.

The most dubious parts of the new act are the provisions tax-

\textsuperscript{103}Sec. 703, 1934 Act.
\textsuperscript{104}Because of space limitations, references to excise taxes and to administrative and procedural provisions have been omitted. [Ed.]
ing capital gains and losses. But the difficulty here is more or
less intrinsic to the subject. Although they scrap a system backed
by eleven years experience, the new provisions are an intelligent
plan for dealing with the problem, which merit a trial.

The new act makes no attempt to touch the most prolific
source of tax avoidance, the interest from tax-exempt securities.
Aside from any constitutional difficulties the state of the govern-
ment's finances precluded any tinkering in this direction. When
conditions improve, this problem should be met. The constitu-
tional difficulties to be overcome are not insuperable. The current
suggestion of an excise tax imposed on the business of owning
such securities, measured by their return, is more pedantic than
practical. But in the absence of any constitutional provision re-
stricting the federal legislature from impairing the obligation of
contract, a liberal court would probably uphold a federal income
tax upon federal securities which were tax-exempt when they were
issued. The due process clause of the fifth amendment is a pos-
sible obstacle, but when has a sympathetic Supreme Court been
worried about due process? At any rate, it is a close enough ques-
tion to make the experiment worth trying, and there certainly is
no constitutional objection to issuing federal securities in the fu-
ture without the immunity from federal taxation.

A federal tax upon the income from state securities presents
a more perplexing problem. There seems to be no evident reason,
however, why Congress could not enter into reciprocal agree-
ments with the states to allow mutual taxation of income from
each other's securities. These reciprocal exemptions from tax-
exemptions would be easier perhaps to negotiate than a constitu-
tional amendment, and they would be just as effective, if they
were sufficiently appealing to the states to ensure widespread
adoption.

There was another proposal in connection with the prevention
of tax avoidance during the deliberations on the new bill, which
raised a rather intriguing constitutional question. This was the
plan to require married couples to file joint returns. Although
this suggestion was not finally adopted, it is difficult to see the
supposed constitutional obstructions in its way. In *Hoeper v. Wiscon-
sin*, it is true, the Supreme Court invalidated a state law
which required a husband to pay a tax on the income of his wife
and minor children. But this is not precisely the plan which was

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105 (1931) 284 U. S. 206, 52 Sup. Ct. 120, 76 L. Ed. 248.
proposed in connection with the new law. Requiring a husband and wife to file a joint return is a different proposition than requiring A to pay an income tax on B's income. It would be perfectly constitutional to require a consolidated return from affiliated businesses, and the joint return of a husband and wife is not such a different proposition. Moreover, the categorical assumption that A cannot constitutionally be taxed for B's income goes too far. *Burnet v. Wells* held very definitely that A may be taxed for B's income, if there is a sufficient reason for the tax. There seems to be a sufficient reason to justify any casual injustice done the taxpayer by requiring a joint return in the necessity of preventing a very common kind of tax avoidance.

Taxation is more than a mere matter of economics. It is a very definite modern method of social control. The wisdom of a tax system, however, which reaches directly only a minim of the citizenry is open to serious question. The exemptions in all the federal income taxes, for example, have been much too high. A very low rate of tax on very small incomes would be a salutary lesson in the responsibilities of citizenship. In an era of incomparable governmental extravagance it is particularly necessary to devise some method of impressing the great mass of tax-exempt voters with the fact that government is not a self-supporting institution and that government largess is not the gratuitous gift of a remote deity in Washington. The ability to pay principle is an incomplete philosophy of taxation. Those most able should bear the lion's share of the cost of government, but this is not inconsistent with smaller taxes on those who have some, albeit less, ability to pay. It is probably true that a large portion of the taxes which are directly assessed against the rich are shifted to the poor. But a direct attack on small incomes is better pedagogy in instilling the lessons of responsible self-government than a lengthy dissertation on an economic abstraction. The government would probably spend more in administering these small taxes than it would gain in increased revenues. But it would be money well spent. The great danger in the socialized conception of government is not that the American people will be treated like guinea pigs. No people who do not wish to be guinea pigs need to be. But there is a very real and imminent peril that vast segments of the citizenry will acquire a guinea pig complex, the mentality of a guinea pig. They will demand to be cared for as

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guinea pigs are. An administration which built a concrete mountain in a zoo for the edification of the sheep in that institution, in order to distribute a dole under the polite synonym of made work, is not honest in concealing from the voter who paid for this aid to nature. A common and just criticism of the modern corporate structure is that ownership is divorced from control. An even more fundamental principle of democracy is outraged by a tax system which entrusts government to an untaxed citizenry, which is not required to contribute any direct financial stake to the undertaking.