July 31, 1940

MAJOR LOOPHOLES IN THE FEDERAL REVENUE STRUCTURE

Our existing tax structure with the inclusion of an effective excess profits tax would be adequate if broad avenues of tax avoidance were not opened to the taxpayer seeking relief from the high surtax rates of the individual income tax and the high rates in the upper brackets of the estate tax. The following table shows the estimated yield of the existing tax structure supplemented by an excess profits tax at varying levels of the national income.

Estimates of Yield of the Existing Federal Tax Structure (as Modified by the Revenue Act of 1940) and of an Excess Profits Tax, at Varying Levels of the National Income 1/
(Billions of dollars)

Revenues	National income of preceding year			
	70	80	90	100
Budgetary receipts under existing tax structure	6.3	8.5	11.4	14.6
Excess profits tax	0.6	0.7	0.8	1.0
Net social security receipts	1.1	1.2	2.1	2.5
Total	8.0	10.4	14.3	18.1

Besides the usual qualifications attached to estimates bearing upon an uncertain future and upon levels of the national income beyond

1/ The amounts shown would be collected in the calendar years following the calendar years in which the national income reached the levels indicated. Estimates of fiscal year collections would differ only slightly from the estimates shown. For purposes of estimating transactions which have a predictable trend over time, the calendar year in which these collections are made are assumed to be 1941 (year following $70 billion national income), 1942 (year following $80 billion national income), 1943 (year following $90 billion national income), and 1945 (year following $100 billion national income).

the range of our actual experience, these figures are subject to another qualification, the full importance of which is not widely realized. The existing tax structure contains wide loopholes through which large amounts of income escape the surtax rates and large capital sums escape the capital gains tax and the estate tax. With increasing national income the amounts of income potentially taxable at the high surtax rates in the upper brackets increase sharply and the incentive to make use of these avenues of tax avoidance becomes stronger. Although some allowance for this development has been made in the estimates presented above, it is impossible to assess correctly the extent to which taxpayers will resort to the use of these avenues in view of the existing tax rates. It is therefore urgently desirable to repair these gaps in the Federal revenue structure. It is desirable not only to protect the Federal revenue but also to assure equity in the treatment of taxpayers in substantially similar circumstances and in order to derive revenue from those sources which involve the smallest restrictive economic effects. It is important that the group of taxes which bear heavily on savings should be made as difficult to avoid as the group of taxes that bear heavily on consumption.

The following proposals are designed to deal with only the more important loopholes and to illustrate the type of action that is needed. There are others, most of them of minor importance from a revenue point of view. With respect to the estimates of yield presented, it should be noted that it is possible to make estimates only on the basis of the degree to which these avenues of tax avoidance are utilized at present. Taxpayers, under pressure of high rates, will probably use the services of professional tax consultants to an increasing extent in the future and for this reason the revenue which will be lost if these avenues are not closed exceeds the figures shown here by an appreciable, if unpredictable, amount.

Proposals relating to the individual income tax:

1. Abolition of Husbands' and Wives' Privilege of Filing Separate Returns. Husband and wife living together have an option, as the law now stands, of filing separate returns or a single joint return including their aggregate income.

This permission to husband and wife to file separate returns results in unfair discrimination between persons whose income is derived principally from property and persons whose income is derived principally from personal services. Property owners frequently convey part of their property to their spouses, thus reducing income tax, whereas individuals deriving income from personal services are not able to secure a corresponding reduction in income tax, since and assignment of income from personal services is not recognized for income tax purposes. On the other hand, in the community property states income even from services is divided equally between husband and wife, which gives the citizens of these states a special substantial advantage over the income of citizens from the other 40 states. This situation may become aggravated by the fact that there is a tendency in some states to establish an optional community property system. It is understood that Oklahoma has recently passed such a statute.

Under existing law a married person earning a net income of $100,000 pays income taxes of $43,476. A man receiving a $100,000 income from property may succeed, by transferring assets to his wife, in giving her a taxable income of $50,000 and reducing his own to $50,000. Under these circumstances the couple pays taxes of only $28,256, saving $15,220, or 35 per cent of the tax liability on the $100,000 taxes as a single income. For an income of $60,000 the potential saving attributable to the separate filing privilege amounts to $8,000, or 42 per cent of the tax liability on the single income.

