1/13/37

MEMORANDUM OF TRANSMITTAL
OF A AND A-1

TO: Honorable Henry Morgenthau
Secretary of the Treasury

FROM: The White House

I transmit to you herewith a copy of a memorandum marked A prepared by Mr. Randolph E. Paul, whom I have consulted with respect to possibilities of securing additional revenue by the elimination of various discriminations contained in the statutes covering the taxation of income, estates and gifts as now enacted. I would like to have from you an estimate of the revenues which would reasonably be derived from Mr. Paul's suggestions. For your convenience I enclose a memorandum of specific questions keyed to Mr. Paul's memorandum, marked A-1.

I realize that some of these questions will be difficult to answer in categorical terms. Where the question deals with suggestions of a tentative nature, I will be obliged if you will make your answers as definite as may be possible under the circumstances.

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MEMORANDUM A

MEMORANDUM OF POSSIBLE CHANGES IN THE TAX LAW WHICH WOULD INCREASE REVENUE BY THE ELIMINATION OF DISCRIMINATIONS

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MEMORANDUM OF POSSIBLE CHANGES IN THE TAX LAW WHICH WOULD INCREASE REVENUE BY THE ELIMINATION OF DISCRIMINATIONS

INCOME TAX

1. Existing Law as to Personal Exemptions (Sec. 25 (b)) The Internal Revenue Code now allows personal exemption of $1,000 to a single person and to a married person not living with husband or wife, and a personal exemption of $2,500 to the head of a family or a married person living with husband or wife. A credit is also allowed for dependents amounting to $400 for each person dependent upon the taxpayer.

DISCUSSION This provision involves serious discrimination in favor of high bracket taxpayers. To a married person with a net income of less than $4,000 it means a tax saving of 4% (the normal tax rate) of $2,500, or $100. To a married person with a net income in excess of $100,000 and not in excess of $150,000 the provision means a tax saving of 62% of $2,500, or $1,550, which is more than 15 times the saving to the first low bracket person mentioned. To a married person with a net income in excess of $5,000,000 the same exemption means a tax saving of 79% of $2,500 or $1,975, which is almost 80% of the personal exemption.

RECOMMENDATION Section 25 (b) should be amended so that the credit now allowed therein for both normal tax and

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surtax purposes is made a credit <u>against tax</u> under which equal benefit is given by the exemption to taxpayers in the low brackets and taxpayers in the high brackets. An alternative remedy might be to limit the credit presently in the statute by making it a credit for normal tax purposes only.

2. <u>Existing law as to Stock Dividends (Sec. 115(f))</u> The statute since 1936 has contained an illuminating provision that a "distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution." This provision was drawn in the light of such cases as <u>Eisner v. Macomber</u>,[1] <u>Koshland v. Helvering</u>,[2] and <u>Helvering v. Gowran</u>.[3] In practice it means that stock dividends of the type involved in <u>Eisner v. Macomber</u> (common upon common with no other class of stock outstanding) are still exempted from tax. Most other dividends, such as (1) preferred upon common and (2) common upon preferred, are regarded as taxable.

<u>Discussion</u> As was prophesied by Mr. Justice Brandeis in his dissenting opinion in <u>Eisner v. Macomber</u>, the existing

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1. 252 U.S. 189 (1920)
2. 298 U.S. 441 (1936)
3. 302 U.S. 238 (1937)

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statutory provision, as administratively interpreted, constitutes a serious revenue leak. There are approximately 850 issuers of stock listed on the New York Stock Exchange, the total issues of these issuers being approximately 1230. Excluding common stock issues of railroad companies, there are approximately 390 issues of common stock on the New York Stock Exchange of 390 companies in which the capital is represented by common stock, or which have a small senior equity security ranking prior to the common stock. The capitalization of these companies, including 33 preferred stock issues, no one of which is of a $1,000,000 nominal value, consolidate into approximately 625,000,000 common shares having a nominal value in excess of $16,000,000,000. These figures constitute a prima facie showing of the companies merely on the New York Stock Exchange which are now in a position to issue tax-free stock dividends. Further investigation would no doubt show that many, if not the majority, of these corporations have an earned surplus upon the basis of which stock dividends may be distributed.

Recommendation It is highly desirable to subject all stock dividends to tax by an amendment either to the statute or to existing regulations. Such an amendment either of the statute or of the regulations would avoid difficulties as to retroactive application which would arise from a judicial decision decreeing

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all stock dividends to be taxable under the existing regulations. If there be any doubt as to the possibility of securing a statutory amendment, some attempt should be made through the courts to secure a reversal of Eisner v. Macomber. In spite of the Supreme Court's decision of November 6, 1939, in the Wilshire Oil case, the issue of a regulation prospectively incorporating a new rule[1] may be advisable.

3. Existing Law as to Trust Income (Secs. 166, 167)

A number of years ago Sections 166 and 167 were placed in our revenue act for the purpose of taxing the grantors of tax-avoidance trusts which did not accomplish any transfer away from the grantor of unfettered control over the corpus or income of the trust. These sections, according to Mr. Justice Roberts, were designed to prevent "facile evasion of the law."[2] The constitutionality of Section 167 was upheld in Burnet v. Wells.[3]

Discussion The purpose of these sections has been very largely frustrated by court and Board decisions. The sections, as interpreted by the courts,[4] permit the accomplishment of the

1. Helvering v. Reynolds Tobacco Co., 306 U.S. 110 (1939).
2. Reinecke v. Smith, 289 U.S. 172, 178 (1933).
3. 289 U.S. 670 (1933). See Corliss v. Bowers, 281 U.S. 376 (1930).
4. See e.g., Clifford v. Helvering, 105 F92d) 586 (CCA 8th, 1939); Corning v. Comm., 104 F(2d) 329 (CCA 6th, 1939); John E. Rovensky, 37 BTA 702.

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tax-avoidance purpose of the grantor in the case of the income of short-term trusts.[1] Thus, even though the grantor-trustee has reserved broad powers of sale and investment, the grantor has been held not taxable upon the income of a trust for the benefit of his wife where the trust was to terminate at the end of five years, or upon the death of the beneficiary or the grantor during that period, and the remainder (in excess of the undistributed income or the proceeds of the investment thereof) was to go to the grantor.[2] If it is certain that the <u>power</u> to revest will come into being at a fixed point of time, Section 166 will be applicable, but if the same substantial result is accomplished by providing that the trust automatically ceases to exist at the end of a fixed period, without any affirmative act on the part of the grantor in exercise of a power, then the grantor is not taxable under Section 166.[3] This means that the grantor in high brackets on account of other income is able to transfer high-bracket income to a trust which starts in the low brackets.

