The Individual Income Tax Act of 1944

Henry Rottschaefer
THE INDIVIDUAL INCOME TAX ACT OF 1944

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The federal income tax taxpayer has become rather accustomed to frequent changes in the law fixing the amount of his tax. The first income tax statute enacted after the adoption of the Sixteenth Amendment was that of October 3, 1913. This was a rather badly drafted and clumsily organized law as was not unnatural considering that it represented the first attempt by Congress to frame a general income tax law since the Civil War period. Less than three years thereafter this was supplanted by the income tax act of September 8, 1916. This remained in force, with some amendments made during 1917, until the Revenue Act of 1918 (enacted during February, 1919) became effective. This represented the first general revision of the system of income taxation since the Act of October 3, 1913. The form that the income tax provisions were given in that Act remained substantially unchanged in the Revenue Acts of 1921, 1924, and 1926, although some rather important amendments of substance were made especially in the provisions dealing with tax-free exchanges and the treatment of capital gains. The present organization of the materials in the income tax chapter of the Internal Revenue Code dates back to the Revenue Act of 1928. It was repeated in the Acts of 1932, 1934, 1936 and 1938, some of which involved also changes of substance. In 1939 there was enacted the Internal Revenue Code, which was intended to include all the general and permanent federal laws relating exclusively to internal revenue in force on January 2, 1939. Since then changes affecting liability with respect to income taxes have generally taken the form of amendments to the appropriate sections of the Code. There were minor amendments thereof by Revenue Acts enacted during 1939, 1940, and 1941. More important were those made by the Revenue Act of 1942, the Revenue Act of 1943 (which became law during February, 1944), the Current Tax Payment Act of 1943, and the Individual Income Tax Act of 1944. The foregoing survey is not complete since it ignores a great deal of legislation involving piecemeal amendments of particular sections of particular Revenue Acts. Neither does it include such important changes as were effected by

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the Public Salary Tax Act of 1939, nor undertake to trace the history of federal war and excess profits taxation. It is sufficiently formidable as it stands.

It would, however, be a mistake to infer from this review of the procession of federal income tax laws that the taxpayer has invariably been forced to acquire a wholly new technique for the preparation of his tax return with the advent of each new Revenue Act. It was only occasionally that the changes introduced by the new Act were so revolutionary as to destroy the value of whatever skill he might have acquired theretofore in preparing his return. The advent of the free-spending era, and even more so the preparation for and the waging of war, forced the government to tax the incomes of many who had never theretofore had any direct experience with the income tax. The vast increase in the number of federal income tax taxpayers since 1941 is matter of common knowledge. It was then that official opinion sensed the importance of simplifying the tax provisions applicable to individual taxpayers. The desire to do this could not be carried out fully and at once since it was practically impossible immediately to reconcile this need with that of the fisc for increased revenues. The result of the amendments of the Code by the Revenue Act of 1942, and of the special provisions of Current Tax Payment Act of 1943 which dealt with relief from double payments in 1943, was generally felt to have made the return which individual taxpayers were required to file for 1943 almost too complex to be understood by even very intelligent laymen. That opinion was well justified although it must in all fairness be said that those officials who devised Form 1040 for 1943 did an excellent job in not making it even more complex than it was. The imposition of the victory tax in addition to the regular income tax was one of the factors that helped to confuse the average taxpayer who had theretofore prepared his own return. The other feature that worried many a taxpayer arose from the particular manner in which the "tax-forgiveness" program was carried out. It may well have been that the average taxpayer should have been able to fill out Form 1040 for 1943 by a careful study of it and the accompanying instructions. The fact remains that many were not able to do it, and that many more were never certain that they had done it correctly. It is certain that the protests that arose because of it helped along the movement for a simpler system for taxing in-
individuals. The Individual Income Tax Act of 1944 represents Congress' first approach to that objective. The present article will be concerned principally with its provisions.

There are several general matters concerning the subject of tax simplification that should be noted before considering in detail the provisions of the 1944 Act. The proper evaluation of demands therefor requires some consideration of the factors that have produced the complexities of our recent federal income tax laws against which taxpayers have complained often and vigorously. Some of the difficulties are due to the demands of those taxpayers who seek relief, often for sound reasons, from unjust results produced by the application of the broad general rules of liability that have been framed for the general run of cases. Our tax laws abound with them. The provisions relating to tax-free exchanges represent a very good example hereof. No one would deny their justice as long as the policy of taxing capital gains is continued in force. While there may not be many taxpayers affected by them, they are of considerable importance to those who have transactions of the defined character. The same remarks apply to the treatment of capital gains. There are numerous others of the same general character, but those will suffice to make the point. There are other provisions of similar character that seem to owe their presence in the law to the activities of pressure groups. Still others are the result of the desire on the part of the government to overcome the results of judicial decisions or to promote certain social and economic policies other than the government's own revenue needs. In addition the language of the statutes is often needlessly complicated. Whatever the reasons, taxpayers have justifiably felt that the system defining their income tax liabilities was too complex for great groups who became liable for income tax when the exigencies of financing several wars required sweeping reductions in the amount of income that would bring one within the class of taxable persons. At a subsequent point in this article an attempt will be made to appraise the 1944 Act as a device for simplifying the individual's task of computing his federal income tax. Only experience can give the final answer to that issue, as

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1This will be hereinafter referred to in the text as the 1944 Act. The Internal Revenue Code will be referred to in the text as "the Code," and in the footnotes as "I.R.C."
2I.R.C., Sec. 112.
3I.C.R., Sec. 117.
well as to that of its efficiency from the point of view of the tax administrator.

The Tax Base

The federal income tax was originally based on a taxpayer's net income adjusted by certain credits against net income that varied according as the tax being computed was the individual's normal or surtax. This basis for the tax for individuals remained unchanged until 1941 when the optional tax was introduced into the tax system. This gave certain taxpayers whose gross income was entirely derived from specified classes of income and not in excess of $3000 an election to be taxed on a different basis from that applicable to taxpayers in general. Its chief advantage was that the taxpayer electing this method avoided the necessity of filing a detailed return. The basis of the tax was gross income. The 1944 Act has continued the system under which an individual is given a choice as to the basis on which to compute his tax. However, the election is no longer between taxation on the basis of net income or gross income but between taxation on the basis of net income and what is called "adjusted gross income." There is a further change to which attention should be directed at this point. The net income on which the tax was based in the case of all individuals, who did not elect to be taxed under the provisions of Supplement T, was formerly computed by subtracting from gross income certain specified deductions in an amount that depended upon the extent to which the particular taxpayer had in fact experienced such deduction. The 1944 Act has introduced a new method for computing the amount of the deductions by its provision relating to the optional standard deduction. That deduction is in lieu (among other things) of deductions other than those taken into account in arriving at adjusted gross income. The net result for those who elect this deduction is a tax based on what amounts to a new statutory net income, which is roughly the difference between a taxpayer's adjusted gross income and the

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1. I.R.C., Secs. 400-404, added by the Revenue Act of 1941, Sec. 102. The said five sections constitute Supplement T of the Internal Revenue Code, and taxpayers electing to be taxed by its provisions are frequently referred to as Supplement T taxpayers.

2. I.R.C., Secs. 400-404, as amended by Individual Income Tax Act of 1944, Sec. 5 (a). The new provisions in these sections, and the definition of "adjusted gross income" will be fully considered in a subsequent portion of this article.

3. I.R.C., Sec. 23 (aa), added by Individual Income Tax Act of 1944, Sec. 9. This whole subject will be hereinafter more fully discussed.
optional deduction to which he is entitled. At this point it may be well to state that the tax in the table applicable to Supplement T taxpayers is roughly computed on the basis of reducing such taxpayer's adjusted gross income by the amount that would constitute the amount of his optional deduction. However, formally his tax basis is his adjusted gross income.

The following is a summary of the various bases on which the individual taxpayer's federal income tax may be computed. The discussion of who may use a particular basis will be deferred to a later point in this article. There are then three statutory bases on which the individual taxpayer's income tax may be computed.

1. Any such taxpayer may use as his basis a net income figure arrived at by deducting from his gross income the actual amount of his deductions.

2. There are some taxpayers who may use as their basis a net income computed by deducting from their gross income the sum of their actual deductions of the type permitted to be deducted in arriving at their adjusted gross income and the optional standard deduction, and do so without being required to elect to be taxed under the provisions of Supplement T.7

3. There are some taxpayers who may elect to be taxed on the basis of their adjusted gross income by electing to be taxed under the provisions of Supplement T.

The present system thus represents a considerable departure from the practice that prevailed from 1913 to 1941, inclusive, when all individual taxpayers were taxed on the basis of a single statutorily defined net income. Whether the recent changes will make the taxpayer's task of determining his liability easier remains to be seen. It is not improbable that this boon will not be realized during the transition period. If, however, the new method is permitted to remain in force for a period of years, there are good grounds for believing that the taxpayer will derive some measure of relief in this respect.

Limit on Total Tax

The federal income tax system has for years limited the rate of tax on capital gains. The amount of the Victory Tax was from

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7The taxpayer who uses either this method or that described in 1 is entitled to use the credits against net income in the actual computation of his tax.
its inception limited by the principle that it should not exceed the excess of 90 per cent of the taxpayer's net income for the taxable year over his normal and surtax for that year. The normal tax rates and the surtax rates prevailing at that time were such that the maximum aggregate rate of the normal and surtax for the highest rate bracket was 88 per cent. The net effect of the limitation on the amount of the Victory Tax was, therefore, to limit the aggregate federal taxes of an individual that were based upon income to 90 per cent of his net income for each taxable year. The 1944 Act repealed the Victory Tax. At the same time it so adjusted the normal and surtax rates that the maximum aggregate rate for the highest rate bracket became 94 per cent. The principle of a limitation on the total tax, introduced by the Revenue Act of 1942 in the form described above, was retained by the 1944 Act. That provides that the aggregate of a taxpayer's normal and surtax shall not exceed 90 per cent of his net income for the taxable year. This limitation applies to individuals and all taxpayers subject to taxation under the provisions of the law applicable to individuals. It is a moderate concession to "economic royalists" which few would begrudge them.

Gross Income

There is one factor that is the same regardless of which of three bases a taxpayer uses in computing his tax. The starting point in the computation of each of them is gross income. The legislation since the Revenue Act of 1942 has made but few important changes in the definition of gross income so far as it affects the individual taxpayer. These relate entirely to the matter of exclusions from gross income. The compensation received during any taxable year and before the termination of the present war (as proclaimed by the President) by any member of the military or naval forces of the United States for active service therein during that war is excludible from gross income up to $1500 thereof.

