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MEMORANDUM C

SUMMARY OF MEMORANDUM A SETTING FORTH POSSIBLE CHANGES IN THE TAX LAW WHICH WOULD INCREASE REVENUE BY THE ELIMINATION OF DISCRIMINATIONS

1. Personal Exemptions To a married person with a net income in the neighborhood of $4,000, the $2,500 personal exemption means a tax saving of $100. To a married person with a net income between $100,000 and $150,000, this exemption means a tax saving 15 times greater, or $1500. The exemption is therefore a patent discrimination in favor of high-bracket taxpayers, and the statute should be changed so that no one class of taxpayers derives a greater benefit than other classes.

2. Stock Dividends At the present time common stock dividends upon common stock with no other class of stock outstanding, the type involved in the famous Macomber case, are not taxed. This type of stock dividend should be taxed along with other taxed types, such as (a) preferred on common and (b) common upon preferred.

3. Trusts A person may under existing law reduce taxes by the obvious device of short-term trusts, viz., he may transfer property in trust for a very short period of years, with provision that the property shall return to him at the end of this period. Such trusts do not involve real irrevocable transfers of property, and reduction of the grantor's surtaxes should be prevented by taxing the income therefrom the grantor.

4. Corporate Surplus Accumulations The provisions of existing law penalizing unreasonable corporate accumulations of surplus are

a conspicuous failure. For instance, they permit the stockholders of a corporation to escape tax if the corporation is building up surplus for the purpose of going some day into some nebulous new venture. This is hardly less absurd than the plea made by the White Knight, who carried a beehive around with him because some day he might want to keep bees. The statute should be strengthened in this and in other respects set forth in the enclosed memorandum.

5. Charitable Contributions As the law now stands the taxpayer secures a deduction on account of contributions in the form of property to the extent of the value at the date of gift of the property transferred. For example, a taxpayer has purchased securities in 1932 for $1,000 cash, and their value in 1939 is $5,000. This taxpayer would have a taxable profit of $4,000 if he sold the securities, and made a gift of $5,000 in cash; however, if he is well advised the taxpayer will donate the securities themselves without any sale thereof; the donee institution may then make the sale as it pleases without any tax liability. While charitable and educational institutions may object, contributions in the form of property should be allowed as deductions only in the amount of the cost to the donor or value at the date of the gift, whichever is lower. An alternative possibility would be to allow no greater deduction than would be allowed if the donor sold the property and contributed the proceeds less the capital gains tax.

6. Casualty Losses The provisions now in the statute for losses arising from fire, storm, shipwreck or other casualty or from theft are

particularly availed of by taxpayers who have large country estates and are of no substantial benefit to small taxpayers who cannot afford the high cost of proving such losses. They should be eliminated or treated only as capital rather than ordinary losses.

7. Non-business Interest Deductions Taxpayers are now permitted to deduct interest on non-business borrowings. The principal justification is that such a deduction promotes small home-ownership and building. But this objective could be achieved with a substantial gain in revenue if the deduction were limited to a fixed amount such as $500, sufficient to cover interest on mortgages upon personal homes of limited value.

8. Corporate Interest Deductions There is a serious discrimination in existing law between corporations which secure capital by equity financing and corporations which finance by borrowing. The latter type of corporation secures reduction for interest paid, while the former type secures no deduction for dividends paid. This discrimination against the equity financing corporation is a substantial item, - approximately 18% of the interest paid. If the elimination of the entire interest deduction would be too drastic a remedy, at least corporations should be denied the benefit of tax-free recapitalizations which replace contributed equity capital with borrowed capital merely for the purpose of securing this advantage.

9. Bad Debts The allowance of bad debts as a deduction results in more litigation than any other provision of the statute. The deduction of non-business debts should be coordinated with the deduction of losses,

and limited to debts incurred in trade or business, except bad debts not exceeding $1000 in the case of each debtor.

10. Non-business Tax Deductions The allowance in existing law of a deduction for various types of non-business taxes, like the interest deduction on non-business borrowings, may accomplish its principal justifiable object--the encouragement of small home-ownership--if it is limited to taxes on small homes not exceeding $10,000 in cost or value.