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1. Of course, the trust problem is much broader than here indicated. The splitting of income by irrevocable multiple trusts accomplishes tax avoidance on a large scale. But the only remedy in this case of irrevocable trusts seems to be a system of taxation on a family unit basis. Cf. Hoeper v. Wisconsin, 284 U.S. 206 (1931), which probably would be overruled by the Supreme Court as now constituted.
2. <u>Clifford v. Helvering</u>, <u>supra</u>.
3. See Meredith Wood, 37 BTA 1065, aff'd <u>per curiam</u> 104 F (2d) 1013 (CCA 2nd, 1939); Christopher L. Ward, 40 BTA 225.

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Recommendation Section 166 and 167 should be entirely revamped to prevent this type of tax avoidance. The amendment necessary may be briefly described as an elimination of the emphasis now placed in the statute upon the word "vested", combined with an addition covering short-term trusts which are to revert automatically.[1]

4. Existing Law as to Unreasonable Accumulations of Surplus (Sec. 102) 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 in Helvering v. National Grocery Company,[2] the section has been a conspicuous failure.[3] Up to a few weeks ago the reports show only about 33 cases directly involving Section 102, most of which were decided after 1930. The score in these cases is nominally 18 to 15 in favor of the government, but the score is really against the government when it is remembered that in 13 of the

1. Clifford v. Helvering, 105 F(2d) 586 (CCA 8th, 1939); Meredith Wood, 37 BTA 1065, aff'd per curiam 104 F (2d) 1013 (CCA 2nd, 1939).
2. 304 U.S. 282 (1938)
3. See statement of Mr. Vinson, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess., p. 173 (1937).

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government victories against 9 of its defeats, the taxpayer was one which would now be classed as a personal service corporation.

Discussion What may be now done with impunity under the existing statute is illustrated by the famous Cecil De Mille case.[1] Mr. Cecil De Mille successfully 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[2] 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 distribution was effected should refuse to renew outstanding contracts. This sort of argument is like the argument made by the White Knight who carried a bee hive around with him because some day he might want to keep bees.

Recommendation 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:

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1. 31 BTA 1161, aff'd 90 F(2d) 12 (CCA 9th, 1937) cert. den. 302 U.S. 713 (1937).
2. Fisher & Fisher, Inc., 32 BTA 211, aff'd per curiam 84 F(2d) 996 (CCA 2nd, 1936).

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(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;[1]

(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

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1. The addition of this factor as creating a rebuttable presumption would be quite different from the so-called "third basket" provision as proposed in the House of Representatives in 1938. (See House Bill, Revenue Act of 1938, Secs. 451 et seq.; Ways and Means Committee Report No. 1860, 75th Cong., 3rd Sess., p. 53 (1938)). That proposal imposed a new tax which was totally separate from that imposed by Section 102, and which was inescapable if the stockholding requirements were met. The present suggestion would simply transfer some of the determining factors from the proposed Section 451 into Section 102 itself as an additional ground for raising a rebuttable presumption of intent to avoid tax.

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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 DeMille type.

It may be that the statute of limitations should be lengthened for Section 102 cases, as has been done with respect to foreign personal holding company cases,[1] corporate distributions in liquidation,[2] and where there is a 25% omission from gross income.[3]

An alternative remedy might be to adopt in some part the English counterpart of Section 102.[4] This English statute applies only to closely held corporations, and in effect ignores the separate entity of such corporations. It taxes retained income to the stockholders, a remedy which may be too drastic.

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1. Internal Revenue Code, Sec. 275 (d).
2. Internal Revenue Code, Sec. 275 (e).
3. Internal Revenue Code, Sec. 275 (c).
4. Finance Act of 1922, Sec. 21, First Schedule as Amended by Act of 1927.

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Perhaps also the rates of tax imposed by this section should 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.

5. Existing Law as to Charitable Gifts in Form of Property (Sec. 23 (o)) The Internal Revenue Code now provides for a deduction on account of religious, charitable, scientific, literary, educational and other contributions.

Discussion 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.[1] 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.[2]

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1. Reg. 101, Art 23 (o)-1.
2. Paul, Selected Studies in Federal Taxation, Second Series, p. 173, note 75 (1938).

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Recommendation 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 doner or its value at the date of gift, whichever is lower. A middle alternative would be to allow no more than would be allowed if the donor sold the property and contributed the cash proceeds less the capital gains tax.

6. Existing Law as to Non-Business Casualty Losses (Sec. 23 (e)(3)) The Internal Revenue Code now provides for the deduction of losses on property not connected with the trade or business if the loss arises from fire, storm, shipwreck, or other casualty, or from theft.

Discussion This provision results in substantial deductions and difficulty of administration, particularly in connection with losses of the type sustained on account of the recent hurricane which devastated the eastern seaboard. It is particularly availed of by taxpayers who have large estates; smaller taxpayers cannot afford the appraisal fees involved in proving losses.[1]

Recommendation The provision allowing non-business casualty losses should be eliminated or restricted, like the charitable deduction, to a fixed percentage of the taxpayer's net income as computed without the benefit of this particular deduction.

1. Obici v. Helvering, 305 U.S. 468 (1939).

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Another appropriate limitation might be to treat such losses as capital losses, thus limiting the tax effect thereof.

7. Existing Law as to Interest on Non-Business Loans (Sec. 23(b)) The Internal Revenue Code now allows the deduction of interest on non-business borrowings (see item 8 below).

Discussion While it may be that a deduction should be allowed on business borrowings, although we have here the discrimination mentioned in item 8 below, the principal justification for allowing a deduction of interest on personal borrowings is a desire to promote small home ownership and building. The deduction in its broader aspects is more or less arbitrary, and often results in debatable questions as to whether loans were contracted for any real purpose or a mere tax-avoidance purpose.[1]

Recommendation Section 23 (b) should be amended by limiting the allowance for the deduction of interest on non-business borrowings to a fixed maximum amount of, say, $500, a sufficient amount to cover interest on mortgages upon a personal home of limited value, and on small personal borrowings to pay doctor and hospital bills or to hold title to small investments.