The same amendment of the Code extends the same exclusion to

\[ \text{\textsuperscript{8}} \text{I.R.C., Sec. 456.} \]
\[ \text{\textsuperscript{9}} \text{Individual Income Tax Act of 1944, Sec. 6 (a).} \]
\[ \text{\textsuperscript{10}} \text{I.R.C., Sec. 12 (g), added by Individual Income Tax Act of 1944, Sec. 4 (b).} \]
\[ \text{\textsuperscript{11}} \text{\textsuperscript{11}} \text{I.R.C., Sec. 12 (g), added by Individual Income Tax Act of 1944, Sec. 4 (b).} \]
\[ \text{\textsuperscript{12}} \text{\textsuperscript{12}} \text{I.R.C., Sec. 22 (b) (13), added by Current Tax Payment Act of 1943, Sec. 7. For definition of "military or naval forces of the United States" see I.R.C., Sec. 3797 (15).} \]
citizens or residents of the United States who are in the active service of the military or naval forces of any of the other United Nations during that war. The Revenue Act of 1943 added to the exclusions from gross income amounts received as mustering-out payments with respect to service in the military or naval forces of the United States. It should be noted that there is no time limit on the duration of this exclusion as there is with respect to the compensation excluded by I.R.C., Sec. 22(b) (13). Another class of federal employees who are granted relief by the same device are ambassadors, ministers, diplomatic, consular or Foreign Service officers, clerks and employees in the Foreign Service of the United States, and other civilian officers or employees of the United States stationed outside continental United States. The amounts excluded from their gross income are certain cost-of-living allowances granted under the authority of designated Acts of Congress.

The new exclusion from gross income which is likely to be of interest to the greatest number of taxpayers is one that relates to the earnings of a child. In the past the earnings of a minor child were required to be included in the gross income of the parent entitled to take them under the law of the state of the parent's domicile. The only way in which the parent could avoid this result was by emancipating the minor. This was in fact seldom done, and it was very difficult to prove because of the absence of prescribed legal procedures therefor in practically all our states. There were few taxpayers in fact attempting to do so. There have been instances during the present period of industrial activity in which the earnings of a minor exceeded those of the parent required to treat them as part of his gross income. The system produced considerable grumbling on the part of the taxpayers. The new provision, though not expressly stating so, covers the earnings of minors only, since those of a person who has attained his majority belong to him unless he has assigned them. An assignment of them to the parent would be ineffective for tax purposes under the doctrine of Lucas v. Earl. The minor is now given the status of an independent taxpayer required to include his earnings in his own

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13I.R.C., Sec. 22 (b) (14), added by Revenue Act of 1943, Sec. 109.
14I.R.C., Sec. 116 (j) added by Revenue Act of 1943, Sec. 125 (a). The provision is made applicable to taxable years beginning after December 31, 1942; Revenue Act of 1943, Sec. 125 (b).
15I.R.C., Sec. 22 (m), added by Individual Income Tax Act of 1944, Sec. 7.
16(1930) 281 U. S. 111, 50 S. Ct. 241, 74 L. Ed. 731.
It is also expressly provided that they shall not be included in the parent's gross income. It is immaterial that the parent may in fact have received them or may have disposed of them in advance by way of their assignment. As a concomitant to this new treatment of the minor's income, all expenditures of the parent or child attributable to the production of such earnings are treated as having been paid or incurred by the child. The result hereof is that, if the expenditure is of the kind deductible in computing net income, the deduction will have to be taken by the child, even though paid or incurred by the parent. Assume, for example, that the child has been compelled to join a labor union in order to obtain a job, and that the price of joining was the payment of a fee, and of remaining a member the payment of union dues. Assume, further, that the parent has paid these without reimbursement by the child. These payments are proper deductions in computing somebody's net income. The new provision states that that somebody is the child whose services produced the earnings. The parent may have made those payments because he received the earnings. Nevertheless, the price he pays for excluding the earnings from his gross income is loss of a right to deduct those expenses in his own tax computation. This is both reasonable and fair. The new system was devised to afford relief to those required to include a minor's earnings in their own gross income. The new provision therefore defines the term "parent" so as to include not only those who are related to the minor as father or mother, but also any "individual who is entitled to the services of a child by reason of having parental rights and duties in respect of the child." That is, the class of persons relieved of the duty to include a minor's earnings in their own gross income is defined to include everyone entitled to such earnings in his own right on the basis of being entitled to the child's services because he stands in loco parentis with respect to such child. It will undoubtedly be held that state law determines this matter. It does not, of course, include a mere guardian of the person or property of a minor. But relief from the duty to treat a child's earnings as part of his own gross income does not relieve the parent of a possible liability to pay the tax due from the minor with respect to such earnings. The primary liability for the tax attributable to a minor's earnings is imposed upon him. But, if he should fail to pay, the tax due from the minor, so far as attributable to his earnings, is deemed to have been assessed also
upon the parent who was relieved from the duty of including those earnings in his own gross income. Having been thus assessed against such parent, it can of course be collected from him by any method available for the collection of income taxes. This is unquestionably fair where the parent has in fact received the earnings. It seems perfectly fair also in those cases in which the minor has retained the earnings since the parent cannot expect the government to suffer from his waiver of his legal right to take those earnings. It may involve hardship in those cases in which the parent in fact is for some reason unable effectively to exercise that legal right. But by and large the device is a just method for protecting the federal fisc.

While the most important recent amendments involving gross income were those increasing the exclusions therefrom, there were several others that operated to change the methods of computing inclusions therein or to defer the time when such inclusion was required. The most important of the latter was the addition to tax-free exchanges of certain exchanges of securities in certain corporate reorganizations, exchanges in connection with which were formerly not included among those that could be made tax-free,\(^\text{17}\) and the correlative changes in the basis provisions that this required.\(^\text{18}\) The importance of these for the average taxpayer does not justify anything beyond merely noting them. The most important amendment concerning the computation of gross income of general interest is that relating to gain or loss upon the cutting of timber. The phrase "property used in the trade or business," as used in Code Section 117 (j) (1),\(^\text{19}\) is expanded to include "timber with respect to which subsection (k) (1) or (2) is applicable."\(^\text{20}\) The provision therein referred to is a new subsection of Section 117, added to the Code by the Revenue Act of 1943.\(^\text{21}\) The amendment covers three classes of taxpayers as follows: (1) the owner of timber who cuts it himself; (2) the owner of timber who disposes thereof by a contract under which he retains an economic interest in the timber; and (3) the taxpayer who has a contract right to cut timber, presumably whether or not the con-

\(^\text{17}\)I.R.C., Sec. 112 (1), added by Revenue Act of 1943, Sec. 121 (b).
\(^\text{18}\)I.R.C., Sec. 113 (a) (6), as amended by Revenue Act of 1943, Sec. 121 (c) (1), (2).
\(^\text{19}\)The general subject dealt with in I.R.C., Sec. 117 (j), is the treatment of gains and losses from the involuntary conversion and from the sale or exchange of certain property used in trade or business.
\(^\text{20}\)I.R.C., Sec. 117 (j) (1), as amended by Revenue Act of 1943, Sec. 127 (b).
\(^\text{21}\)I.R.C., Sec. 117 (k), added by Revenue Act of 1943, Sec. 127 (a).
tract is of the type described in (2). However, the new method of treatment applies only if the owner has owned the timber for more than six months prior to the beginning of the taxable year in which he cuts it in cases within (1) or prior to his disposal thereof in cases within (2), or has owned the contract to cut the timber for more than six months prior to the beginning of the taxable year in which he cuts it in cases within (3). This holding period was selected because the amendment was adopted in order to give such taxpayers the benefit of the limited extent to which long-term capital gains are required to be taken into account by other than corporate taxpayers. This objective is secured in the following manner. If an owner cuts timber during a taxable year, he computes (1) its fair market value as of the first day of that taxable year; and (2) his adjusted depletion basis for that timber. The difference between these two quantities represents the extent of the recognition of his gain or loss, as the case may be.

The same principles are employed to determine the extent of the recognition of the gain or loss to the taxpayer cutting timber under a contract right to do so. The method for the owner who disposes of timber under a contract involving his retention of an economic interest in the timber is somewhat different. The extent to which his gain or loss is recognized is the difference between what he receives for the timber and his adjusted depletion basis with respect thereto. The transactions covered by this amendment are expressly treated as sales or exchanges of the timber involved. They, therefore, constitute sales or exchanges of property used in the taxpayer's trade or business by virtue of Code Section 117 (j) (1). The recognized gains or losses therefrom, computed as above described, are subject to the very favorable treatment provided by Code Section 117 (j) for the special types of capital assets therein described. The result is that any gains of an owner from cutting his timber, measured as already described, will be taxed as a long-term capital gain, while any loss therefrom, also measured as already described, will affect his net income by their full amount. The same statements hold if he disposes of his timber by a cutting contract under which he retains an economic interest therein. Heretofore such gains, when realized by him, were treated as ordinary income. It was only by an outright sale of his timber that he could heretofore secure the benefits of the capital gains provisions of the several revenue acts. Similar results inure to the benefit of the person cutting timber under a contract. It is also
provided that the fair market value as of the beginning of the taxable year in which timber is cut shall be deemed the cost of the timber cut during that taxable year for all purposes for which cost is a necessary factor. The purpose of this provision (so far as tax law considerations are concerned) is to equate the gain or loss on the cutting and sale of the timber with what the gain or loss would have been but for the amended provision whose meaning and effect are being discussed. Whether or not a taxpayer wishes to avail himself of this new method is purely optional. He may elect to do so upon his return for any taxable year. He is not required to do so in his return for the first taxable year to which the amendment applies. An election must apply to all the timber owned by the taxpayer or which he has a contract right to cut. It binds him for all subsequent years unless the Commissioner of Internal Revenue permits him to revoke it. The price which he has to pay for such permission is surrendering all right of any further election except with said Commissioner's consent.

Adjusted Gross Income

The 1944 Act introduced several wholly new concepts into the field of federal income taxation. One of the most important of these is "adjusted gross income." There are two aspects of it that require consideration. These are (1) its meaning, and (2) the connections in which it affects the method of taxation and the determination of the amount of the tax. The starting point in its computation is gross income, which in this connection means precisely the same thing as in its other uses throughout the income tax provisions of the Code. Adjusted gross income itself is the difference between gross income and the sum of certain specified deductions. It might just as well have been called some form of net income, since the method for arriving at its amount resembles that used in computing net income rather than that employed in arriving at gross income. All of the permissible deductions must belong to the kinds of deductions allowable under Code Section 23 in computing net income, but only a part of those that enter into

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22So far as the provisions of Sec. 117 (k) apply to an owner's disposal of his timber by a contract under which he retains an economic interest therein, the amendment is in effect made retroactive to February 28, 1913; Revenue Act of 1943, Sec. 127 (c).

23See on the general subject of I.R.C., Sec. 117 (k), Reg. 111, Sec. 29.117-7, as amended by T.D. 5394, and 29.117-8, added by T.D. 5394. The date of said T.D. is July 27, 1944.

24I.R.C., Sec 22 (n), added by Individual Income Tax Act of 1944, Sec. 8.
the determination of net income can be used in arriving at the adjusted gross income. A broad classification of the deductions provided for in Code Section 23 is into (1) deductions expressly limited by the requirement that they be incurred in carrying on a trade or business; (2) those expressly limited by the requirement that they be incurred in the production or collection of income, or in the management and maintenance of income producing property; (3) those deductible because of their specific character (such, for example, as taxes and interest) which are at the same time in an economic sense attributable to the carrying on of a trade or business or to the production of income or the management and maintenance of income producing property; and (4) those of the type referred to in (3) but which are not in an economic sense attributable to the kinds of activities therein named.