11. Basis Where Estate Tax Valuation a Year After Death is Used There is a plain error in the statute in its failure to compel taxpayers, who elect for estate tax purposes a valuation date one year later than the date of death, to take the value so chosen as a basis for taxable gain or deductible loss. A decedent may leave assets with a value of $1,000,000 at the date of death, which drastic market fluctuations reduce to a value a year after death of $100,000. If the executors of such an estate exercise the option to use the lower $100,000 for purposes of estate tax liability, they should be prevented from using the higher basis, upon which they refused to pay estate tax, for the determination of income tax liability.

12. Husbands and Wives A minimum recommendation in regard to husband and wife living together is that they should not be given the privilege of filing joint returns. A larger question, which should be canvassed, involves the extent to which husband and wife should be taxed on a joint basis, or at least on some basis which recognizes the family economic unit.

13. Interest upon State Obligations. The loss of Federal revenue and the unfortunate economic effect of exempting this class of income and other implications of this point are well known to you.

14. Capital Gains You have stated your opinion that Congress went too far in the 1938 Act in reducing the tax burden upon capital gains. Your views in this connection are emphasized in an inflationary period. The shopworn criticism that taxation of capital gains impedes the mobility of capital, and discourages venture capital, is in my opinion grossly exaggerated.

The existing provisions discriminate seriously against earned income. An individual with an earned income of $100,000 (disregarding credits for earned income and dependents, but allowing a $1000 exemption) would be taxed $33,354, whereas an individual realizing $100,000 from long-term capital gains would be taxed only $9,334.

15. Corporate Distributions from March 1, 1913, Surplus Corporate distributions from pre-March 1, 1913, earnings have had 25 years of exemption. Reasonable opportunity has been afforded to accomplish their distribution, and you may wish to consider whether distributions from this source should now be made taxable.

16. Life Insurance Paid in Installments As the income tax statute has been interpreted, the exemption of life insurance proceeds paid by reason of the death, but in the case of insurance paid in installments it includes an exemption for amounts which are referable to the lapse of time after the death of the insured, and are thus in

substance interest upon what is payable at death. There is no valid reason for such exemption.

17. Double Loss Deductions Double loss deductions should be forbidden under all circumstances. Their possibility is countenanced by the mechanism suggested under this point, and the statute should be corrected so as to allow but a single loss deduction for each loss sustained.

18. Basis for Property Transmitted at Death If B acquires property transmitted at death by A, and the property cost A $100,000 in his life time and is worth $500,000 at the date of death, B is entitled to use $500,000 as his basis upon a sale of the property. This means that $400,000 of appreciation in value has never been, and will never be, subjected to income tax. Tremendous loss of revenue must be involved in this statutory rule, and it must have a freezing market effect by discouraging sales by persons late in life. A remedy for this situation seems to me to be to adopt for property transmitted at death substantially the same rule as to basis as is now in the statute in respect to gifts *inter vivos*.

19. Building and Loan Associations The exemption now granted to domestic building and loan associations is not limited to associations the activities of which are related to financing home-ownership, but go much further in the direction of exempting associations, which own and operate office buildings, which make loans to building contractors, and which accept savings deposits, thus competing with banks. This exemption

should somehow be confined to building and loan associations of a genuine cooperative character.

20. Mutual Casualty Companies Mutual casualty and fire insurance companies, as distinguished from stock companies of a like character, almost entirely escape taxation under existing law. This exemption should be limited to companies of a purely local character.

21. Pension Trusts You dealt with the subject of pension trusts in the 1937 Tax Avoidance Investigation, and considerable evidence regarding this matter was presented before the Joint Committee on Tax Evasion and Avoidance in that year. This is a much abused provision of the statute in that key men in employer companies use it as a device for postponing the tax on their high bracket income to a period of retirement when their brackets are low. The tax deferment should somehow be limited as to apply only to limited contributions to pension trusts.

22. Percentage Depletion You dealt with this subject in the 1937 Tax Avoidance Investigation, but the Investigation was so truncated that the Joint Committee did not give any extended consideration to the matter. The point involved in this favored industry deduction need not be elaborated.

23. Development Expense The special election available to oil and gas companies to deduct certain predominantly capital assets as expense deductions should be further investigated. In this connection it is worth consideration whether a further provision should not be enacted,

limiting depletion and depreciation deductions to amounts reported to stockholders in annual reports. Conversely, listing applications to the Securities & Exchange Commission might be required to show depletion and depreciation taken for income tax purposes.