8. Existing Law as to Deduction of Interest Paid or Accrued (Sec. 23(b)) Section 23 (b) of the Internal Revenue Code

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1. Paul and Mertens, Law of Federal Income Taxation, Sec. 24. 06 (1934).

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now allows a deduction for all interest paid or accrued within the taxable year on indebtedness (except indebtedness incurred or continued to purchase certain tax-exempt securities). On the other hand, no deduction is allowed for purposes of the ordinary corporate income tax for dividends paid. From the stockholders' standpoint dividends and interest are treated alike; the provision formerly in the law allowing a credit for normal tax on account of dividends received has been eliminated.

Discussion The above provision is designed to encourage corporate financing by borrowing, rather than by capital contributions.[1] In the last few years a large number of corporations have "recapitalized" without tax under Section 112 (g) by retiring preferred stock and issuing bonds in the place thereof. For instance, if a corporation has outstanding a preferred stock issue of $10,000,000 upon which it pays dividends at a rate of 6%, or $600,000, it is at a disadvantage as compared with a corporation which owes $10,000,000 to bondholders and pays out the same annual interest of $600,000. The disadvantage consists of 18% of $600,000 annually, or $102,000 in years beginning with 1940.

1. See Final Report of the Committee of the National Tax Association on Federal Taxation of Corporations, p. 36: "Certainly the present federal income tax on corporations, which permits the deduction of interest on money borrowed but makes no allowance for imputed interest on proprietor's capital, sets up a marked discrimination against financing by means of stock issues and in favor of financing by bonds."

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Recommendation Section 23 (b) should be amended to eliminate this discrimination. The entire elimination of this deduction would probably be too drastic a remedy, although it would be incentive taxation of an extreme character and would definitely encourage equity financing. A less drastic mechanism would be at least to disallow the deduction in all cases in which a tax-avoidance purpose colored the incurring of the indebtedness. This may be covered, so far as recapitalizations are concerned, by the doctrine of Gregory v. Helvering,[1] although this is by no means certain.[2] At the very least a regulation should be framed to cover such situations.

9. Existing Law as to Non-Business Bad Debts (Sec. 23 (k)) The Internal Revenue Code now allows a deduction for debts ascertained to be worthless and charged off within the taxable year. This provision differs from the provision relating to losses in that generally speaking losses (apart from casualty losses discussed in item 6 above) must be incurred in trade or business, or in transactions entered into for profit. Deductions are allowable to individuals for non-business bad debts, including debts between relatives.

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1. 293 U.S. 465 (1935).
2. The Higgins v. Smith case, now pending in the Supreme Court, may help to settle this question.

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<u>Discussion</u> Few provisions of the statute have been productive of so much litigation as the bad debt provision.[1] A great many so-called debts are originally in fact gifts because there is no intention to repay when the so-called indebtedness is incurred; from the creditor's side there is no expectation of repayment.[2]

<u>Recommendation</u> Section 23 (k) should be amended by limiting the allowance for the deduction of <u>non-business</u> bad debts to a fixed small amount, say $1,000 in the case of each debtor.

10. <u>Existing Law as to Non-Business Taxes (Sec. 23 (d)</u> The Internal Revenue Code allows as a deduction taxes paid or accrued within the taxable year except income, profits, estate, inheritance, legacy and succession taxes and taxes assessed against local benefits. State income taxes, sales taxes, local property taxes, and custom duties are not within the exception. This deduction is allowed without reference to whether the taxes in question are on <u>business property or dealings</u>.

<u>Discussion</u> This allowance involves a manifest discrimination between taxpayers who own their own homes and taxpayers who rent their homes. Taxpayers who own their homes are

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1. See Paul, Studies in Federal Taxation, p. 235 (1937).
2. Paul and Mertens, Law of Federal Income Taxation, Sec. 28.15 (1934).

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enabled through this provision and the provision for the deduction of interest on non-business borrowings (item 7 above) to deduct almost the equivalent of rent, an expenditure which is regarded as a non-deductible personal expense in the case of taxpayers who rent their homes.

Recommendation Section 23 (d) should be amended by limiting the allowance for the deduction of taxes on non-business property or dealings to taxes on small homes not exceeding, say, $10,000 in cost or value. Possibly some exception should be made in the case of state income taxes.

11. Existing Law as to Basis Where Optional Valuation Privilege is Chosen (Sec. 302 (j) of 1926 Act as Amended) The 1935 law added to the estate tax provision Section 302 (j) permitting the executors of a decedent to elect the date a year after the death of the decedent for valuing the decedent's assets. The remedial purpose was to avoid a heavy estate tax where assets have shrunk greatly in value during the period of administration.[1] No corresponding provision has ever been made, however, with respect to the cost basis to be used by the distributees in computing gain or loss upon the sale of the assets. The cost basis of such assets is still the value at the date of acquisition, viz., the date of the decedent's death.

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1. See H. R. Rep. No. 1681, 74th Cong., 1st Sess., p. 9 (1935); H. R. Rep. No. 1885, 74th Cong., 1st Sess., p. 9 (1935).

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Discussion Since executors never use the optional valuation unless there has been a shrinkage of value, taxpayers obviously get the benefit of a differential which was never subjected to an estate tax. For example, a decedent may leave assets having a value of $1,000,000 at the date of his death, and drastic market fluctuations may have reduced the value of these assets a year after the date of death to $100,000. In such a case the executors may exercise the option accorded to them by Section 302 (j), and the basis to the distributees for purposes of depreciation and purposes of computing gain on sale is, nevertheless, $1,000,000, although only 100,000 has been subjected to an estate tax.

Recommendation The simplest solution is to insert a new subdivision in Section 113 stating that where the optional valuation privilege is exercised, the basis of such property shall be the value as used in the estate tax return.

12. Existing Law as to Taxation of Husband and Wife (Sec. 51 (b)) 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.

Discussion 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.

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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 an assignment of income from personal services is not recognized for income tax purposes.[1] 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. Furthermore, many family unit incomes must escape tax under existing law because the income of neither husband nor wife on a separate basis is sufficient to require the filing of an information return by the payor of the income. If the payor of income were required to file an information return on all yearly payments of over $1,000, whether the recipient be single or married, this method of escaping taxes would be curtailed.