With the exception of losses from the sale or exchange of property other than those attributable to a trade or business, the deductions available in computing adjusted gross income are limited to those that are either attributable to carrying on a trade or business, to the performance of services as an employee, or to property held for the production of rents and royalties. Every kind of deduction provided for in Code Section 23 is deductible so far as attributable to carrying on a trade or business. This includes those of the kind described in class (3) above. The principal question with respect to a deduction that is not within the class of ordinary and necessary expenses of carrying on a trade or business, as defined in Code Section 23 (1), will be whether it is attributable thereto. It will undoubtedly be held that other types of deductions permitted by Code Section 23 which constitutes a part of the economic cost of carrying on the trade or business are deductible. This would include interest on business debts, bad debts arising from the business, and most, if not all, taxes in any way payable with respect to carrying on the business. It should include the state income tax on the business net income, even though this might be held by some not to be a cost of the business. If, however, the taxpayer’s trade or business consists of the performance of services as an employee, he is limited to deducting only those of his deductions allowed under Code Section 23 which consist of expenses of travel, and of meals and lodging while away from home in pursuit of his trade or business. Such an employee may have other expenses attributable to his business. If he is a lawyer he may expend sums for bar association dues, subscriptions to law
periodicals, etc. These are deductible in computing his net income, but are not deductible in determining his adjusted gross income. If he computes his tax on the basis other than that permitted by Supplement T, he will deduct these as miscellaneous deductions on page 4 of Form 1040. This limit just described does not apply in cases in which an employee works under a reimbursement or expense allowance arrangement with his employer. In that case he may deduct any deductions allowable under Code Section 23 which consist of expenses incurred by him in connection with his performance of services for his employer. He will, of course, have to include the amounts received as reimbursement or as an expense allowance in his gross income. The deductions which a taxpayer is entitled to take in computing his adjusted gross income where his business consists in the performance of services as an employee, whether or not under a reimbursement arrangement with his employer, must be deducted before entering the wage or salary received in line 2 of page 4 of Form 1040, and an itemized list thereof attached to the return. A taxpayer receiving rents or royalties from property may compute his adjusted gross income by deducting any deductions allowable under Code Section 23 which are attributable to the property producing such income. A taxpayer who as a life tenant or the income beneficiary of a trust is entitled to income from property subject to depreciation or depletion is permitted to take the depreciation or depletion deduction allowed him under Code Section 23 (1) and (m). Any taxpayer is allowed to take a deduction for losses from the sale or exchange of property. This includes capital losses. The language in which the right to these deductions in computing adjusted gross income is framed is such as to prevent any duplication thereof. Form 1040 has been so devised as to make it relatively easy to determine one's adjusted gross income.

A taxpayer's adjusted gross income plays an important part in determining his tax liability in several ways. In the first place it determines whether he may elect to be taxed under the provisions of Supplement T by using the so-called short-form return. The only taxpayers entitled thereto are those whose adjusted gross income is less than $5000.\textsuperscript{25} The right to have the tax computed by the Collector is restricted to those entitled to elect to pay the tax imposed by Supplement T.\textsuperscript{26} Hence that right also is a function of

\textsuperscript{25}I.R.C., Sec. 400, as amended by Individual Income Tax Act of 1944, Sec. 5 (a).
\textsuperscript{26}I.R.C., Sec. 51 (f), added by Individual Income Tax Act of 1944, Sec. 11 (b).
the taxpayer's adjusted gross income. In the second place, a taxpayer's adjusted gross income is an important factor in determining his net income since the limit on, or the amount of, several of his allowable deductions depend upon its amount. Heretofore the individual's deduction for contributions to charitable, etc., institutions was limited to 15 per cent of his net income computed without regard to that deduction and that for medical expenses. The limit thereon is now 15 per cent of his adjusted gross income.\(^7\) His deduction for medical expenses is now also stated in terms of his adjusted gross income instead of his net income computed without regard to the deduction itself. It is the excess thereof over 5 per cent of the adjusted gross income.\(^8\) The limits thereon remain unchanged. Furthermore, the optional standard deduction is expressly stated as a definite percentage of the adjusted gross income.\(^9\) The other income factors affected by the amount of the adjusted gross income apply only to taxpayers electing to be taxed under the provisions of Supplement T. Prior to the 1944 Act a taxpayer could not elect this method if any part of his gross income consisted of capital gains. This condition to the right to elect this method no longer exists.\(^10\) The prior definition of "net capital gain" included as a factor in its determination the taxpayer's net income. A Supplement T taxpayer has no net income for tax purposes. Hence the definition of "net capital gains" had to be modified for his case. This was effected by substituting "adjusted gross income" for "net income" in the case of Supplement T taxpayers.\(^11\) For the same reasons a like change was made in the Code provision limiting the deduction of capital losses.\(^12\) The result is that a Supplement T taxpayer is limited in deducting capital losses (a deduction permitted to be taken in computing his adjusted gross income) to an amount equal to the sum of (1) his capital gains, plus (2) his adjusted gross income (computed by disregarding his capital gains and losses) or $1000, whichever is the smaller. Lastly, a taxpayer's adjusted gross income may also

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\(^7\) I.R.C., Sec. 23 (o), as amended by Individual Income Tax Act of 1944, Sec. 8 (b).
\(^8\) I.R.C., Sec. 23 (x), as amended by Individual Income Tax Act of 1944, Sec. 8 (c).
\(^9\) I.R.C., Sec. 23 (aa) (1), added by Individual Income Tax Act of 1944, Sec. 9 (a).
\(^10\) I.R.C., Sec. 400, as amended by Individual Income Tax Act of 1944, Sec. 5 (a).
\(^11\) I.R.C., Sec. 117 (a) (10) (B), as amended by Individual Income Tax Act of 1944, Sec. 8 (d) (1).
\(^12\) I.R.C., Sec. 117 (d) (2), as amended by Individual Income Tax Act of 1944, Sec. 8 (d) (2).
affect his personal exemption for normal tax purposes. This occurs only in case a husband and wife file a joint return. If in such case they do not elect to pay a tax under Supplement T, the normal tax exemption (the maximum of which in case of such joint return is $1000) cannot exceed $500 plus the adjusted gross income of that spouse whose adjusted gross income is less than $500.\textsuperscript{33} The purpose of this limitation is too obvious to require comment. The adjusted gross income operates in a wholly different manner if husband and wife file a joint return when electing to be taxed under Supplement T. The taxes shown in the Table found in the amended Code Section 400 (the same as that found on page 2 of Form 1040) allow (among other things) for a normal-tax exemption of $500. That is the normal-tax exemption to which an individual filing a return for himself is entitled. If a husband and wife file a joint return, and each of the spouses has some adjusted gross income, the tax in the Table would be unfair to them. This is eliminated by reducing the tax shown due by the Table (which is based on their combined adjusted gross income) by 3 per cent (the normal-tax rate) of the adjusted gross income of that spouse whose adjusted gross income is the smaller. The maximum reduction is $15, that is, 3 per cent on $500 (the maximum normal-tax credit allowed any individual taxpayer).\textsuperscript{34}

The introduction of the concept of the "adjusted gross income" into the system for determining the individual's income tax is likely to cause taxpayers considerable confusion and uncertainty at first. This is likely to disappear in time as they become more familiar with the form of return constructed on the basis of the functions that the adjusted gross income performs in the tax system. It is of course true that every new concept is likely to produce disputes as to its exact meaning and content. The new concept is not free from difficulties that only authoritative decisions can ultimately settle. It is to be hoped that this process will not be of too great duration. It is quite certain, however, that many taxpayers will wonder why the process of tax simplification had to add to the concepts that they are required to understand a wholly new one.

\textit{Deductions}

The 1944 Act has made few important changes in the character of the deductions a taxpayer is required to make in comput-

\textsuperscript{33}I.R.C., Sec. 25 (a) (3), added by Individual Income Tax Act of 1944, Sec. 10 (a).

\textsuperscript{34}See the note found at the end of the tax table referred to in the text.
ting his net income. It is true that he has been forced to classify them into those that are deductible only for purposes of computing his adjusted gross income and those that are deductible from that in arriving at his net income. He may feel somewhat chagrined at being thus compelled to manipulate new tools just when he was becoming fairly familiar with the use of the old ones. But that is not as likely to disturb him as are changes that deprive him of the right to take in any manner deductions he had been long accustomed to take. Yet that is exactly what has happened with the deduction of taxes paid or incurred. The taxes formerly deductible which are no longer so are federal import duties and federal excise and stamp taxes. These were formerly deductible merely on the basis of their payment or accrual by the taxpayer. They are now deductible only if they constitute ordinary and necessary expenses of carrying on a trade or business, or producing or collecting income, or of managing, conserving or maintaining property held for the production of income.35 This change is not likely to give rise to many difficulties of construction and application. The changes in the limit upon the deductibility of charitable contributions, and in the amount of medical expenses, by making that limit, and that amount, a function of adjusted gross income, were noted in the section devoted to considering that concept. A minor change has been made in the treatment of the bad debt deduction. The prior law permitted the Commissioner of Internal Revenue to allow partial write-offs in cases in which he was satisfied that a debt was recoverable only in part. This is still permitted. But under an amendment made by the Revenue Act of 1942 the amount of such deduction could not exceed that part of such debt as had become worthless during the taxable year. The amended provision declares that the amount of such deduction shall not exceed such part of such debt as was charged off during the taxable year.36 The “charge-off” problem thereby enters the income tax field again, although one of the purposes of the amendments to the bad debts subsection of Code Section 23 which were made by the Revenue Act of 1942 was to rid the administration of the income tax of that very thing. However, its re-entry is on a much more modest scale than was its presence prior to the Revenue Act of 1942.37 A
wholly new special deduction is provided for blind persons. The definition of "blind individual" is stated in technical scientific language. The status of an individual as a blind person for purposes of this provision is determined as of July 1 of his taxable year unless that does not include that date. In that event it is determined as of the last day of his taxable year. The amount of the deduction is $500. The limit upon the deductibility of capital losses was discussed when dealing with the adjusted gross income and need not be repeated here.

