

WARTIME TAX AVOIDANCE



**A Report by Secretary Morgenthau to the
Joint Committee on Internal Revenue Taxation
May 28, 1942**

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Statement of
SECRETARY MORGENTHAU
before the
Joint Committee on Internal Revenue Taxation
Thursday, May 28, 1942

THE VERY HELPFUL interest in tax collection problems shown by the members of the Joint Committee on Internal Revenue Taxation, under the able leadership of your Chairman, Mr. Doughton, encourages me to appear before you to discuss an administrative matter.

I know that this Committee and the Congress are determined that no man and no corporation shall be permitted to make exorbitant profits out of the war effort. It is the responsibility of the Congress to draft legislation to achieve that purpose. It is our responsibility at the Treasury to use all the powers the Congress has given us to see that all taxes are fully, honestly and justly collected. It is our responsibility to see that by no form of trick or chicanery is any one taxpayer permitted to escape his just share and thus to throw unjust burdens on others.

I have come before this Committee tonight to tell you of some instances of what seem to me to be particularly unpardonable attempts to escape wartime taxation, and I should like to report what the Treasury is doing and intends to do to stop these practices. In every instance the method used by the taxpayer was to inflate expenses with the evident purpose of avoiding normal and excess profits taxes on corporation earnings. The devices used included the payment of excessive salaries, the distribution of unearned bonuses and the payment

of unreasonable sums for purported services to persons closely connected with the management of the companies involved.

It will be obvious to members of this Committee that these practices, if successful, would reduce the revenue of the Government, the revenue we need so urgently for fighting and winning the war.

We do not intend that this shall happen. We do not intend that any of these practices shall succeed. The Congress has already given power to the Treasury to deal with cases of this kind, and that power is being exercised.

The instances I shall mention to you were discovered as a result of speeding up our investigation of 1941 returns of corporations holding war contracts. Reports of the examination of 31 returns for 1941 are now available. Let me mention briefly seven cases illustrating the practices with which we have to deal.

Company A makes an important airplane part. This corporation is owned by one man who hired himself as its sales representative. His compensation in 1941 was \$1,656,000. By consolidating these earnings with those of the corporation, we have blocked this obvious attempt to divert profits and we have increased the corporation's income tax by \$1,117,000.

Company B makes steel. All stock in this corporation is held by three families. Excessive salaries were paid to officers who were also stockholders. The Revenue Agent has recommended disallowance of \$82,000 in salaries, and the company has already agreed to this disallowance.

Company C makes vital equipment for airplane pilots. This corporation paid \$31,104 in rent in one year to the wife of the president for using property which had cost her \$45,412. A brother of the principal stockholder, without special training or ability, drew a salary of \$15,000 a year and a son and daughter, just out of school, got \$7,500 a year each.

Company D makes tools and dies. This company is owned

by two brothers and their wives. It paid dividends of \$40,000 in 1940 and \$100,000 in 1941, while salaries totaling \$128,000 were paid in 1941 to the president, his wife and his brother.

Company E makes forgings. The stock is owned by three families. From 1938 to 1941 the salaries of employees who were stockholders and relatives of stockholders increased 523 percent. Excessive salaries for 1941 have been disallowed to the amount of \$568,000.

Company F makes equipment for airplanes. Three principal officers of this corporation took salaries of \$100,000 each and the corporation claimed it had set aside over \$575,000 in bonuses. Salary and bonus payments totalling \$516,000 were found to be excessive. Other disallowed deductions included \$16,000 paid for watches given to employees, \$14,000 for banquets and picnics, \$4,000 for photographs taken at banquets and picnics, and \$1,900 for tickets to football games. Other important deficiencies were found in the tax return.

Company G makes a device important to aviation. This corporation is owned almost entirely by one man, his wife and his brother. The two men increased their salaries from \$12,000 and \$15,000 in 1939 to \$72,000 and \$90,000 in 1941. The royalty rate on the patent jointly held by them was increased, with the result that with expanded sales for war purposes, the royalties paid to them increased from \$87,000 in 1939 to \$1,179,000 in 1941.

You will note that I have not named any of the corporations or the individuals concerned. I leave it to this Committee to decide whether that should be done. Personally I am inclined to believe it would have a very wholesome effect.

Assistant Secretary Sullivan and Commissioner Helvering are here tonight to give you further details of the results of some of these investigations. They stand ready to come before you from time to time and to report the results of further investigations now in progress.

It should be noted that these cases all deal with returns for 1941. It is of course true that all of the contracts for war work covered by these 1941 returns were signed before the United States entered the war and that nearly all the earnings represented in the tax-dodging devices attempted were pre-war earnings. But I think that changes the situation very little. An attempt to escape lawful taxes while we were actually at war would be only a slight degree blacker than an attempt to escape taxes which would pay for arming and equipping our Army and Navy when we stood in imminent danger of attack.

It may be that these instances are an isolated few and that not many more of the same kind will be found. I sincerely hope that will be the case. I am wholly confident that the great and overwhelming proportion of American corporations are too patriotic even to consider such practices.