Recommendation One thing which could be done in this situation is to require husband and wife living together to file a joint return. If this recommendation is adopted, a difficult

1. Corliss v. Bowers, 281 U.S. 376 (1930); Lucas v. Earl, 281 U.S. 111 (1930).

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differentiation should probably be made, in the interests of the modern independent status of women, between husbands and wives who are on an independent earnings or property basis and husbands and wives who transfer property to each other for the purpose of saving tax, the requirement being limited to the latter type of case. If the recommendation is not adopted, the present _permission_, as distinguished from _requirement_, of husband and wife to file a joint return might be eliminated from the statute. Such a return is never filed under existing circumstances unless it is to the advantage of the spouses. Still another method might be to tax the income of husband and wife on a combined basis. Or the method employed in the British statute might be adopted, -- namely the assessment of the entire income of both spouses against the husband at a rate determined by the combined total.[1/] Still another method, which would come substantially to the same result, is to assess husband and wife separately at surtax rates based upon the combined income.

13. _Existing Law as to Taxation of Interest from Governmental Obligations (Sec. 22 (B) (4))_ At the present time the Internal Revenue Code excludes from gross income (1) interest upon the obligations of a state, territory or any political subdivision thereof, or the District of Columbia, (2) interest upon

1. See Paul, Five Years with Douglas v. Willcuts, 53 Harv. L. Rev. 1 (1939); Paul and Havens, Husband and Wife under the Income Tax, 5 Bklyn L. Rev. 241 (1936).

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the obligations of a corporation organized under act of Congress if it is an instrumentality of the United States (to the extent provided in the acts authorizing the issue of such obligations), and (3) interest upon obligations of the United States or its possessions (to the extent provided in the acts authorizing the issue of such obligations).

Discussion Extended discussion of this exemption is unnecessary. It results in a serious loss of revenue.

Recommendation 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.

It would not be fair to tax the income from past issues of state and municipal bonds even though it might be constitutional to do so. In so far as Federal bonds have been issued on a tax-exempt basis, the impairment of contract clause would probably prevent their taxation.

Although it is not suggested that income on past issues of state and municipal bonds or of tax-exempt Federal bonds should be taxed, Senator Glass's proposal, that the surtax on income from

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non-tax-exempt sources should take into account the existence of tax-exempt income, should be adopted; that is, a taxpayer with an income of $200,000, one-half of which comes from existing tax-exempt securities, ought to pay surtaxes on the non-exempt half at the rates applicable to incomes between $100,000 and $200,000. That would not be taxing income from tax-exempt securities. If the court wished to sustain the tax, it could do so by reasoning that this would simply be denying the taxpayer the right to escape his proper surtax on his non-tax-exempt income.

14. <u>Existing Law as to Taxation of Capital Gains</u>

<u>(Sec. 117)</u> The Internal Revenue Code now lays a tax on capital gains, which in the case of long-term capital gains cannot exceed 15% of the gain on the sale of assets held two years, and 20% of the gain on the sale of assets held from 18 months to two years. Short-term capital gains, which arise upon the sale of assets held less than 18 months, are subjected to the ordinary surtaxes.

<u>Discussion</u> This tax is extremely lenient, particularly as it will operate in an inflationary period. It involves a serious discrimination against persons who derive their income from personal services.[1] The oft-repeated criticism that the

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1. Internal Revenue Code, Sec. 117. An individual with an earned income of $100,000 (disregarding credits for earned income and dependents, but allowing a $1,000 exemption) would be taxed $33,354, whereas an individual realizing $100,000 from long-term capital gains would be taxed only $9,334.

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taxation of capital gains impedes the mobility of capital, and discourages capital from venturing, is exaggerated.

Recommendation The capital gain rate should be increased, or, in lieu of a flat increase, tax should be imposed on capital gains by reference to the other non-capital gain income of the taxpayer. If the taxpayer is in a bracket between $200,000 and $300,000, he can afford to, and should, pay a higher capital gains rate than a taxpayer in the bracket just above the point at which it pays to elect to be taxed at the flat rates contained in the existing statute. An additional thought would be to give some favored treatment on account of the reinvestment of the proceeds of capital gains in equity risks in new enterprises.

15. Existing Law as to Corporate Distributions of March 1, 1913 Profits (Sec. 115 (b)) Every corporate distribution of earnings and profits accumulated, or increase in value accrued before March 1, 1913, is exempt from income tax. Such a distribution cannot be made so long as a corporation has earnings or profits accumulated since February 28, 1913, because there is a conclusive presumption in the statute that every distribution is made out of most recently accumulated earnings or profits. But the pre-March 1, 1913 profits, or increase in value of property, may be distributed free from tax if all more recently accumulated earnings or profits have been distributed.

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Discussion There is no constitutional reason why earnings or profits accumulated, or increase in value of property accrued before March 1, 1913, should not be taxed.[1] Corporations have been given a reasonable opportunity (20 years) to distribute pre-March 1, 1913 earnings and increase in value of property without any tax.

Recommendation You may wish to revive the attempt once made to amend Section 115(b) so as to eliminate the exemption therein given to corporate distributions of earnings or profits accumulated, or increase in value of property, accrued, before March 1, 1913.[2]

16. Existing Law as to Life Insurance Proceeds Paid in Installments (Sec. 22(b)(1)) The Internal Revenue Code provides for an exemption for income tax purposes of amounts received under a life insurance contract paid by reason of the death of the insured. In Section 22(b)(1) there follows a parenthetical clause to the effect that if life insurance proceeds are held by the insurer under an agreement to pay interest thereon the interest payment shall be included in gross income.

Discussion This provision does not work satisfactorily. A few years ago the General Counsel ruled[3] that this provision

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1. Lynch v. Hornby, 247 U.S. 339 (1918); Lynch v. Turrish, 247 U.S. 221 (1918).
2. Such an amendment at least once passed the Senate, but did not survive in the final bill enacted.
3. G.C.M. 13,796, CB XIII-2, p.41.

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exempted only the principal sum or capital value of the life insurance policy as of the date of the insured's death, and that all amounts which are added to such principal sum when it is paid in installments by reason of the running of time should be taxable. The Board has recently held that this interpretation was incorrect, and that the Congressional intent was to exempt amounts received by the beneficiary of a policy paid by reason of the death of the insured in installments or in annuities and not merely amounts paid upon the death of the insured or payable at that time. Putting this thought in another way, the exemption is construed not to apply merely to the commuted value of the face of the policy, but rather to the face amount of the policy whenever its proceeds are paid. Only income from the retained face amount of the policy, usually taking the form of excess interest dividends, is taxable, because such excess interest dividends are not received solely by reason of death of the insured, but are paid by reason of the withholding of the future installments of the principal amount and are profitable investments by the company.[1/]

<u>Recommendation</u> Section 22 (b) (1) should be amended in such a way as plainly to incorporate the principles announced in G.C.M. 13796.