A change in the law which, though unlikely to affect many individuals, is rather interesting is that which deals with what are called "hobby losses." It is aimed at those individuals who continue to carry on a trade or business for a long period despite the constant existence of operating deficits throughout the period. The conduct of such business may have been no more than an indulgence by the taxpayer of a hobby from which he never expected to realize any profits. However, the actual coverage of the provision is not limited to instances in which that is the fact. The new provision imposes a limit on the extent to which losses attributable to such business may be taken. The limit applies only if the deductions attributable to such business (excluding taxes and interest) have for each of five consecutive taxable years exceeded the gross income from that business by more than $50,000. In such case the taxpayer's net income from all sources for each of those years must be recomputed. In this recomputation the deductions attributable to that business (other than for taxes and interest) are limited to its gross income plus $50,000. The net operating loss attributable to the business is not included among the deductions for this purpose. While the taxes and interest attributable to the business are excluded in determining whether the conditions precedent to the application of this provision have been met, they are deductible in recomputing the annual net incomes for each of those five years. The tax for each of those years is then recomputed on the basis of the recomputed net income thereof. Adequate provision is made for the collection of the resulting tax de-

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38 I.R.C., Sec. 23 (y), Sec. 23 (y), added by Revenue Act of 1943, Sec. 115.
39 For an amendment of the provisions dealing with depletion based on discovery value, see I.R.C., Sec. 114, as amended by Revenue Act of 1943, Sec. 124. The amendment transfers certain minerals from the class to which this method may be applied to the class to which the "percentage of gross" method is applicable.
40 I.R.C., Sec. 130, added by Revenue Act of 1943, Sec. 129 (a).
41 For meaning of "net operating loss" see I.R.C., Sec. 122.
ficiencies. The result of this treatment of the deficits incurred in carrying on such a chronically losing business is to limit the extent to which an individual can offset the losses from such a business against his other income. The amendment will not affect any individual's tax liability for any taxable year beginning prior to January 1, 1944, but in determining whether the conditions precedent to the application of this provision have been met any taxable year beginning after December 31, 1939, is to be taken into account. 42

Optional Standard Deduction

The changes in the treatment of deductions that were considered in the preceding section, however important, still carry out the older theory that the amount of the deductions should be a function of the actual expenditures made or the actual losses sustained by the taxpayer. The optional standard deduction represents a departure from that approach. 43 No taxpayer is compelled to use it, and some are denied the right to do so. The option to take it is, however, available to most individual taxpayers. The new subsections contain elaborate rules as to the methods and effects of an election to take it. An election made in the prescribed manner is irrevocable. A taxpayer whose adjusted gross income shown on his return is $5000 or more (he is debarred from electing to be taxed under Supplement T by its terms) must indicate his election on line 2 of page 4 of Form 1040. If he fails to do so he is denied the right to take it. It may happen that he has made a mistake in stating his adjusted gross income, and that the correct amount thereof is less than $5000. Such a taxpayer is one entitled to be taxed under Supplement T, and the law expressly provides that his election to take the standard deduction shall constitute an election to be taxed under Supplement T, while one similarly situated who did not elect to take the standard deduction is held to have elected not to be taxed under Supplement T. An error in the computation of his adjusted gross income by the taxpayer may thus result in having his decision on whether or not to take the standard deduction operate as a decision on whether or not to be taxed under Supplement T. If he elects to take that deduction he may be forced to be taxed by a method which he would not have voluntarily chosen and which may be disadvantageous to him de-

42 Revenue Act of 1943, Sec. 129 (b).
43 I.R.C., Sec. 23 (aa), added by Individual Income Tax Act of 1944, Sec. 9 (a).
spite the theoretical basis on which the taxes found in the Supplement T tax table were computed. If he has failed to take the standard deduction, he finds himself barred from the right to make an election with respect to being taxed under Supplement T, a method which might be to his advantage. In either case he is deprived of a choice accorded taxpayers who have correctly computed their adjusted gross income at an amount less than $5000. This will undoubtedly aid in the administration of the new tax system, but it is not likely to add to its popularity. The amounts involved for any taxpayer are certain to be relatively small, but this may prove no barrier to his resentment at having his mistake operate as shown above.

The taxpayer whose adjusted gross income as shown by his return is less than $5000 must, if he elects to take the standard deduction, also elect to be taxed under Supplement T. The effect of that requirement is to force him to choose a method of taxation that allows for no deductions whatever except those taken in arriving at adjusted gross income and these do not include the deductions for which the standard deduction is a substitute. He is therefore denied the right to a standard deduction as such. This is on the theory that the taxes found in the Supplement T tax table are computed by making an allowance of approximately 10 per cent of the taxpayer's "income" to cover the type of deductions for which the standard deduction is a substitute. This may be felt as a minor injustice by the taxpayer, but at least he is not being penalized for making what he might well believe to be an excusable error. However, a taxpayer whose return shows an adjusted gross income of less than $5000 may have erred in its statement. The new subsection 23(aa) deals expressly with the case in which the correct adjusted gross income is $5000 or more. The true facts of such a taxpayer's case exclude him from the class entitled to elect taxation under Supplement T. Such taxpayer may belong to any of the following groups with respect to his original return. (1) He may have elected to take the standard deduction and also complied with the condition to being permitted to take it that he elect taxation under Supplement T. Since he cannot legally be taxed thereunder, no effect can be given to that part of his election for that purpose. There is no reason why his election to take the standard deduction should not be given effect since (as-

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44This is the term used on page 2 of the Instruction Sheet accompanying Form 1040. Note that the standard deduction is based on "adjusted gross income."
suming no error in his deductions for which the standard deduction is a substitute) the only result of the error is to increase his standard deduction. The law, however, does not adopt that method although it does secure that result. But it does so by providing that his election to be taxed under Supplement T shall be treated as an election to take the standard deduction. (2) A taxpayer whose return shows an adjusted gross income of under $5,000 but whose correct adjusted gross income is $5,000 or more may have made no election with respect to either the standard deduction or Supplement T. He, of course, gets the benefit (if it be that) of neither of those provisions. That follows from the fact that a taxpayer must elect each of them before they are applied to his case. This may deprive him of a benefit since election of the standard deduction might have been advantageous on the basis of the actual facts of his case. (3) A taxpayer the relation of whose reported and correct adjusted gross income is like that of the taxpayer last considered may have elected to take the standard deduction but not taxation under Supplement T. Since election to be taxed under that Supplement is a condition precedent to being permitted to take the standard deduction, and since it is expressly provided that a failure to make the election to take that deduction in the prescribed manner involves a denial of the right to take it, no effect will be given to his election to take it. This line of reasoning is reinforced by the very specific provision of this new subsection 23(aa) that in such a case failure to elect to be taxed under Supplement T is to be treated as an election not to take the standard deduction. Cases are conceivable in which this may deprive him of a tax benefit because he failed to comply with a condition which would not have applied to his case but for his own error. That is, he is penalized for failure to elect a method that he could not legally have used on the basis of the true facts of his case. (4) The last case is that in which such a taxpayer has not elected to take the standard deduction but has elected to be taxed under Supplement T. It is expressly provided that if a taxpayer's adjusted gross income shown on his return is less than $5,000 but the correct amount thereof is $5,000 or more, the election to be taxed under Supplement T shall be considered an election to take the standard deduction. This principle is not made to depend upon an election also to take the standard deduction. Hence the taxpayer in this case (4) is required to take the standard deduction. This seems perfectly fair since the only effect thereof is to give him a larger
deduction than he may be deemed to have contemplated when he elected taxation under Supplement T. There again is no doubt that these provisions will make tax administration easier, but, at least in some of the cases, it may provoke a sense of being unfairly penalized for an excusable error.

The right to use this deduction is denied to all but individuals, and to some individuals as well. It is expressly denied to estates and trusts, to common trust funds, and to partnerships. Nor are non-resident aliens allowed to take it. A taxpayer otherwise eligible to elect it is prohibited from doing so if he makes a return for a taxable year of less than twelve months as an incident to a change in his accounting period. If a husband and wife are living together neither may take it if the net income of the other spouse is computed without regard to the standard deduction. The time as of which it is determined whether or not they are living together is the last day of the taxable year unless one of them dies during the taxable year in which case it is the date of such spouse's death. The denial occurs whether or not the two spouses have the same taxable year. Thus, if the husband reports on a calendar year basis and the wife on the basis of a fiscal year ending June 30, the husband could not take it if living with his wife on December 31, and the wife would be denied it if living with her husband on June 30. Assume in such a case, that the wife died on December 15. Since that is a day within the taxable year of each of them, each would be denied the right to take the deduction. In the case of the husband that would be for the calendar year in which said December 15 fell, assuming that he lived until December 31. If he died prior thereto it would be for the fractional part of that year during which he was alive. In the case of his wife it would be for the fractional part of her taxable year ending on the date of her death.

The maximum permissible optional deduction is $500. It can be taken in that amount only if the taxpayer's adjusted gross in-
come is $5,000 or more. In the case of those whose adjusted gross income is less than $5,000 it is equal to 10 percent of the adjusted gross income that would determine his tax did he elect to be taxed under Supplement T. Since a taxpayer in this latter class is required to be taxed under Supplement T as a condition to being allowed to elect the standard deduction, this provision is of slight importance except as it affords a basis for constructing the Supplement T tax table. In determining whether he should use the standard deduction, a taxpayer must count the price he is required to pay for the privilege. He loses the right to take certain specified deductions and credits. These include (1) all deductions other than those that may be subtracted from his gross income in arriving at his adjusted gross income; (2) all credits against net income with respect to interest on obligations of the United States and Government corporations which are among the credits against net income for normal tax purposes; and (3) all credits for income and profits taxes paid to a foreign country or a possession of the United States, and for federal income taxes withheld at the source with respect to interest on tax-free covenant bonds. Each taxpayer will have to make a computation to determine whether or not the use of the standard deduction results in any tax saving for him. In most cases this will mean merely a comparison of his total deductions of the kind for which the standard deduction is a substitute with the amount of his standard deduction. If the former exceeds the latter he should not choose the latter. However, the comparison involves more complicated and tedious computations if his tax data include items of the other classes the right to use which he relinquishes by electing to take the standard deduction. It can scarcely be said that the tax system has been simplified for him by the introduction of this standard deduction as a factor in the determination of his federal income tax.

Credits Against Net Income

The 1944 Act made the most radical changes in the individual taxpayer's credits against net income that have been made since the enactment of the first modern federal income tax act in 1913.

\[ I.R.C., \text{Sec. } 23 \text{ (aa) (1) (A), added by Individual Income Tax Act of 1944, Sec. 9 (a).} \]
\[ I.R.C., \text{Sec. } 23 \text{ (aa) (1) (B), added by Individual Income Tax Act of 1944, Sec. 9 (a).} \]
\[ I.R.C., \text{Sec. } 23 \text{ (aa) (2), added by Individual Income Tax Act of 1944, Sec. 9 (a).} \]
It made no change in the credits for tax-exempt interest. The earned income credit formerly allowed for normal-tax purposes had already been repealed by the Revenue Act of 1943,\textsuperscript{54} effective with respect to taxable years beginning after December 31, 1943. The 1944 Act completely revised the Code provisions relating to the personal exemption and the credit for dependents. The provisions relating to them in force prior to the recent amendments are so familiar as to require no discussion. The new normal-tax exemption is now $500 for each individual taxpayer, regardless of his marital status or whether or not he is the head of a family.\textsuperscript{55} If a husband and wife make separate returns, each is entitled to the $500 exemption. If they file a joint return, one of them will lose a part of that amount if his or her adjusted gross income is less than $500. In such case the joint normal-tax exemption is $500 plus the adjusted gross income of the spouse whose adjusted gross income is less than $500. Of course, if neither spouse has an adjusted gross income of $500, their joint return will show no amount that can serve as the basis for a normal tax. The changes in the surtax exemption are equally radical.\textsuperscript{56} Each taxpayer is entitled to a $500 exemption on this account. If a husband and wife file separate returns, each is entitled to the $500 surtax exemption. If one of the spouses makes a separate return and the other has no gross income for the calendar year in which the former's taxable year begins, his or her surtax exemption is $1,000, but this does not apply if the spouse having no gross income is the dependent of another taxpayer. A husband and wife having the same taxable year may file a joint return\textsuperscript{57}. If they do, the surtax exemption is $1,000. The head of a family is entitled to the $500 exemption which is the same as that allowed a married person. The status of a taxpayer as a married person is determined as of the last day of his taxable year, unless his spouse dies during the year, in which case it depends upon the status existing on the date of the spouse's death.