We are taking two steps to detect and deal with the evils I have mentioned. In the first place, we are expediting examination of the tax returns and records of all corporations, beginning with those who have war contracts, to determine whether excessive expenses are being claimed. Ordinarily our investigation of returns filed for the year 1941 would not begin until July 1, 1942, and this work would continue through the fiscal year ending June 30, 1943. Under present circumstances we cannot afford to wait so long before acting. By speeding up our investigations we expect to check unlawful practices of this sort at an earlier stage.

In the second place, we are disallowing excessive expenditures which have the effect of reducing corporate tax liabilities. We are compelling the corporations to include such amounts in earnings, and at the same time we are requiring the recipient to pay full personal income taxes on the amounts received.

The disallowance of excessive expenditures does not represent a new procedure. The law and regulations permit the deduction only of ordinary and necessary business expenses

for the purpose of determining profits. In applying the law and regulations, the Bureau of Internal Revenue has often disallowed expenditures which seemed to lack sound business justification and which were, in effect, distributions of profits. Today, however, the problem has assumed major importance in view of the huge increases in income of a great number of corporations resulting from the war effort.

In presenting this problem to you, I am anxious to be as constructive as possible. It seems to me that the businessmen of this country are entitled to know not only the extent of our legal powers but also the standards that we have adopted in applying them. Accordingly, it may be helpful if I outline the following general considerations that will guide us in examining expenses claimed in tax returns.

1. *Salaries and Bonuses Paid to Officers and Employees.*

Deductions claimed for greatly increased salaries and extraordinary bonuses paid to officers or employees will be disallowed unless the taxpayer proves that the payments are, in fact, for services actually rendered and are reasonable.

In determining whether the payments are reasonable, it will be assumed that reasonable compensation is only as much as would ordinarily be paid for like services by like enterprises under like circumstances. The factors that will be considered in determining the reasonableness of such payments are the duties performed by the recipient, the character and amount of responsibility, the time devoted to the enterprise, and the peculiar ability or special talent of the particular officer or employee. Where the payments are to relatives or to shareholders, the taxpayer must show that family considerations have not influenced the amount paid and that the payments are not distributions of profits in disguise. Large profits attributable to causes entirely unrelated to the activities of the officers or employees, which are not unusual in these abnormal

times, do not of themselves justify or warrant large salary payments.

2. *Rents, Royalties and Other Payments to Shareholders.*

Deductibility of rents, royalties or other payments to shareholders depends upon whether such charges are in fact fair and reasonable payments for the use of property and are not merely a device for distribution of profits. Any shareholder should be entitled only to a fair return on his investment in the property which he permits the corporation to use.

3. *Payments to Profit Sharing or Pension Trusts.*

The deductibility of payments to pension trusts is governed by section 23(p) of the Internal Revenue Code. If payments to such trusts are reasonable, their deduction will be allowed. If the payments are unreasonable in amount, or if the trust is not created for the exclusive benefit of employees, or if it is a device to distribute profits to shareholders, the deductions will be disallowed. It is also our purpose to set up a barrier to deductions of large salaries, bonuses, or insurance premiums for officers under the guise of payments to a pension trust.

4. *Payments for Repairs.*

The deductibility for income tax purposes of costs of repairs depends upon whether the expenditure is actually for repairs, or is in fact a capital expenditure which should be added to capital investment or charged against reserve for depreciation, since the costs of repairs are deductible while capital expenditures are not. We must guard against the tendency during high profit years to make extensive improvements and to charge the cost of such improvements against profits under the caption of repairs.

It will be our policy to scrutinize carefully the items claimed as deductions for expenditures for repairs. We shall disallow

such deductions where it is not shown that the expenditures are in fact for repairs instead of for improvements or betterments which should be capitalized.

5. *Expenses or Allowances Paid to Obtain Government Business, Including Fees Paid to Washington Representatives or for Other Professional Services.*

Whether deductions for items of this class will be allowed depends upon whether they meet the test laid down in the Internal Revenue Code, that is, whether they are necessary and ordinary and reasonable. If such items are considered exorbitant or unreasonable, they will be disallowed as deductions. Many of the factors that apply in determining the deductibility of salaries and bonuses will apply also in determining the deductibility of items of this class. Particular attention will be given to deductions for payments which are against public policy, and all such deductions will be disallowed.

6. *Amounts Paid for Advertising.*

The test of whether expenditures for advertising are deductible is whether they are ordinary and necessary and bear a reasonable relation to the business activities in which the enterprise is engaged. This is not intended to exclude institutional advertising in reasonable amounts or good will advertising calculated to influence the buying habits of the public. If such expenditures are extravagant and out of proportion to the size of the company or to the amount of its advertising budget in the past, or if they are not directed to public patronage which might reasonably be expected in the future, such payments will be disallowed as deductions.

With these standards as our guideposts, we are progressing as fast as practicable with our investigation of the 1941 returns. Those who are engaged in this work must, of course, think not only of the best interests of the Government but also of the

need of being completely fair to the taxpayers. The Committee, the Congress and the country are entitled to know that the unscrupulous and selfish few are not being allowed to distort their tax returns so as to escape their fair share of the costs of the war. I can assure the Committee of this: that nothing is being left undone which will expedite our work. If we find that our existing powers are not adequate to deal with the evil I have been discussing, I shall not hesitate to come before the appropriate committee to ask for any additional authority that may be needed.