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1. See Sidney W. Winslow, Jr., 39 BTA 373; of United States v. Heilbroner, 100 F(2d) 379 (CCA 2nd, 1938); Edith M. Kinnear, 20 BTA 718.

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17. Existing Law as to Double Loss Deductions (Secs. 23 (e), (f), 24 (b), 112 (b) (5), 113 (a) (8)) It is possible under the law as it stands for an individual who owns securities which have substantially decreased in value to transfer these securities to a new corporation without the recognition of loss under Section 112 (b) (5). The corporation under Section 113 (a) (8) takes over the high cost basis of the individual transferor. It may then sell the securities and obtain the benefit of the loss. If there is a mere expectation and not an agreement to liquidate the corporation at the time of the transfer of the securities to it, a second or double loss deduction may be secured upon the liquidation of the corporation.[1]

Discussion Although double deductions are frowned upon by the Supreme Court,[2] this seems to be a wholly indefensible loophole. While several members of the Board dissented in the W. & K. Holding case and the case may be reversed on appeal, there is a substantial possibility that it reflects a correct interpretation of the present statute.

Recommendation The statute should be amended to prevent this double loss deduction.

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1. See W. & K. Holding Corp., 38 BTA 830, 839.
2. McLaughlin v. Pacific Lumber Co., 293 U.S. 351 (1934); Ilfield Co. v. Hernandez, 292 U.S. 62 (1934).

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18. Existing Law as to Basis of Property Transmitted by Death (Sec. 113 (a) (5)) 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).

Discussion 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. Tremendous 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.

Recommendation Section 113 (a) (5) of 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.[1] While this would raise the basis where property has depreciated in value between original acquisition by the

1. It is realized that this change may involve problems of distribution among legatees, the high donor cost basis property being of greater value to a legatee, but problems of this sort are hardly insuperable.

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decedent and the date of death, it is perfectly fair to allow such a potential loss to be carried over from the decedent; moreover, this aspect of the change should not so greatly affect the revenue, since losses are frequently consummated during life to save taxes, whereas many gains for the same reason go deliberately unrealized. In connection with this recommendation it should be noted that it is fairer than the basis in the case of gifts _inter vives_ established by Section 113 (a) (2) which establishes as a _gain_ basis of cost to the donor, but limits the donee to a _loss_ basis of cost to the donor, or value at the time of gift, whichever is lower.

Another alternative remedy for this situation would be to count death as a closed transaction, somewhat in the manner established by Section 42 with respect to accrued income. This remedy, however, would be largely self-defeating under the present scheme of estate tax deductions in that the additional tax imposed upon the decedent during the last taxable year of his life time would be increased and this would automatically increase the estate tax deductions.[1]

19. _Existing Law as to Domestic Building and Loan Associations (Sec. 101 (4))_ The Internal Revenue Code under certain conditions now allows a special exemption from income tax to domestic building and loan associations, substantially all business of

1. See Reg. 80, Art. 37.

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which is confined to making loans to members.

<u>Discussion</u> This broad provision gives exemption to building and loan associations the activities of which are not related to financing home ownership, but go to the length of owning and operating office buildings; also to associations which make loans to building contractors, as distinguished from persons who are purchasing or erecting their homes for personal use; and also to building and loan associations owned by small groups, which derive substantial income from their ownership of the association. It does not destroy exemption that associations accept what are substantially savings deposits, and thus compete with banks.

<u>Recommendation</u> Although the line of demarcation is hard to draw, Section 101 (4) of the statute should be redrawn in such a way as to limit the exemption given to building and loan associations of a genuine cooperative character, the activities of which are primarily related to financing home ownership.

20. <u>Existing Law as to Mutual Casualty and Fire Insurance Companies (Secs. 101 (11), 207 (c) (3))</u> Section 101 (11) of the Internal Revenue Code exempts farmers' or other mutual hail, cyclone, casualty or fire insurance companies or associations (including interinsurers and reciprocal underwriters) the income of which is used or held for the purpose of paying losses or expenses. Section 207 (c) (3) gives a special allowance to mutual

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insurance companies (including interinsurers and reciprocal underwriters but not including mutual life and marine companies) requiring their members to make premium deposits to provide for losses and expenses consisting of the amount of premium deposits returned to their policy holders and the amount of premium deposits retained for the payment of expenses, losses and reinsurance reserves.

The effect of these provisions, as interpreted by the Bureau rulings, practice and regulations,[1] is that practically all mutual insurance companies other than life are exempted from income tax; those which fail to secure exemption under Section 101 (11) escape tax in large part by reason of Section 207 (c) (3). It is believed that virtually no substantial tax is collected from such mutual companies, although a substantial tax is collected from stock insurance companies of the same type.

Recommendation Section 101 (11) and Section 207 (c) (3) should be modified so that exemption is limited to companies of a purely local character, the phrase eliminated by Section 1013 (b) of the Revenue Act of 1924. Further protection should be introduced into the statute to prevent undue deductions under

1. See Reg. 101, Art. 101 (11)-1; Reg. 101, Art. 207-6. See also Comm. v. National Grange Mutual Liability Co., 80 F(2d) 316 (CCA 1st, 1935); McLaughlin v. Philadelphia Contributionship for Insurance of Houses from Loss by Fire, 73 F(2d) 582 (CCA 3rd, 1934) cert. den. 294 U.S. 718 (1935); Commercial Health & Accident Co. v. Pickering, 281 Fed. 539 (1922); Baltimore Equitable Society v. United States, 3 Fed. Supp. 427 (Ct. Cls., 1933) cert. den. 290 U.S. 662 (1933); Mutual Assurance Society of Virginia, 24 BTA 1102, acquiesced in CBXIII-1, p. 11; L. O. 1050, CB 3, p. 279; S.O. 156, CB III-1, p. 284; A.R.R. 7939, CB III-1, p. 294.

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Section 207 (c) (3). One method would be to use the provisions of existing law applicable to the taxation of stock insurance companies other than life. Other possible methods should be canvassed.

21. Existing Law as to Employers' Contributions to Pension Trusts (Secs. 23 (a), (p), 165)) The Internal Revenue Code allows a deduction on account of amounts transferred to pension trusts. Although amounts transferred to stock bonus, pension or profit-sharing plan trusts are deductible by the employer, the amounts transferred to the trusts are not taxable to the employee until they are paid out of the trust after retirement or otherwise, according to the pension plan. The trust itself is not taxable with respect to income earned upon the investment of the funds transferred to it.