The credit for dependents has also been greatly modified.\textsuperscript{58} It

\textsuperscript{54}Revenue Act of 1943, Sec. 107 (a).
\textsuperscript{55}I.R.C., Sec. 25 (a), as amended by Individual Income Tax Act of 1944, Sec. 10 (a). This citation also covers all matter relating to the new normal-tax exemption.
\textsuperscript{56}I.R.C., Sec. 25 (b), as amended by Individual Income Tax Act of 1944, Sec. 10 (b).
\textsuperscript{57}I.R.C., Sec. 51 (b), as amended by Individual Income Tax Act of 1944, Sec. 11 (a).
\textsuperscript{58}I.R.C., Sec. 25 (b) as amended by Individual Income Tax Act of 1944, Sec. 9 (b).
was formerly allowed for both normal-tax and surtax purposes, but can now be taken only for the latter purpose. Its amount is $500 for each dependent whose gross income for the calendar year in which the taxpayer’s taxable year begins is less than $500. For example, if the gross income of A, who is B’s dependent, is $500 or more during 1945, then B is not entitled to a credit for him for 1945 if B reports on the calendar year basis, nor for any taxable year of B that commences during 1945 if B reports on a fiscal year basis. He could, however, treat A as a dependent for his taxable year beginning during 1944 and ending during 1945, assuming that A’s gross income during 1944 was less than $500. The question of who was a dependent under prior income tax laws produced many a controversy. The amended provision has eliminated most of these by giving a very detailed definition of the term “dependent.” A person can be a dependent of a taxpayer only if he receives from such taxpayer more than half of his support for the calendar year in which the taxpayer’s taxable year begins. This gives statutory form to what was in fact the law. It may well give rise to troublesome questions where the dependent is a minor child receiving earnings for personal services totalling less than $500 and having no other kind of gross income. The parent is no longer chargeable with those earnings, the minor being required to treat them as his own for tax purposes. Since, however, they total less than $500, he pays no tax thereon, and furthermore, can still qualify as a dependent so far as that depends on the amount of his own gross income. If the parent should permit the child to retain those earnings, and himself pay the entire cost of the child’s support, then that child is clearly a dependent within the statutory definition. It would be far fetched to hold that his being allowed to keep them is itself equivalent to the minor contributing the amount thereof to his own support. Assume, however, that he does use them for purposes for which the parent would be expected to provide as part of his duty to support the minor. The case is not so clear. However, since the parent had a legal right to those earnings, can it not be held that in law the minor is merely the parent’s agent, using funds that the parent might claim as his own, when he expends them for his own support, and that in reality the parent is to be treated as using his own funds for the support of such minor? This seems a reasonable interpretation of the facts. A fortiori, would that be the proper view if the parent actually

\[50\text{I.R.C., Sec. 25 (b) (3), as amended by Individual Income Tax Act of 1944, Sec. 10 (b).}\]
took the minor's earnings and used them to help support the latter? There is no valid basis in the tax law for reducing the parent's contribution to the support of his dependent minor child by the amount of the latter's earnings which wholly escape taxation under the provisions of the revenue laws. The new provision creates no new issues so far as a dependent has income of his own other than his personal earnings in the case of the minor. In any event, the requirement as to the fraction of his support which a person must receive from a taxpayer to entitle the latter to treat him as a dependent will prevent the same person from being a dependent of more than one taxpayer, since no one can receive more than half of his support from more than one taxpayer. This involves no change in the law as heretofore applied. Prior revenue acts did not expressly limit dependents by the factor of the relationship of the dependent to the taxpayer. The amended Code Section 25(b) deals expressly with this matter. It is a detailed enumeration of persons who can, if the other conditions are present, qualify as a taxpayer's dependent. The dependent must in every case belong to a class defined by reference to the relationship of its members to the taxpayer or to some one related to him. It includes (a) the taxpayer's children and their descendants; (b) his stepchildren; (c) his brothers or sisters by the whole or half-blood, and his stepbrothers and stepsisters; (d) his father or mother, or an ancestor of either; (e) his stepfather or stepmother; (f) his nephews or nieces, whether they be children of his brothers or sisters by the whole or half-blood; (g) his uncles or aunts whether they be related to his father or mother by the whole or the half-blood; and (h) his various "in-laws." A legally adopted child is considered as a child by the blood of the adopter in determining whether any one of the foregoing relationships exists. The net result, so far as this factor is concerned, is to limit the class of possible dependents somewhat more narrowly than under the law in force at the time the new provision became operative. There are two new express exclusions from the class of potential dependents. The first includes all subjects or citizens of a foreign country who reside in any place other than the United States or a foreign country contiguous thereto. The other prevents a taxpayer from taking as his dependent a married person, otherwise qualified as his dependent, who has made a joint return with his or her spouse for a taxable year beginning in the calendar year in which

60See in this connection, Reg. 111, Sec. 29.25-6.
the taxpayer's taxable year begins. There is one change in the
definition of a dependent that has secured universal approval from
taxpayers. Prior laws required a dependent to be either under
eighteen years of age or to be incapable of self-support because
mentally or physically defective. These requirements are not found
in the amended provision and are accordingly no longer applicable.
The Revenue Act of 1943 also made one change affecting all
credits against net income that is of general interest. The various
income tax acts had required a reduction of these credits in the
case of a return for a fractional part of a year other than one
necessitated because of a change in the taxpayer's accounting
period. Such reduction is now required only where the return
for the fractional part of the year is due to the Commissioner
making a jeopardy assessment under the provisions of Code Section
146(a) (1).61 The changes made by the 1944 Act relating
to the credits against net income, that have been herein considered,
necessitated certain technical changes in several other provisions
of the Code to conform their language to the changes made. These,
and several others, are listed in the footnotes.62

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**Back Pay Attributable to Prior Years**

The problem of treating justly gains and income actually
realized or received in one or a few years, which were due to
causes or activities extending over a much longer period of time,
has proved one of the most vexing of all those that have con-
fronted those responsible for formulating our income tax policies.
The several attempts to solve this with respect to capital gains are
familiar to all. The Revenue Act of 1939 was the first to attempt
a solution of the problem with respect to compensation for serv-
ices rendered over a period of years (it adopted a period of five
years or more).63 The Revenue Act of 1942 changed the period to
thirty-six months or more, and extended it to cover gross income
from patents, copyrights, artistic works, etc.64 It was expanded to
apply to back pay attributable to prior years by the Revenue Act

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61I.R.C., Sec. 47 (e), as amended by Revenue Act of 1943, Sec. 104,
and Individual Income Tax Act of 1944, Sec. 10 (c).

62See the following: I.R.C., Sec. 143 (a) (2), as amended by Indi-
vidual Income Tax Act of 1944, Sec. 10 (d); I.R.C., Sec. 163 (a) (1), as
amended by Sec. 10 (f) of said 1944 Act; I.R.C., Sec. 215 (b), as amended
by Section 10 (g) of said 1944 Act; I.R.C., Sec. 251 (f), as amended by
Section 10 (h) of said 1944 Act; and I.R.C., Sec. 3797 (a) (17), as amended
by Sec. 10 (i) of said 1944 Act.

63I.R.C., Sec. 107, added by Revenue Act of 1939, Sec. 220.

64I.R.C., Sec. 107, amended by Revenue Act of 1942, Sec. 139.
of 1943. An important factor responsible for this extension is
found in the numerous retroactive pay increases directed under
the authority of such governmental agencies as the National War
Labor Board. This provision, unlike the others found in Code Sec-
tion 107, is not limited to cases in which the compensation is for
services performed during a particularly defined period of time.
It is sufficient, so far as this factor is concerned, that the compensa-
tion be for services performed prior to the taxable year of its
receipt. However, it does not apply to all cases in which a person
receives in one taxable year payment for services rendered an em-
ployer during a prior year. The delay that brought it into a taxable
year subsequent to that in which the services were performed for
which it constitutes the compensation must be due to certain
specified causes. The first category consists of remuneration (de-
veloped to include wages, salaries, retirement pay and other similar
compensation) received or accrued during the taxable year by an
employee for services performed prior thereto for his employer,
where its payment prior to the taxable year was prevented (a) by
the employer's bankruptcy or receivership; (b) by a dispute as to
the employer's liability to pay it which is determined after the
commencement of court proceedings (such determination might
take the form of a judgment, a compromise agreement, or an
arbitration); (c) by a lack of funds appropriated to pay it in
cases where the employer is the United States, a State, any po-
litical subdivision of either of them, the District of Columbia, or
any agency or instrumentality of the foregoing; or (d) by any
other event which the Commissioner's regulations determine to
be of a similar nature. It is unlikely that, except with respect
to sub-class (d), any great difficulty will be experienced in apply-
ing this principle to concrete cases. Some question may arise as to
whether the person seeking the benefits of this provision is to be
deemed an employee within its terms, and as to when funds will
be deemed to have been appropriated to pay the remuneration to
which it refers. But, except for these, the provision should prove
easy to apply. The second class covered by the new provision
consists of wages and salaries received or accrued during the tax-
able year for services performed for his employer prior thereto
which constitute retroactive wage or salary increases ordered,
recommended or approved by a federal or state agency and made
retroactive to any period prior to the taxable year. This would

65I.R.C., Sec. 107 (d), added by Revenue Act of 1943, Sec. 119 (a).
include retroactive wage awards made by the National War Labor Board. The last class consists of payments received or accrued during the taxable year as the result of an employer’s alleged violations of any federal or state law relating to labor standards and practices. In this case, however, the Commissioner must determine that such payments are attributable to a prior taxable year by regulations prescribed by him. Payments for violation of the Federal Fair Labor Standards Act, the Wagner Labor Relations Act, and State Minimum Wage Acts, are undoubtedly included in this class. It is expressly provided that amounts not includible in a taxpayer’s statutory gross income are not to be considered “back pay.” The earned income of a citizen of the United States excludible from his gross income under the provisions of Code Section 116 (a) may be taken as an example thereof.