Income utilized for the maintenance of a common household should be taxed as a single income, regardless of the fact that it may have nominally separate sources. The present state of the law represents serious discrimination, both against single individuals and against married persons with income derived solely from the husband's earnings. The practice of filing separate returns is so widely prevalent among high income families that the effectiveness of the progressive income tax is substantially impaired. Of the 3,908 married couples with incomes of more than $100,000 a year in 1937, 3,583 filed separate returns and were taxed at considerably lower rates than applied to equivalent incomes received by couples without property income or received by single persons.

This proposal might be somewhat qualified to permit wives to file separate returns for *bona fide* earned income.

There are legal obstacles to this proposal, which are especially formidable with respect to income of taxpayers in community property states. But even if a joint return of income for such taxpayers cannot be obtained, the proposal remains justified on grounds of equity and will raise substantially the same revenue as if universally applied.

Revenue yield:

Level of national income (Billions of dollars)	Yield (Millions of dollars)
70	200
80	300
90	450
100	600

2. Elimination of Tax Exemption on Government Securities. At the present time bonds of the Federal Government are exempt from normal tax; Treasury bills and notes and obligations of states and local governmental units are wholly tax-exempt.

Interest upon all bonds, state and Federal, issued after the date of introduction into Congress of a new act should be taxed directly and completely. This would of course mean that Congress would have to refrain from authorizing any issue of tax-exempt bonds by the Federal Government or affiliated organizations, such as the Federal Farm Loan banks. Interest on future issues of state bonds should be taxed directly and completely.

This proposal is opposed only by the comparatively small group of wealthy investors in tax-exempt securities and by state financial officers who believe that it would greatly increase the cost of borrowing to the states. Consideration should be given to a number of means of bringing pressure to bear upon the states to discontinue their opposition to this proposal: a) repeal of the legislation permitting the states to levy income taxes on the salaries of Federal employees, b) less generous allowance of credit for payment of state taxes under the estate tax or under the unemployment compensation tax.

The revenue yield of this proposal will be negligible for some years to come. Its importance as a revenue-producer will increase with the increasing magnitude of Federal borrowing under the defense program.

3. More effective taxation of capital gains

(a) Repeal of the provisions restricting the rate of tax on long-term capital gains to a maximum of 15 per cent.

Under the rates of the Revenue Act of 1940, an income of $50,000 derived wholly from wages or salaries pays income taxes of $14,128. Under the existing procedure with respect to the taxation of capital gains an income of $50,000 derived wholly from long-term capital gains need pay income taxes of only $7,500. The provision that only 50 per cent of capital gains on assets held more than two years should be taken into account in computing net income constitutes adequate recognition of the difference between capital gains and other types of income; the present differentiation in the rate of tax is unnecessary.

Revenue yield: Any effective increase in taxes on capital gains is likely to have at least a temporary retarding effect on the realization of capital gains, especially if taxpayers expect that the tax increase will be temporary. This effect is observable in the period 1934-37, at the end of which the Revenue Act of 1938 fulfilled taxpayers' expectations that the increased taxes imposed by the Revenue Act of 1934 would be substantially reduced. If it were not for this effect, the proposal might yield:

Level of national income (Billions of dollars)	Yield (Millions of dollars)
70	30
80	60
90	100
100	150

(b) Definition of the basis for computation of capital gains and losses on property acquired by inheritance as the cost basis in the hands of the decedent.

Under the Internal Revenue Code taxable gain and deductible loss on the sale or exchange of property transmitted at death (acquired by bequest, devise or inheritance or by decedent's estate from the decedent) is the fair market value of the property at the time of acquisition (death). For example, 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, when he sells the property is entitled to use $500,000 as his basis. This means that $400,000 of appreciation in value has never been, and will never be, subject to income tax. Great loss of revenue must be involved in this rule, and it must have a freezing market effect by discouraging sales by persons late in life.

The Internal Revenue Code should be amended to provide that the basis for gain or loss on the disposition of, or for purposes of depreciation or depletion upon, property transmitted at death is the adjusted cost basis in the hands of the decedent, rather than value at the date of death. While this would raise the basis where property has depreciated in value between original acquisition by the decedent and the date of death, it is fair to allow such a potential loss to be carried over from the decedent; moreover, this aspect of the change will not greatly affect the revenue, since losses are frequently consummated during life to save taxes, whereas many gains for the same reason go deliberately unrealized.

Revenue yield: The comment as to the possibilities of retarding the realization of capital gains made in connection with the preceding proposal also apply here. No precise estimate can be made but even in years of exceptionally heavy capital gains it is doubtful whether this proposal would yield more than $10 million a year.

(c) Allowance of deduction for income tax purposes of charitable gifts not in money form only to the extent of adjusted cost basis to the donor or value at date of gift, whichever is lower.