Discussion These statutory provisions were undoubtedly intended to encourage pension and retirement plans which would give a measure of old age security to employees.[1] They have been employeed, however, to a large extent for the purpose not of benefiting junior low-paid employees, but rather for the purpose of laying aside for future lower-bracket taxation after retirement, large blocks of the salaries payable to senior key men in the employer companies.

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1. The purpose of these statutory provisions is stated in part in Conference Report No. 486, 67th Cong., 1st Sess., p. 29, Nov. 19, 1921; Finance Committee Report No. 960, 70th Cong., 1st Sess. p. 29, May 1, 1928. See also Oscar A. Olstad, 32 BTA 670.

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Recommendation Sections 23 (b), (p) and 165 of the statute should be amended so as to limit the deduction for payments made by employers to pension trusts to some fixed amount (say $5,000) for any one employee.

22. Existing Law as to Discovery Value and Percentage Depletion (Sec. 114 (b)) Section 114 (b) of the Internal Revenue Code allows special depletion in the case of mines (other than metal, coal or sulphur mines) discovered by the taxpayer. The basis is the value of the property at the date of discovery, or within 30 days thereafter; the depletion allowance is limited to 50% of the net income of the taxpayer from the property. In the case of oil and gas wells, the allowance is 27½% of the gross income from the property (excluding rents and royalties), but the allowance may not exceed 50% of the net income of the taxpayer from the property. In the case of coal mines, the percentage of gross income is 5%; in the case of metal mines it is 15%; in the case of sulphur mines it is 23%. These last three allowances are limited to 50% of the net income. It should be noted that these percentage allowances go on indefinitely and not merely until a definite capital sum is exhausted.

Discussion The special depletion deductions originated in discovery value deductions included in the Revenue Act of 1918 which was during the World War.[1] They were designed to encourage

1. Paul and Mertens, Law of Federal Income Taxation, Sec. 21.53 (1934).

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metal resource development, particularly oil wild catting. In 1926, because of valuation difficulties, percentage allowances were substituted in the cases mentioned for discovery value allowances. The original discovery value allowances were "favored industry" deductions, and involved the factor of incentive taxation. In 1937 the President and the Secretary of the Treasury recommended[1] the elimination of these provisions, but the recommendation was not adopted.

Recommendation You will no doubt wish to urge once more the elimination of these special depletion allowances. Of course, depletion on the basis of cost or value at March 1, 1913, should be retained in the statute.

23. Existing Law as to Development Expense Under the regulations now outstanding[2] the taxpayer is given the option to charge to capital or expense intangible drilling and development costs, including expenditures for wages, fuel, repairs, hauling supplies, etc., incident to the drilling of wells and the preparation of well for the production of oil or gas.

Discussion Expenditures of the type mentioned result in a capital asset, which in the case of productive properties

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1. Letter of President Roosevelt, June 1, 1937, quoted in 1 Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st Sess., p. 1 (1937); Secretary Morgenthau, Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess., p. 11 (1937).
2. Reg. 101, Art. 23 (m)-16.

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continues to produce income throughout the life of the property. The so-called option is only an option in an artificial sense,[1] since taxpayers generally take the cash and let the credit go by availing themselves of the privilege of deducting immediately the full cost of capital assets, rather than postponing the deduction to years when it may be recovered through the door of depreciation of a capitalized item. The Treasury made a move about a year ago in the direction of eliminating this so-called election, and compelling capitalization, but abandoned the idea after industrial hearings.

Recommendation This option has been granted by the regulations for a long period of years, and may have become embedded in the statute. Its elimination for the future will not require a statutory provision.[2]

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. Existing Law as to Taxation of Non-Resident Alien Individuals and Foreign Corporations (Secs. 211-219; Secs. 231-238) Under the Internal Revenue Code neither non-resident

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1. See Government Brief in Wilshire case, p. 9.
2. Helvering v. Wilshire Oil Co., U.S. (1939); cf. Helvering v. R. J. Reynolds Co., 306 U.S. 110 (1939).

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individuals nor foreign corporations are now taxable with respect to capital gains; and foreign corporations are given the benefit of a flat rate of 15% on their taxable income, and 10% in the case of dividends (which may be reduced to 5% in the case of a corporation organized under the laws of a contiguous country - Canada and Mexico - if so provided by treaty with such country).

Discussion No sufficient reason appears why non-resident aliens should have this distinct advantage over citizens and residents of the United States, nor why foreign corporations over domestic corporations should have any advantage with respect to rates of tax or types of taxable income. If anything, discriminations should operate in the opposite direction.

Recommendation Sections 211 to 219, and 231 to 238, of the Internal Revenue Code should be amended to tax non-resident aliens and foreign corporations upon income from sources within the United States in such a way that there is no discrimination in their favor. There appears no reason why non-resident aliens and foreign corporations should not be taxed upon capital gains consummated within the United States even though they have no office or place of business within this country.

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ESTATE TAX[1]

25. Existing Law as to Estate Tax Exemptions (1932 Act. Sec. 401 (c), 1926 Act, Sec. 302 (g)) The Internal Revenue Code now grants 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.

Discussion While a general estate tax exemption should be allowed in the case of reasonably small estates,[2] and while a $40,000 special insurance estate tax exemption should perhaps be allowed also in the case of small estates, these two exemptions as they now operate confer an undue benefit upon estates in high brackets. 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 insurance exemption. It is well known in insurance circles that many persons with high brackets estates

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1. Section number references under the estate tax are to the several revenue acts and not to the new Internal Revenue Code with which latter section numbers most persons are not yet familiar.
2. Possibly an even greater exemption should be allowed in the case of small estates.

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take out insurance policies of $40,000 not because they are interested in insurance, but merely to secure a $40,000 exemption.

Recommendation As in the case of the personal exemption and credit for dependents in connection with the income tax, these $40,000 exemptions should be modified so that they are of equal benefit to large and small estates; or perhaps they should be eliminated altogether in the case of net estates in excess of a given substantial figure. One mechanism for accomplishing this change would be to insert normal and surtax structure in the estate tax allowing the $40,000 exemption for normal estate tax purposes. The special insurance exemption should perhaps be eliminated in the case of all estates and an increase of the general exemption allowed to small estates.