There is a further condition that has to be met before a taxpayer may take advantage of the relief afforded by this addition to Code Section 107. He may invoke it only if the back pay received or accrued during the taxable year exceeds fifteen percent of his gross income for that year. If, however, it does exceed that percentage, then there is a limit imposed on the tax attributable to the inclusion of such back pay in his gross income for that taxable year. It is provided that the tax attributable thereto shall not exceed the increases in the taxes for prior taxable years resulting from the inclusion in the income for each of such years of the portions of such back pay attributable to each of them. The Commissioner is required to issue regulations determining how the amount of back pay attributable to each such prior taxable year is to be computed. The modus operandi of this technique can be illustrated by an example. Assume that A (who reports on a calendar year basis) receives during 1944 $3,000 of back pay which is determined, in accordance with the regulations issued by the Commissioner, to be attributable to prior tax years as follows: to 1943, $1,500; to 1942, $1,000; and to 1941, $500. The steps to be taken by A are as follows: (1) A first computes his tax for 1944, including the entire $3,000 in his 1944 gross income; (2) he next computes his 1944 tax, excluding the entire $3,000 back pay from his gross income; (3) the difference between item (1) and item (2) represents the increase in his 1944 tax due to the inclusion of the $3,000 back pay in his 1944 gross income; (4) he then recomputes his taxes for 1943 by increasing his gross income for that year by $1,500, for 1942 by increasing his gross income for that year by $1,500.
income therefor by $1,000, and for 1941 by increasing his gross income therefor by $500; (5) he then computes the sum of his taxes for 1943, 1942, and 1941, excluding from the gross income of each year the back pay included in making the computations described in (4) (presumably he will already have done this when reporting for those years); (6) the difference between the sum of the taxes for 1943, 1942, and 1941, as computed in (4) and the sum of the taxes for the same years, as computed in (5), represents the aggregate of the increases in his taxes that would have resulted had he received his $3,000 back pay during the years to which it was attributable; and (7) his total tax for 1944 equals the tax computed in (2) plus the amount of item (6), if that is less than his 1944 tax computed as in (1), as it is almost certain to be. The amendment is made retroactive with respect to all taxable years beginning after December 31, 1940. It is not on record that this particular case of retroactivity drew any of the President's fire in his message vetoing the Revenue Act of 1943.

**Estates and Trusts**

The Revenue Act of 1943 and the 1944 Act made but few changes in the taxation of estates and trusts. The amendments made by the former of those Acts are the only ones of any great importance. The purpose of one of them was to grant relief from double taxation of the income of an estate or trust which was made possible by the addition of subsection (d) to Code Section 162 by the Revenue Act of 1942.66 That subsection set forth certain rules that were to be applied in determining the special deductions estates and trusts were permitted to take on account of income which became payable during their taxable year to a legatee, heir, or beneficiary. Subsection (d) (2) dealt with income for a period beginning prior to the beginning of the taxable year of the estate or trust during which it became payable. It was provided that, if this became payable more than 65 days after the beginning of the taxable year of the estate or trust, it was to be deducted by the estate or trust in that taxable year to the extent that it represented estate or trust income of such period or, if such period was more than 12 months, of the last 12 months thereof. The amount so deductible by the estate or trust had to be included in the gross income of the distributee during the taxable year in which he received it. The following is an example hereof. T, a trustee, re-

66I.R.C., Sec. 162 (d), added by Revenue Act of 1942, Sec. 111 (c).
ports on a calendar year basis. He is required under the trust-deed to distribute on each June 30 the trust income accumulated since the last preceding distribution. Assume that on June 30, 1944, he distributes to C, the beneficiary, $10,000, of which $6,000 was accumulated during the last half of 1943. That $6,000 would already have been taxed to T for 1943, and is again taxed to C for 1944. Of course T is entitled to take an equal amount as a deduction in computing the trust 1944 net income. However, if the trust's 1944 net income prior to deducting that amount of $6,000 is less than $6,000, the trust will fail to get the full benefit therefrom for 1944. Hence, to the extent of that failure has the trust been taxed thereon in 1943 and C, the beneficiary, in 1944. Should the trustee seek to avoid this possibility by adopting a taxable year such that the June 30 distribution will occur during the first 65 days of the trust's taxable year, a similar possibility may result because of the rule provided by Code Section 162 (d) (3) (A). That provides that, if estate or trust income for a period beginning before the beginning of their taxable year becomes payable within the first 65 days of such taxable year, it shall be deemed to have been distributed on the last day of the preceding taxable year to the extent of the estate or trust income for the period not falling within the taxable year during which the distribution was in fact made (but such part is in no case to exceed 12 months). Assume that a trust is required to distribute on each March 1 the trust income accumulated since the last prior distribution; that it reports on a calendar year basis; that its income for the last 10 months of 1943 was $20,000, and its net income for January and February, 1944, is $4,000. It distributes $24,000 to C, the beneficiary, on March 1, 1944. Of this amount $20,000 is deemed distributed by it as of December 31, 1943, and is, therefore, deductible by it for its taxable year 1943. Of course it is reported as income by C in his 1944 return (assuming him to report on a calendar year basis). If the trust's net income for 1943, prior to its deduction of said $20,000, is less than $20,000, it fails to get any benefit therefrom to the extent of that difference. The beneficiary, however, is taxed for 1944 on the whole $20,000. This is not exactly double taxation but results in imposing a tax on the beneficiary without at any time allowing the trust the benefit of a deduction therefor. It is inconsistent with the general theory that treats a trust as a conduit for any of its income taxable to a beneficiary.
The solution of this problem made by the amendment of Code Section 162 (d) of the Revenue Act of 1943 is as follows. If for any of the estate's or trust's taxable year the deductions discussed in the preceding paragraph exceed its net income for such taxable year computed without taking those deductions, then the amount of such excess is not to be included in computing the net income of the heir, legatee, or beneficiary. Take the example first given in the preceding paragraph. The total distributed to C, the beneficiary, during 1944 was $10,000. Of this amount $4,000, the income accumulated during the first six months of 1944, would have been deductible apart from Code Section 162 (d) (2). Hence only $6,000 was deductible by the trustee for 1944 by virtue of that provision. Assume now that the trust's 1944 net income without the deduction of said $6,000 was $2,000. The excess of such deduction over such net income is $4,000, and this is excluded in computing the 1944 net income of the beneficiary. He is thus required to include in his gross income the exact amount by which the trustee has been able to treat the distribution as an effective deduction. That is, the theory of the trust as a mere conduit with respect to any of its income taxable to the beneficiaries is perfectly realized. Had there been more than a single beneficiary the benefit of the exclusion would have been divided among them in proportion to their sharing in the income. Similar examples could be developed for the case where the injustice results from the provisions of Code Section 162 (d) (3) (A), or from a combination of both it and Code Section 162 (d) (2). The amendments considered in this and the preceding paragraphs are made effective as if they were a part of the original amendment made by Revenue Act of 1942.67

The other principal amendment affecting trusts was occasioned by the decision of the Supreme Court in Helvering v. Stuart.68 That decided, among other things, that the income of a trust which could, in the discretion of the settlor and a co-trustee with no substantial adverse interest, be used to maintain the settlor's minor children was taxable to the settlor under Code Section 167 (a), whether or not so used. The amendment under consideration has

67I.R.C., Sec. 162 (d) (4), added by Revenue Act of 1943, Sec. 133, also contains the following provision: "In any case where the estate or trust is entitled to a deduction by reason of paragraph [162 (d)] (1), in the determination of the net income of the estate or trust for the purposes of this paragraph [Sec. 162 (d) (4)] the amount of such deduction shall be determined with the application of paragraph [Sec. 162 (d)] (3) (A)."

limited the scope of this decision. It provides that the income of a trust shall not be taxed to the grantor under Code Section 167 (a) or any other provision of the income tax chapter of the Code (a thrust at the liberal use of Code Section 22(a)), merely because it may, in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain. Such trust income is made taxable to the grantor only to the extent to which it is in fact so applied or distributed. It is also provided that where the amounts so applied or distributed are paid out of corpus or other than the income for the taxable year, they shall be deemed to have been paid out of income to the extent of the trust income of the taxable year which is not paid, credited or to be distributed under Section 162 and which is not otherwise taxable to the grantor. The effect of this last provision is to insure that it shall not be deemed a distribution of income which is already taxable to the grantor on the basis of the principles defined in Code Section 162 or on the basis of any other provision of the Code. The amendment is given absolute retroactivity with respect to taxable years beginning after December 31, 1942, unless the taxable year of the trust beginning in 1942 ends in a taxable year of the grantor beginning in 1943. It is given a conditional retroactivity with respect to all other taxable years.

The 1944 Act also made certain amendments to the Code Sections dealing with the taxation of estates and trusts. They are not permitted to take the standard optional deduction, or to pay the tax imposed under the provisions of Supplement T. The language in which the personal exemptions accorded estates and trusts are granted has been changed to reflect the changed approach to these matters in the case of individual taxpayers, but there has been no change in their amounts.

**Taxation under Supplement T**

Supplement T deals with what is known as the alternative tax. It was introduced into the federal income tax system in 1941 and

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60I.R.C., Sec. 167 (c), added by Revenue Act of 1943, Sec. 134 (a).
61Revenue Act of 1943, Sec. 134 (b) (1).
62Revenue Act of 1943, Sec. 134 (b) (2), (3).
63I.R.C., Sec. 162 (f), added by Individual Income Tax Act of 1944, Sec. 9 (b) (1).
64I.R.C., Sec. 404, as amended by Individual Income Tax Act of 1944, Sec. 5 (a).
65I.R.C., Sec. 163 (a) (1), as amended by Individual Income Tax Act of 1944, Sec. 10 (e).
has remained a part thereof ever since that time. The right to be
taxed under its provisions was originally restricted to taxpayers
whose gross income was $3,000 or less, but then only if the entire
gross income were derived from salaries, wages, compensation for
personal services, dividends, interest, or annuities. The 1944 Act
has adopted a wholly new basis for determining who are entitled
to use this method. The general rule is that any individual not ex-
pressly denied the right may do so if his adjusted gross income
for the taxable year is less than $5,000. The restriction that the
gross income must have been derived from certain specified sources
has been eliminated so that now no individual is barred from its
use solely because of the source of any part of his income. Certain
taxpayers are, however, expressly denied the right to its use. These
are non-resident alien individuals, citizens of the United
States entitled to the benefits of Code Section 251, estates, trusts,
individuals making a return for a period of less than 12 months on
account of a change in their accounting period, and a married per-
son living with his or her spouse on the last day of his or her tax-
able year (or on the date of the death of one of them if such death
occurs during the taxable year) if such spouse does not elect to
compute her or his net income by taking the optional standard de-
duction provided for by Code Section 23 (aa), which was added
by Section 9 of the 1944 Act. The denial of the right to those last
mentioned is accomplished by indirection. Amended Code Section
404 does not explicitly deny such married person that right, but
states “For provisions making both husband and wife ineligible to
elect to pay the tax imposed by this supplement if either does not
elect to take the standard deduction, see section 23 (aa) (4).”
The section thus referred to merely denies a husband or wife living
together, at the time already indicated, the right to elect the stand-
ard deduction if the net income of the other spouse is determined
without taking it. The reference to this section clearly implies that
the provisions of Code Section 23 (aa) (4) operate, by themselves
or in connection with some other provisions of the statute, to deny the
husband or wife, whose spouse fails to elect the standard deduc-
tion, the right to be taxed under Supplement T. It does not do
so by its own terms since it merely denies certain taxpayers the
right to elect the standard deduction. The only provision of Code

\[75\text{I.R.C., Sec. 400, as amended by Individual Income Tax Act of 1944, Sec. 5 (a).}\]

\[76\text{I.R.C., Sec. 404, as amended by Individual Income Tax Act of 1944, Sec. 5 (a).}\]
Section 23 (aa) that could bear on the issue at all is that dealing with the method of election of the standard deduction by a taxpayer whose return shows an adjusted gross income of less than $5,000, which it would have to show before he would be likely to elect taxation under Supplement T. This denies such taxpayer the right to take the standard deduction unless he also elects to be taxed under Supplement T. It does not state that the right to be taxed thereunder shall be limited to those entitled to take the standard deduction. Nor has any other provision been found that conditions the right to be so taxed upon the taxpayer being entitled to take the standard deduction. It follows that Code Section 23 (aa) (4) does not make “both husband and wife ineligible to pay the tax imposed by this supplement (i.e., Supplement T).”

