July 31, 1940

SUGGESTED REMEDIES FOR CERTAIN INJUSTICES TO TAXPAYERS UNDER THE FEDERAL REVENUE STRUCTURE

Proposals relating to the corporation income tax:

1. Permission to file consolidated returns. The income tax law since 1934 has abolished the privilege of filing consolidated corporate returns, except with reference to railroad corporations. It seems to be generally accepted good accounting that the accounts of affiliated corporations should be computed on a consolidated basis. Separate corporate returns often mean multiple taxation of the same earnings, and put an irresistible premium upon artificial intercompany transactions to reduce the tax burden. Also, Internal Revenue Bureau decentralization enormously complicates the problem of auditing unconsolidated returns. What is really a single business unit should properly be taxed as such. Although the older provisions on this point were productive of considerable litigation as to the existence of affiliation and the precise treatment of various intercompany items, the use of consolidated returns would be practical and feasible, especially in the light of previous experience. The loss of revenue involved would be less than is generally believed, since it is difficult to administer the statutory safeguards against artificial inter-company transactions with thoroughness.

Affiliated companies should either be required or permitted (if not required) to file consolidated returns under the general method applicable to years prior to 1934. If the latter alternative is adopted, a higher rate of tax and consent to various regulations might be required as a price for the privilege of filing a consolidated return; such a differential was provided in the 1932 Act.

Loss of revenue: It has been estimated on the basis of sample studies of consolidated returns actually filed that taxation of separate returns would have yielded about $90,000,000 additional revenue in 1933 and $180,000,000 in 1930, if the additional baxable net income had been taxed at the rates provided by the Revenue Act of 1940. If artificial intercompany transactions have been widely resorted to since 1934 as a result of the abolition of the consolidated filing privilege, the loss in revenue as a result of restoring the privilege would be somewhat less than these figures would indicate.

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2. Retroactive relief from undistributed profits tax to corporations with impaired capital. Though it expired at the end of 1939 the undistributed profits tax still leaves a large number of controversies arising with respect to earlier years since 1935. Relief from this tax was accorded to insolvent companies and to companies in receivership. However, companies which had an impaired capital structure, but which had somehow managed to stay out of bankruptcy or receivership, were given no similar relief, even though they were equally unable under local law to distribute any dividends. The charter of such a corporation was held not to be a contract executed by the corporation, and the statute so interpreted has been held constitutional.

There is still no authoritative decision upholding the right of Congress to tax as undistributed profits earnings the distribution of which is forbidden by state law. The right to tax in such cases will probably be upheld, but such a conflict between national and local statutes is certainly inexpedient. It was often not feasible, due to limitations of time or to the unwillingness of preferred creditors, for companies with impaired capital to write down their capital structure in order to distribute the current earnings. Therefore, such corporations are practically in the same position as corporations in receivership or bankruptcy, and should be given the same relief. Otherwise, the very corporations least able to pay dividends are forced to pay the greatest undistributed profits tax.

If it is deemed inadvisable retroactively to exempt deficit corporations from the undistributed profits surtax to the extent of their capital impairment, then they should at least be given the favored treatment of a flat tax at a rate substantially below the average effective undistributed profits tax rate.

Loss of revenue: Probably less than $5,000,000.

3. Relaxation of the judicial doctrine of *res judicata* in tax cases. The general judicial doctrine of *res judicata* is that given issues of law or fact determined in a suit between given parties cannot be re-litigated. It is obviously sound as a general proposition, but it produces some unusually harsh results in income tax matters, since the income tax involves items such as trust income, depreciation and many others which recur annually year after year. In one case a husband who created an alimony trust in behalf of his divorced wife was held to be taxable on the trust income. Several years later in a different case, the court overruled the first case and held that the income from a substantially identical alimony trust was not taxable to the husband who litigated the later case. Nevertheless, because of the operation of *res judicata*, the unhappy husband in the

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first case apparently must continue to pay tax on the trust income. The courts and the Board of Tax Appeals should be authorized to relax the rule of res judicata in meritorious cases.

Loss of revenue: No estimate is possible.

4. Allowing status as dependents for income tax purposes to persons between 18 and 21 years of age. The existing law granting a $400 credit for dependents has been stated in the accompanying memorandum. This credit for dependents now provided by the statute ceases when the dependent reaches the age of 18 years, unless the dependent is physically incapable of self support. The accompanying memorandum suggests an elimination of the discrimination involved in the fact that taxpayers in the high brackets receive more tax saving than those in the lower brackets. On the other hand, the credit for dependents is inadequate in that it stops, as indicated above, at the age of 18 years. This is about the college entering age, when in families able to provide college education for their children dependents become most expensive and the credit for dependents is most needed.

Assuming the discrimination involved in the credit is eliminated, it is worth serious consideration whether the maximum age of 18 should not be lifted to 21 years, the standard age of attaining majority.

Loss of revenue: Under the existing system of allowing credit for dependents as a credit against net income: about $7,000,000. Under the system of allowing a flat credit against tax for dependents proposed in an accompanying memorandum: about $3,000,000. These figures would show relatively little variation with the level of national income or general business conditions.

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