26. Existing Law as to Taxation of Life Insurance (1926 Act, Sec. 302 (g)) Apart from the contemplation of death provision the proceeds of life insurance payable to beneficiaries other than the estate of the insured are taxable only if the insured is vested at the date of death with incidents of ownership in the policy. Incidents of ownership are now definied as including:

(1) The right of the insured or his estate to the economic benefits of the policy;

(2) The power to change the beneficiary;

(3) The right to surrender or cancel the policy;

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(4) The right to cancel the policy;

(5) The right to revoke an assignment;

(6) The right to pledge the policy for a loan; and

(7) The right to obtain from the insurer a loan against the surrender value of the policy.[1]

If the insured irrevocably assigns the above incidents of ownership to another person (usually his wife), there is no estate tax upon the proceeds of the insurance, unless the transfer is held to be in contemplation of death. The more modern form of avoidance in this field of the law is the issuance of cross policies, one on the life of the husband taken out and owned by the wife, and the other on the life of the wife taken out and owned by the husband. This method avoids the necessity of any assignment or irrevocable transfer of the incidents of ownership.

<u>Discussion</u> Large amounts of insurance proceeds altogether escape tax under existing law. Insurance is sold to large customers upon the basis of a tax-avoidance selling appeal.[2] It is believed that intra-company schools are maintained by the insurance companies in which salesmen are instructed how to discuss possible tax savings with prospective insurance buyers.

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1. Reg. 60, Art. 25, as amended by T.D. 4729, CB 1937-1, p. 284.
2. See Wright and Lowe, Selling Life Insurance through a Tax Approach.

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Insurance proceeds, in so far as they exceed cash surrender value, are at the date of the death of the insured enjoyable for the first time by the beneficiary. The death of the insured creates an additional untaxed value and frees it for the first time to the beneficiary's use. Such a genuine enlargement of the beneficiary's rights has been enough, without any shift of economic benefits from the estate, to support the taxation (1) of interests held by joint tenants and tenants by the entirety;[1] (2) of property as to which the decedent has retained for life the possession or enjoyment of the income if transferred after the 1931 Joint Resolution amending Section 302 (c);[2] and (3) of property as to which the decedent has retained nothing more than a veto right to prevent a revocation of the trust by the beneficiaries alone.[3] Where it is necessary to prevent tax avoidance devised by ingenious minds, there may be no denial of due process in measuring the tax upon the transfer of insurance by reference to what passes at death.

Recommendation We may be precluded from amending outstanding regulations retroactively.[4] Regulations 80, Article

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1. Tyler v. United States, 281 U.S. 497 (1930).
2. Helvering v. Bullard, 303 U.S. 297 (1938).
3. Helvering v. City Bank Farmers Trust Co., 296 U.S. 85 (1935).
4. Helvering v. Reynolds Tobacco Co., 306 U.S. 110 (1939); cf. very recent opinion in the Wilshire Oil case.

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25, as amended, should be further amended at least for the future. If necessary, the statute should be amended so as to make inescapably clear the intention of Congress to subject to tax the proceeds of all life insurance policies taken out by the decedent on his own life to the extent that he has paid premiums thereon, or where he possessed at the time of death some incident of ownership over the policies. In the situation involving cross-policies, commonly taken out and paid for by spouses with their separate funds, there is lacking any substitute for testamentary disposition, and Congress might well canvass the comparative merits of revamping the present income-tax exemption of insurance proceeds, or of imposing a special excise tax, wholly dissociated from the estate tax title, upon the receipt by the beneficiary of life insurance proceeds in excess of the aggregate premiums paid by him. However, any amendment taxing the proceeds of policies, regardless of incidents of ownership or regardless of the source of premium payments, should be only prospective in application, to avoid obvious unfairness against persons who have already procured policies in reliance upon the Treasury's outstanding interpretation of the statute. It might be possible to apply the amended statute to policies taken out before its passage, but to exempt from ultimate estate tax the cash surrender value of policies theretofore taken out, existing as of the passage of the amendment, or to exempt an amount bearing

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the same ratio to the total proceeds as the time between the issuance of the policy and the passage of the amendment bears to the total period until the date of death. This amendment involves the elimination from the statute of the completely unsatisfactory language "policies taken out by the decedent upon his own life."[1]

27. Existing Law as to Property Passing Under Powers of Appointment (1926 Act. Sec. 302 (f)) The estate tax statute now provides that there shall be included in the gross estate property passing under a general power of appointment exercised by the decedent (1) by will, or (2) by deed exercised in contemplation of or intended to take effect in possession or enjoyment at or after death, or (3) by deed under which the decedent has retained for his life, or any period not ascertainable without reference to his death, or for any period which does not in fact end before his death (A) the possession or enjoyment of, or the right to the income from, the property, or (B) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Discussion The use of the word "passing" makes it possible to escape all estate tax at the election of the person for whom the power is exercised, if that person would have taken the

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1. See Paul, Life Insurance and the Federal Estate Tax, 52 Harv. L. Rev. 1037 (1939); Bailey v. United States, very recently decided by the Court of Claims.

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same property in default of appointment. For instance, if a power is given to A, and in default of his exercise of the power by will the property is to pass to A's issue, or if no issue to A's heirs-at-law, A's heirs may still elect to take under the will of the donor of the power, rather than under the appointment itself, even though A has expressly exercised the power in their favor.[1] The Board of Tax Appeals recently decided James Webster, Exec.,[2] under authority of the Grinnell case. This case illustrates a simple estate tax avoidance expedient. The rule stated is that if the beneficiary-appointee receives no more because of the exercise of the power by the donee than he already had under the donor's will in default of the exercise, Section 302 (f) will not apply.[3] This rule is highly prejudicial to the revenue because it will apply to numerous family testamentary dispositions.

So long as the statute covers only general powers, there are ample means of avoiding tax deriving from technical distinction between general and special powers. The outstanding regulations say that a power is general if the donee may appoint to himself, his estate or his creditors.[4] A special power may be used which in no way will affect the desired purpose of the donee.

1. Helvering v. Grinnell, 294 U. S. 153 (1935).
2. 38 BTA 273.
3. Lewis Spencer Morris, Exec., 39 BTA 570 followed the same rule.
4. Reg. 80, Art. 24.