The reasoning that the draftsman followed was probably along the following line: (1) the taxes found in the tax table of Supplement T are computed by allowing for a standard deduction of approximately 10 percent of the taxpayer’s adjusted gross income on account of the deductions for which the standard deduction is a substitute; (2) no taxpayer denied the right to take the standard deduction should be allowed to evade that prohibition by electing to be taxed under Supplement T; (3) a husband or wife are denied the right to take the standard deduction under the conditions set forth in Code Section 23 (aa) (4); (4) therefore, the spouse denied that right thereunder should not be permitted to evade that denial by electing to be taxed under Supplement T. But this line of reasoning is not based on what the Code provides. That says nothing about how the taxes found in the Supplement T tax table were arrived at. The assumptions are stated on page 1 of Form 1040, but that is scarcely a part of the Code. It is questionable whether the reference in Code Section 404 to Code Section 23 (aa) (4) has accomplished what it appears to have been intended to accomplish. But, let us assume that it has succeeded in this respect. It would have taken fewer words in Code Section 404 to have accomplished that result than were used to make the reference to Code Section 23 (aa) (4). It could simply have been stated in Code Section 404 that “A husband or wife denied the

77I.R.C., Sec. 23 (aa) (3) (B), added by Individual Income Tax Act of 1944, Sec. 9 (a).

78Form 1040, however, uses the term “income” instead of “adjusted gross income.” That it probably meant the latter is supported by the fact that, strictly read, it would make the right to use Supplement T depend upon “income” whereas the law explicitly makes it depend upon the amount of a taxpayer’s “adjusted gross income.”
right to take the standard deduction under section 23 (aa) (4) may not elect to be taxed by this supplement." This contains 24 words (treating "23 (aa) (4)" as one word) whereas the actual sentence in Code Section 404 which it would replace contains 31 words on the same basis. Not all the complexities of the law are due to the complexity of the problems with which it deals.

No taxpayer is compelled to be taxed under this Supplement. He will be taxed thereunder only if he elects to do so in the manner provided by regulations prescribed by the Commissioner.79 This election is exercisable with respect to each taxable year. However, there are certain acts of a taxpayer, not specifically directed at making an election with respect to taxation under Supplement T, to which the law gives effect as an election, or refusal, to be taxed thereunder. The majority of these were discussed when discussing the standard deduction, and require no further consideration.80 The other will be discussed in connection with returns by wage earners.81

Amended Code Section 403 reads as follows: "For credits against tax and net income not allowed, in the case of a taxpayer who elects to pay the tax imposed by this supplement, because of the fact that such election constitutes an election to take the standard deduction, see section 23 (aa)." The only taxpayers denied those credits hereunder are those whose election to pay the tax under Supplement T operates under the provisions of Code Section 23 (aa) as an election to take the standard deduction. That includes only those whose adjusted gross income as shown on their return is less than $5,000, who are required to elect taxation under Supplement T to be entitled to elect the standard deduction. These are divided into two groups: (1) those whose correct adjusted gross income is less than $5,000; and (2) those whose correct adjusted gross income is $5,000 or more. The former will of course be taxed under Supplement T approximately on the basis of their adjusted gross income. The latter group cannot be taxed under Supplement T since their correct adjusted gross income is too large. However, they are forced to take the standard deduction which they did in fact elect to take, and thereby lose the credits referred to in Code Section 403 above. However, a taxpayer eligible to be taxed under Supplement T may apparently do so without electing to take

79I.R.C., Sec. 402, as amended by Individual Income Tax Act of 1944, Sec. 5 (a).
80See pp. 111-115, supra.
81See pp. 130, 131, infra.
the standard deduction by any method prescribed by Code Section 23 (aa). There is no Code provision that expressly states that a tax-
payer electing to be taxed under Supplement T automatically elects
to take the standard deduction. It may be that this is the effect of
what he does, but that is due to the method of computing the taxes
in the Supplement T tax table. His election must necessarily involve
a waiver of his right to any deductions other than those permitted
in arriving at his adjusted gross income and to credits against net
income, since he elects a given amount of tax. But that tax is ex-
pressly said to be in lieu of those imposed by Sections 11 and 12,
that is the ordinary normal-tax and surtaxes. In the case of this
particular type of taxpayer, who has not elected the standard
deduction by a method prescribed by Code Section 23 (aa), para-
graph (2) thereof has no application. It furnishes no basis for
denying him the credit against the tax allowed under Code Sec-
tions 31 and 32. A cogent argument can be made for the position
that the taxpayer who has elected to be taxed under Supplement
T by this method, as distinguished from the taxpayer taxed there-
under under the provisions of Code Section 23 (aa), is entitled
to credit against the tax due under Code Section 400 the taxes for
which a credit against the tax is provided by Code Sections 31
and 32. Here again, resort to reference to another Section instead
of use of direct statement, may have produced an unintended re-

The tax under Supplement T is computed by reference to the
tax table set forth in Code Section 400. Its amount is a function
of (1) the taxpayer's adjusted gross income, and (2) the number
of his surtax exemptions. The latter is defined as the "number of
exemptions allowed under section 25 (b) as credits against net in-
come" for surtax purposes. It is stated on Form 1040 that the
taxes in the table have taken account of the single normal-tax
credit of $500 to which each taxpayer is entitled if he files a

\[\text{\textsuperscript{52}}\text{I.R.C., Sec. 400, as amended by Individual Income Tax Act of 1944, Sec. 5 (a).}\]

\[\text{\textsuperscript{53}}\text{I.R.C., Sec. 401, as amended by Individual Income Tax Act of 1944, Sec. 5 (a).}\]

\[\text{\textsuperscript{54}}\text{I.R.C., Sec. 400, as amended by Individual Income Tax Act of 1944, Sec. 5 (a).}\]
separate return. It is because of this that a deduction is made from the tax shown due by the table, in the case of a joint return by husband and wife, in an amount equal to 3 percent of the smaller of their adjusted gross incomes. The maximum deduction on this account is $15, that is, 3 percent (the normal-tax rate) of $500 (the maximum credit for normal-tax purposes).

Returns

The only significant change in the Code provisions dealing with returns by individuals is that relating to returns by wage earners.\textsuperscript{84} In the case of ordinary returns (that is Form 1040) the taxpayer computes his own tax and shows its amount on his return. In the case of this special class (described in the law as wage earners) the tax is to be computed by the Collector of Internal Revenue. The amount so computed is payable within 30 days after the Collector has mailed the taxpayer a notice stating the amount due and demanding payment thereof.\textsuperscript{85} The method is wholly optional with the taxpayer. In order to be entitled to elect it he must meet the following conditions: (1) he must be entitled to elect to be taxed under the provisions of Supplement T; (2) his gross income must be less than $5,000; (3) that gross income must be from one or more of the following sources: remuneration from services as an employee, dividends, or interest; and (4) the amount of his gross income from sources other than wages subject to withholding of the income tax may not exceed $100. The Commissioner is authorized to expand the class entitled to elect this method to include (a) taxpayers having gross income from sources other than those mentioned in (3), above; (b) taxpayers whose gross income is in excess of $5,000 but not in excess of $5,200; and (c) taxpayers whose income from sources other than wages subject to withholding of income tax exceeds $100 but does not exceed $200. He is also required to provide regulations for the application of this method to joint returns by husband and wife. The election must be made by making the return on the form prescribed therefor by the Commissioner. He has prescribed Form W-2 (revised) for this purpose. Election of this method constitutes an election to have the tax determined under the provisions of Supplement T. It is for this reason that it is limited to taxpayers eligible to be taxed

\textsuperscript{84}\textit{I.R.C.}, Sec. 51 (f), added by Individual Income Tax Act of 1944, Sec. 11 (b).
\textsuperscript{85}\textit{I.R.C.}, Sec. 56 (i), added by Individual Income Tax Act of 1944, Sec. 12.
thereunder. This new provision is the greatest stride in tax simplification that has yet been taken. Its benefits are, however, limited to a special class, but it is the class that undoubtedly was most in need of relief of this kind.

Estimated Tax

Until recently a taxpayer was required to pay the tax due with respect to a given taxable year in his next succeeding taxable year. Collection by withholding entered the federal income tax system on a broad scale with the enactment of the Victory Tax, a portion of which was collected by withholding from wages (including salary) payments. The system of tax withholding from wages was expanded into a device for the collection of both the Victory Tax and the regular individual income tax by the Current Tax Payment Act of 1943. It was retained for the latter only when the Victory Tax was repealed in 1944. The 1944 Act also made important amendments to the tax withholding provisions of the Current Tax Payment Act of 1943. The extension of the tax withholding system to the individual income tax was an integral part of a plan to make that tax currently payable during the year of its accrual so far as possible. The other part of that plan was provided for by instituting the system of requiring individual taxpayers to make current payments on the basis of an estimated tax. It applies both to taxpayers receiving wage income subject to withholding and to those who have no such income.

The first step in the process is the declaration by the taxpayer of an estimated tax for his current taxable year. This is required to be made on a form whose content is prescribed by the statute and the Commissioner's regulations. It is a very simple and intelligible form. It is required of every individual (except as hereinafter indicated) if his gross income from wages subject to withholding is more than $100.

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\(^{80}\)See I.R.C., Secs. 605-670.

\(^{81}\)The expressions "tax withholding," and "tax withholding from wages" will be used throughout to mean the withholding from wages of amounts for purposes of the income tax.

\(^{82}\)Individual Income Tax Act of 1944, Sec. 6 (a).

\(^{83}\)The tax withholding provisions applicable to the individual income tax constitute Chapter 9, Sub-Chapter D, of the Internal Revenue Code. The amendments thereto made by the Individual Income Tax Act of 1944 will be found in Sections 21 and 22 thereof. The present article will not discuss these tax withholding provisions in either their original or amended form.

\(^{84}\)See I.R.C., Secs. 58, 59, and 60, originally enacted by Current Tax Payment Act of 1943, Sec. 5, and amended by Individual Income Tax Act of 1943, Sec. 5, and amended by Individual Income Tax Act of 1944, Sec. 13.

\(^{85}\)This is Form 1040-ES.
holding can reasonably be expected to exceed $5,000 plus $500 with respect to each surtax exemption (other than his own) provided for in Code Section 25 (b). These are the surtax exemptions for the spouse of a married man if a joint return is filed or a separate return where such spouse has no gross income, and for his dependents. It should be noted that the number of these exemptions is not the same as those he can claim in the withholding exemption certificate that he is required to file in connection with the tax withholding system. He is entitled to claim thereon a withholding exemption for himself, and for his spouse unless she has one in effect on which she claims such exemption for herself.