The Internal Revenue Code now provides for a deduction on account of religious, charitable, scientific, literary, educational and other contributions. This provision works satisfactorily with respect to cash distributions, but it is wholly indefensible as to contributions in the form of property. As the law now stands, a taxpayer secures a deduction to the extent of the value of the property transferred at the date of the gift. 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 cash; however, if the taxpayer is well advised, he will donate the securities themselves without any sale thereof; the donee institution may then make the sale as it pleases without any tax liability.

Gifts not in money form to religious, charitable, scientific, literary and educational institutions should be allowed as a deduction only in the amount of the adjusted cost basis of the property to the donor or its value at the date of gift, whichever is lower.

Revenue yield: Not more than $10 million a year.

4. Substitution for the present system of personal exemptions and credit for dependents, applied against net income before computation of tax, of a system of flat credits, applied against the tax itself.

The purpose of this proposal is to eliminate the differential subsidy to higher incomes involved in the present system. The $2,000 exemption for married persons is worth $1,580 (79 per cent of $2,000) in tax saving to a person with an income in excess of $5,000,000; it is worth only $80 (4 per cent of $2,000) to a person with an income of $5,000. If subsidies of this type were paid by the Treasury in the form of cash outlays, the unjustified expense would be generally condemned; in their present form they are as costly and just as little justified as if they were paid in cash.

A tax credit of $32 might be substituted for the present personal exemption of $800 for single person; a tax credit of $80 for the present personal exemption of $2,000 for married persons; and a tax credit of $16 for the $400 credit for each dependent. The present rate of 4 per cent on surtax net income of $4,000 to $6,000 might be lowered to 1 per cent in order to avoid a sharp increase in taxes for those who are now exempt from surtax by only a small margin and for those who now pay small surtaxes.

Revenue yield:

Level of national income (Billions of dollars)	Yield (Millions of dollars)
70	100
80	150
90	225
100	300

5. Final elimination of the personal holding company as a tax-avoidance device. Section 102 of the Internal Revenue Code provides a special penalty tax upon corporations formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders (or the shareholders of any other corporation) through the medium of permitting the accumulation of earnings or profits. Although the constitutionality of this statutory provision was recently sustained by the Supreme Court, attempts to enforce the section have resulted in conspicuous failure. What may be now done with impunity under the existing statute is illustrated by the famous Cecil De Mille case. Mr. Cecil De Mille sucessfully advanced as a reason for the large surplus accumulation in his corporation the argument that his corporation was building up its surplus to a point where it could some day achieve independent picture production. Mr. Bud Fisher successfully maintained that his corporation was building up a surplus so as to have capital sufficient to effect the distribution of independent comic strips in the contingent event that a syndicate through which distributions was effected should refuse to renew outstanding contracts. This sort of argument is like the argument made by the White Knight who carried a beehive around with him because some day he might want to keep bees.

Section 102 should be strengthened by adding to the section a clause similar to subdivision (b) now therein providing that certain facts "shall be prima facie evidence of a purpose to avoid surtax upon shareholders." Among such facts constituting prima facie evidence may be suggested the following:

(a) The fact that less than a stated percentage of income is distributed;

(b) The fact that more than a given percentage of income consists of dividends;

(c) The fact that the corporation is to a stated degree closely held;

(d) The fact of any major change in distributive policy resulting in a lower percentage of distribution;

(e) The existence of substantial loans to stockholders;

(f) The existence of substantial non-interest bearing loans by stockholders; and

(g) The fact that the non-distribution of profits actually had the effect of a substantial tax saving.

Another amendment which would strengthen Section 102 at one of its weakest points would be the insertion before the word "business" in subdivision (c) of the word "existing", making the "fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the (existing) business" determinative of the purpose to avoid surtax upon shareholders unless there is a clear preponderance of evidence to the contrary. This would mean that the term " reasonable needs" of the business would be related to the business in which the corporation is currently engaged and would place a greater burden upon the corporation to justify accumulations allegedly designed to permit the corporation to enter some new business activity. This sort of amendment would prevent tax avoidance of the De Mille type.

The rates of tax imposed by this section should also be increased. In relation to our present surtax brackets the existing rates - 25% upon the undistributed Section 102 net income not in excess of $100,000, and 35% upon such income in excess of $100,000 - render it advisable for some corporations to pay the tax rather than distribute.