24. Non-resident Aliens and Foreign Corporations Non-resident alien individuals and foreign corporations are distinctly favored under existing law as compared with citizens and residents of the United States. Foreign corporations are given the benefit of a flat rate of 15% on their taxable income (10% in the case of dividends - which may be reduced by treaty to 5%). There is no capital gain tax upon non-resident aliens. I see no reason why non-resident aliens and foreign corporations should be given this distinct advantage over American citizens.

25. Estate Tax Exemptions The estate tax exemptions - the $40,000 general exemption and the $40,000 insurance exemption - confer an undue benefit upon high-bracket estates. The $40,000 general exemption means $400 to an estate of between $40,000 and $50,000. In the case of a net estate in excess of $4,000,000, but not in excess of $4,500,000, the exemption means $20,000 in tax. In the case of an estate in excess of $50,000,000 the exemption means $28,000 in tax. The same figures may be applied to the additional insurance exemption of another $40,000 for the proceeds of policies payable to third persons. It is well known in insurance circles that many persons with high brackets estates take out insurance policies of $40,000 not because they are interested in insurance, but merely to secure a $40,000 exemption. These

exemptions should be modified so that they are of equal benefit to large and small estates.

26. Life Insurance and the Estate Tax It is impossible briefly to deal with the recommendations as to the taxation of life insurance. The statute, as now interpreted, opens the door to tax avoidance on a wide scale. Large amounts of life insurance proceeds now altogether escape tax. Insurance is sold to large customers on the basis of a high-pressure tax avoidance selling appeal. The thought is that the insured avoids having any incidents of ownership at the time of death, either by transferring the incidents of ownership to the other spouse, or by taking out cross policies - the husband on the life of the wife and the wife on the life of the husband. It should certainly be made inescapably clear that the intention of Congress is to subject to estate tax the proceeds of all life insurance policies on the life of any decedent to the extent that the decedent has paid premiums thereon, as well as when he possesses some incidents of ownership at the time of his death.

27. Powers of Appointment and the Estate Tax It is now possible under the law as to the estate taxation of property over which the decedent has a power of appointment almost completely to avoid tax. In Delaware it is possible to avoid all estate tax by the simple expedient of leaving a life estate in a child with power of appointment to issue of that child, and the issue then repeating the same process through his generation, and so on. In Maryland virtually no power of appointment can be reached by the statute. This absurd situation plainly demands statutory amendment.

28. Reverter Interests and the Estate Tax Under the existing statute, if the decedent provides that the benefit of the property should pass to A for life with a reservation of the fee to the grantor, but with a remainder in fee to A contingent upon A's survival of the grantor, then the property is includible in the grantor's estate. However, if a technically vested fee title to the property is given to A but with a further provision that the property should revert to the grantor if A predeceases him, no estate tax is imposed, although the net effect of the disposition is exactly the same as in the preceding case. This perfectly artificial discrimination should be remedied by a statutory provision along the lines of a recent dissenting opinion by Mr. Justice Stone in which he thought that the existing estate tax imposed tax in all cases in which the decedent in making distribution of his property retains any valuable interest in the property such as a reverter interest by which he postpones final disposition of the property until his death.

29. Gifts in Contemplation of Death Although the statute has a provision purporting to tax gifts in contemplation of death, many gifts of this character escape tax under the existing law. In one case a gift by a person over 90 years of age was held not to be in contemplation of death. Here I would recommend, in addition to the rebuttable presumption that gifts made within a certain period prior to death are to be presumed to be in contemplation of death, a conclusive presumption to be applied in the case of decedents who were 60 years, or over, at the time of gift.

30. Insurance and Claims Against an Estate As the estate tax

has been interpreted, Federal estate taxes may in many states be escaped altogether if the claims against the estate exceed not only the net estate, but also the statutory gross estate, including life insurance proceeds; and this is true even though the claims in question cannot be collected out of the insurance proceeds. In one case an estate valued at over $2,000,000, more than half of which consisted of the proceeds of life insurance, had valid claims against it amounting to some $6,000,000, none of which constituted a charge against the proceeds of the policies; such an estate completely escapes estate tax. The statute should be amended so that uncollectible claims are not allowable deductions.

31. Gift Tax Exemptions The existing $4,000 gift tax exemption is much abused. Many taxpayers spread large amounts of valuable gifts among several persons, and accomplish substantial transfers of property without any gift tax. Furthermore, a donor who sufficiently anticipates the future may over a span of years give away a considerable amount of property free from tax. The statute should here be amended so as to restrict exempted gifts at least to gifts to members of the donor's immediate family.