Thus, a married man whose wife has no gross income and who has three dependents would be entitled to a surtax exemption for four persons, but to claim five withholding exemptions. The total gross income from wages subject to withholding that he would have to have reasonable grounds for expecting to earn during his taxable year would be $5,000 plus $500 for each of four persons, that is, a total of $7,000. It is not likely that many wage earners will have to file a declaration of estimated tax. It seems to be expected that the amount of tax withheld from their wages will at least equal the amount of any tax likely to be due from them for the taxable year. An individual is also required to file a declaration of an estimated tax if (1) he can reasonably expect a gross income of more than $100 for the taxable year from any source other than wages subject to withholding for income tax purposes, and (2) he can reasonably expect his total gross income to exceed $500. The reason for requiring such person to make a declaration is that, as to income described in (1), there is no tax withholding of the kind being herein considered. The act expressly states that no declaration need be made by estates, trusts, or non-resident aliens with respect to whose wages tax withholding does not apply. The only reason for expressly excluding estates and trusts is that these are treated like individuals for many purposes of the income tax laws. It should be noted that a husband and wife may make a joint declaration unless one of them is a non-resident alien. The liability for the estimated tax is in such case joint and several. The fact that they have made a joint declaration does not prevent them

\[9^{\text{a2}}\] For definition of the wages that are subject to withholding, see I.R.C., Sec. 1621 (a).

\[9^{\text{a3}}\] See on these matters, I.R.C., Sec. 1621 (e), as added by Individual Income Tax Act of 1944, Sec. 22 (a), and I.R.C., Sec. 1622 (h), as amended by Sec. 22 (d) of said 1944 Act.
from making separate final returns. If they do that, the estimated tax may be treated as that of either or be divided between them. It is of course implicit in this that, should the estimated tax be treated as that of one of them, the other will not be charged with having failed to make the required declaration or having failed to pay the installments due thereon, nor with the penalties that these omissions entail.

The time when this declaration must be filed depends upon the date when "the requirements of section 58 (a) are first met." The requirements referred to are those discussed in the preceding paragraph. If these are met prior to March 2, the declaration has to be filed on or before March 15. That means that a person who can reasonably be expected before March 2 to have during the taxable year either the requisite amount of gross income from wages subject to tax withholding, or from other sources, must file on or before March 15. This gives the taxpayer some leeway, but it is certain that the actual state of his own mind on the matter of the probable amount and character of his gross income for his taxable year will not be accepted as final when the question of penalties for failure to file is in issue. The remainder of the law relative to time of filing can now be readily disposed of. If he first meets the requirements after March 1 but before June 2, the date is on or before June 15; if after June 1 but before September 2, the filing date is on or before September 15; and if after September 1, the filing date is on or before January 15 of the succeeding taxable year. The Commission is authorized to grant reasonable extension of the time for filing which may not exceed 6 months except in the case of taxpayers who are abroad. The failure to file timely declarations entails certain penalties, which, however, do not apply where the failure is due to a reasonable cause and not to wilful neglect.4 The burden of showing that the penalties do not apply rests upon the taxpayer. The penalties are of two kinds. The first is equal to 5 percent of each installment due and unpaid; the other is 1 percent of the unpaid amount of each installment for each month or fraction thereof during which such amount remains unpaid, excepting only the first month. There is, however, a maximum imposed upon these penalties in that their sum shall not exceed, with respect to each installment, 10 percent thereof. The computation of those penalties is made on the assumption that a timely declaration was

4I.R.C., Sec. 294 (d) (1) (A), added by Revenue Act of 1943, Sec. 118 (a).
filed which showed an estimated tax equal to the correct taxe (i.e., the amount of tax shown due on a final return for the taxable year) minus credits for taxes withheld. This, of course, fixes the amount of each installment if the date when the declaration should have been filed is determined. Once that has been determined, the computation of the penalties involves quite simple operations only. It should be noted that the taxpayer who incurs these penalties has his installments determined on the basis of the correct tax for the taxable year rather than on the basis of his estimate. This is likely to result in increased amounts for these penalties.

The law grants taxpayers the privilege of correcting their estimated tax by filing amended estimates. Any estimate previously made may be amended except that made on January 15 of the succeeding taxable year. An amendment must, however, be filed on or before the 15th day of the last month of any quarter of the taxable year, except that an amendment made after September 15 may be filed on or before January 15 of the succeeding taxable year. Not more than one amendment may be made and filed in any quarter of the taxable year or in the period from September 16 through January 15 of the succeeding taxable year. Any taxpayer may file a final return on or before the date last mentioned. If he does so, and pays in full the tax shown payable thereon, that return operates as an amendment of his declaration, or the last amendment thereof, if the tax shown due by the return, reduced by the credits against that tax for federal income taxes withheld, is greater than his estimated tax shown on his declaration or the last amendment thereof. This enables him to escape any penalties that might otherwise be imposed for a substantial understatement of his estimated tax. A taxpayer is, however, required to accompany his final return with the receipt for the income taxes withheld by his employer. Since the employer is not required to furnish this until January 31, the majority of such taxpayers will be unable to file a final return on January 15. However, all can escape the penalty for substantial understatement by filing an amended declaration by that date showing a tax that will prevent the accrual of the penalty and paying whatever amount is necessary to bring their total payments for the taxable year up to the amount of tax shown on that final amendment.

What has been said thus far represents the general rule. These have been varied by the act itself for three special cases. An individual whose estimated gross income from farming for the tax-
able year is at least equal to two-thirds of his estimated gross income from all sources for that year, is not required to make any declaration of his estimated tax for that year until January 15 of the succeeding taxable year. He may avoid even this by filing a final return on or before that date and paying in full the tax shown due thereon. Of course, such a person may select to come in under the general rule. If circumstances at any time make it reasonable for him to expect a state of affairs that would result in removing him from this favored group, he will have to file at the time indicated by the general rule.

The general rule and the special rule for farmers were stated on the assumption of taxpayers reporting on a calendar year basis. If they report on a fiscal year basis the dates specified in the general rule and the special rule for farmers are modified to those dates that would correspond thereto in their particular fiscal year. The last special case mentioned in the act is that of a taxpayer reporting for a taxable year of less than 12 months. The act merely provides that the Commissioner shall prescribe special rules for this case.

The filing of a declaration constitutes an assessment of the tax shown due thereon, and of neither more nor less than that. If the original declaration is amended, there is a correlative adjustment in the amount of the tax assessed. The declaration and its amendments bring into operation a very minutely prescribed schedule of payments. If the declaration is filed on or before March 15, the estimated tax may be paid in four equal installments payable, respectively, on or before the 15th day of March, June and September of the taxable year, and of January of the succeeding year. If the first declaration is not required to be made until June 15, the tax may be paid in three equal installments payable, respectively, on or before the 15th day of June and September of the taxable year, and of January of the succeeding taxable year. If the first declaration is not required to be made until September 15, the tax may be paid in two equal installments on or before that date and on or before January 15 of the succeeding taxable year. If the first declaration is required to be filed after September 15, the whole tax must be paid at the time of filing. If the first declaration is made after the date when it should have been filed, all installments due on or before that date must be paid at the time of filing. The remaining installments are payable at the times and in the amounts that they would have been payable had the
declaration been filed on time. The amendments to declarations may either increase or decrease the estimated tax payable. In either case, the remaining installments are ratably adjusted to reflect this change. This would mean, in the case of an amendment made after September 15 that the entire increase was payable on filing the amendment and the act expressly so provides. In the case of the farmer who is not required to file a declaration until January 15 of the succeeding taxable year, he must pay the full tax shown thereon when he files it. In his case, there is really no current payment of the tax. The payment dates of fiscal year taxpayers are changed in precisely the same manner as are their filing dates. It is needless to do more than call attention to the fact that any taxpayer may pay any installment in advance of its due date. The penalties for late payment are practically the same as for tardy filings of the declaration. It is not clear whether the penalties for tardy filing and payment are to be paid along with the installment payments of the tax. It is unlikely that they will be held so payable.

It is essential to the efficient operation of this system of the declaration and payment of estimated taxes that there be a penalty for substantial underestimates of the estimated tax. This is not likely to prove unjust now that the right of amending the declaration extends into the succeeding taxable year. The penalty is invoked only if 80 percent of the tax (i.e., the tax unreduced by the credits for taxes paid at the source with respect to the interest on tax-free covenant bonds and for tax withheld from wages for income tax purposes) for the taxable year exceeds the estimated tax (increased by such credits since it was computed by deducting them). In the case of farmers, other than those who elect to file their first and only declaration on or before the 15th day of their succeeding taxable year, the percentage is 66-2/3 instead of 80. The penalty is the lesser of (1) the difference between 80 percent of the correct tax and the amount of the estimated tax, or (2) 6 percent of the difference between the correct tax (determined as above) and the estimated tax (also determined as above). No such penalty is imposed for the taxpayer's taxable year in which falls the date of his death. Nor does it apply to a taxable year if the taxpayer determines his estimated tax therefor on the basis of the facts shown on his return for the preceding taxable year.

95The penalty provision referred to is I.R.C., Sec. 294 (d) (2), as amended by Individual Income Tax Act of 1944, Sec. 6 (b) (8).
except that his status with respect to his personal exemption must be determined on the basis of the facts existing as of the date of filing the declaration. In the case of a farmer who elects to file his only return on the 15th of January of the succeeding taxable year, the status date is stated as July 1. However, to escape the penalty on this ground the taxpayer is required to make timely payment of his estimated tax within or before each quarter of the taxable year. In the case of the farmer referred to above, such payment must be within the last quarter. It is doubtful whether these provisions relating to such a farmer are still in force.

Conclusions

The foregoing discussion has aimed to cover the important changes that have been made in the Internal Revenue Code since the enactment of the Revenue Act of 1942, so far as they affect the taxes of individual taxpayers. The emphasis has been upon the changes wrought by the Individual Income Tax Act of 1944, since that was definitely aimed at simplifying the tax for individual taxpayers. There is no doubt that it has done so for that large group of them that can pass to the Collectors of Internal Revenue the task of computing their taxes. But only experience with the modified system can tell whether it has done so for other taxpayers. The introduction of new concepts may even tend to complicate it for them, and increase the amount of work required of them to make their returns. It seems not unfair to ask whether tax simplification could not have been more successfully achieved had some of these changes not been made.

*This was the language used when I.R.C., Sec. 294 (d) (2) was added by Revenue Act of 1943, Sec. 118 (a). At that time such a farmer had to file his first and only declaration on or before December 15 of the taxable year and July 1 was the status date of individual taxpayers with respect to the exemptions referred to in the text. Since then both these factors have been changed by the Individual Income Tax Act of 1944, Secs. 13 (a) and 10. No corresponding change was made in I.R.C., Sec. 294 (d) (2). The result is an anomalous one. This is equally true of the language in parentheses occurring in this subsection which reads "or in case the 15th day of the third month of the taxable year occurs after July 1, on July 1 of the taxable year." The text has ignored this latter.

97See footnote 96.