Revenue yield:

It is impossible to estimate the revenue yield of this proposal, as the Treasury has never published, and presumably has never tabulated, figures relating to corporations "improperly accumulating surplus" in the economic, rather than the strictly legal sense. It should also be noted that the enforcement of this proposal will depend upon the attitude of the administrative authority as well as upon that of the courts so long as the definition of a corporation improperly accumulating surplus is made to turn, in the last analysis, upon purpose, rather than upon objective fact.

Proposals relating to the estate tax:

6. Effective taxation of property transferred in the form of insurance and under powers of appointment. The estate tax is designed to tax transfers of property that occur at the death of the owner. But many transfers have substantially this effect in practice although they do not have the ordinary legal form of a transfer by will. Among such alternative legal forms are life insurance and powers of appointment (that is power to specify who shall receive property). The present statute attempts to apply the estate tax to certain types of insurance and certain powers of appointment, but defects in the language of the provisions permit much tax-avoidance. Insurance is sold to large customers on a tax-avoidance selling appeal. The provisions relating to insurance and powers of appointment should be broadened to cover more of the cases.

Revenue yield:

No basis exists for any reasonably accurate estimate of the yield of this proposal. If it is assumed that as much property is transferred by these methods as by means of life insurance reported as part of gross estates for which returns have been filed in recent years, the yield would be about $25,000,000. The assumption probably overestimates the amount of property so transferred.

7. Effective taxation of gifts made in contemplation of death or in pursuance of a plan to avoid estate tax. A gift made in contemplation of death is another type of transfer that is much the same in substance as a transfer by will. Hence the statute purports to apply the estate tax to such gifts, and it establishes a presumption that gifts made within two years of death were made in contemplation of death. But in deciding whether this presumption is rebutted courts tend to be extremely liberal in favor of decedent estates. In one case a gift by a person over 90 years of age was held not to be in contemplation of death.

Under existing law the initial transfers made under a tax-avoidance program designed to transfer an appreciable part of an estate by gift avoid taxation at the highest rate of estate tax to which the estate would be subject by incurring taxation at the lowest rates of gift tax. For example, a gift of $10,000 from an estate that will amount to slightly more than $1,000,000 at the death of the donor avoids a prospective estate tax of $3,200 by paying a gift tax of only $150. The tax treatment of property passing by gift and by bequest should be more nearly equalized.

Both these types of tax avoidance would be effectively dealt with by the inclusion of gifts during the life of the donor in the computation of the taxable estate; that is, assessment of the estate tax on the total of estate passing at death plus gifts during life, with a credit for gift taxes previously paid.

Revenue yield:

Level of national income (Billions of dollars)	Yield (Millions of dollars)
70	30
80	40
90	50
100	70

8. Equalization of the benefits of exemptions under the estate and gift tax for large and small estates. The Internal Revenue Code now grants a cumulative exemption of $40,000 under the gift tax, a general estate tax exemption of $40,000, and a special exemption of $40,000 of insurance upon policies taken out by decedent upon his own life and payable to beneficiaries other than the estate of the insured. While a general estate tax exemption should be allowed in the case of reasonably small estates, these two exemptions as they now operate confer an undue benefit upon estates in high brackets. The $40,000 general exemption means $800 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 gift tax exemptions and to the insurance exemptions. It is well known in insurance circles that many persons with high bracket estates take out insurance policies of $40,000 not because they are interested in insurance, but merely to secure a $40,000 exemption.

As in the case of the personal exemption and credit for dependents in connection with the income tax, the estate tax exemptions should be modified so that they are of equal benefit to large and small estates. The special insurance exemption should be eliminated. A flat tax credit of $800 to be applied against gift or estate tax should be substituted for the present system of exemptions.

Revenue yield:

Level of national income (Billions of dollars)	Yield (Millions of dollars)
70	100
80	110
90	120
100	130

NOTE: The foregoing list of loopholes omits mention of what is probably the most important of all, namely, undistributed corporate earnings. A discussion of this problem has been omitted because of the political difficulties which are believed to prevent the enactment of an effective measure for dealing with it. In view of the unpopularity of the undistributed profits tax, the most promising way of dealing with this problem appears to be the taxation of corporate earnings to the individual stockholder regardless of whether the earnings are distributed or not. Various methods of accomplishing this result were proposed in 1937 by a committee of the Twentieth Century Fund. It seems to be the prevailing legal view that despite the Supreme Court's opinion in the Macomber case, it would not now declare unconstitutional a measure of this type.

Taxation of stock dividends and further limitations on unreasonable accumulation of corporate surpluses offer possibilities for limited action designed to deal with the undistributed earnings problem. It should be made clear, however, that either of these measures taken separately or both of them in combination would deal with only a very small part of the general problem.