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Examples of such special powers are:

(1) A power to appoint among natural persons and charitable corporations in which the donee is deprived of the right to appoint business corporations.[1]

(2) A power exercisable with the consent of a trustee.[2]

(3) Under Maryland law a power which on its face is general becomes a special power because no appointment can be made to creditors. In that state virtually no power of appointment can be reached by Section 302 (f) as the section now stands.[3]

Recommendation

(1) The word "passing" should be eliminated from the statute so as to preclude escape from tax when a general appointment gives the beneficiary-appointee the same or less than he would have received in default of the exercise.

(2) The words "alone or in conjunction with any person" should be associated in the statute with the word "exercisable."

(3) The statute should include within its scope special powers, as well as general powers, with a provision for the exception of some special powers to cover cases in which an appointment under a special power after a single life tenancy can be exercised only among the children of the donor or donee, and where the

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1. Waldemar R. Helmholz, Exec., 28 BTA 165.
2. Charles J. Hepburn, Exec., 37 BTA 459.
3. Leser v. Burnet, 46 F.(2d) 756 (CCA 4th, 1931).

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property in default of appointment is to be distributed among that class. This would not postpone the tax "unduly," but would prevent such situations as exist in Delaware, where an estate can escape tax forever by giving a son a life estate and a special power to appoint any of the son's children; each generation can then repeat this process.

(4) There should be provision for a tax on powers, whether they are exercised or not, except in the case of the exception mentioned in (3).[1]

If special powers were taxed regardless of the limitation suggested, testators would immediately turn to the alternative of setting up life estates with vested remainders. Therefore, if no such limitation were placed upon the taxation of property passing under a special power, Congress should canvass the possibilities of imposing a succession or inheritance[2] (rather than an estate) tax whenever a remainderman under a will succeeds to property upon the death of the preceding life tenant. This would not be an extreme hardship, since life tenants are frequently given a power of invading the trust corpus, which gives them virtually the same economic control over the remainder as is possessed by the donee of a

1. This whole subject is ably discussed in Griswold, Powers of Appointment And The Federal Estate Tax, 52 Harv. L. Rev. 929 (1939).
2. See letter of the President to Congress quoted in Ways and Means Committee Report No. 1681, 75th Cong., 1st Sess., p.1 (1935).

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power of appointment. The rates of taxation upon the remaindermen in such cases should be considerably lower than those under the present estate tax law; and the remainder should probably be exempted from the tax if the life tenant dies within a period of five years after the death of the original decedent. Any statutory amendment along this line would have to cover the still further alternative of buying an annuity for the wife (as distinguished from making her a life tenant) and leaving the balance outright to the children, perhaps with enjoyment postponed until a certain age.

28. Existing Law as to Reverter Interests (Sec. 302 (c) as Amended by the 1932 Act. Sec. 803 (a)) In Helvering v. St. Louis Union Trust Co.[1] the Supreme Court decided by a vote of 5 to 4 that there is no tax upon the estate of the grantor of a trust where the only reservation in the trust instrument is a possibility of reverter (as to income) if the beneficiary (the grantor's daughter) should predecease the grantor. This decision resulted in a revision of the estate tax regulations and the insertion of the following language:[2]

> "On the other hand, if, as a result of the transfer, there remained in the decedent at the time of his death no title or interest in the transferred property, then no part of the property is to be included in the gross estate merely by reason of a provision in the instrument of transfer to the effect that the property was to revert to the decedent upon the predecease of some other person or persons or the happening of some other event."

1. 296 U.S. 39 (1935).
2. Reg. 80, Art. 17 (1937 Ed.)

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Discussion The existing statute, as so interpreted, makes a highly artificial distinction. For instance, 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. On the other hand, 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.

Recommendation There are, of course, all sorts of variations of reverter interests, but certainly as to many of them the dissenting opinion[1] of Mr. Justice Stone, concurred in by 3 of his associates, reflects the rule that should be incorporated into the statute. In net effect the rule is that the estate tax should be imposed in all cases in which the decedent in making disposition of his property retains any valuable interest in the property by which he postpones final disposition of the property until his death. The Supreme Court may, however, relieve this difficulty in several pending cases in which an overruling of the St. Louis doctrine is being requested by the government.

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1. Helvering v. St. Louis Union Trust Co., 296 U.S. 39 (1935).

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29. Existing Law as to Gifts in Contemplation of Death (Sec. 302 (c) of 1926 Act) The estate tax statute provides that there shall be included in the gross estate gifts and transfers in trust made in contemplation of death.

Discussion The statute, by making taxability depend on the motive or purpose accompanying the gift, incorporates a subjective test.[1] Whether there is contemplation of death is a question of fact which the courts tend to answer with extreme liberality in favor of decedent estates. In United States v. Wells[2] the frankly admitted motive of the decedent in making the gift was to reduce income taxes. The only motive connected with life which prevented the gift from being subjected to an estate tax was itself a tax-reduction motive. In many cases gifts made by persons well over 60 years of age are held not to be in contemplation of death; in one case a gift by a person over 90 years of age was held not in contemplation of death.[3]

Recommendation Some provision should be made to show Congressional intent to tax all gifts and transfers in trust which serve as substitutes for testamentary disposition. The 1926 Act inserted a two-year conclusive presumption which was held unconstitutional by a 6 to 2 decision in Heiner v. Donnan.[4] While the

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1. Paul, Selected Studies in Federal Taxation, Second Series, p. 285 (1938).
2. 283 U.S. 102 (1931).
3. Rochester H. Rogers, 21 BTA 1124.
4. 285 U.S. 312 (1932).

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present Supreme Court might sanction such a provision, it would be extremely unfair in the case of gifts by relatively young persons. A general provision might perhaps be enacted establishing conclusive presumption to cover cases in which the gift is made after the decedent reaches 60 years of age, with the present rebuttable presumption covering cases in which someone under the age of 60 makes a gift and dies thereafter within a two-year period.

30. Existing Law as to Elimination of Estate Tax Against Insurance Proceeds by Reason of Uncollectible Claims (Sec. 303 (a)) Under the Internal Revenue Code claims against the estate which are allowed in the jurisdiction in which the estate is being administered, are deductible in determining the net estate, even though the claims are not enforceable against some particular assets of the estate.

Discussion In many states the proceeds of life insurance payable to named beneficiaries are not subject to claims against the estate. Taxes are escaped altogether if the claims against the estate exceed not only the net estate, but also the statutory gross estate, including life insurance proceeds. In one case[1] an estate

1. Comm. v. Ames, 88 F(2d) 338 (CCA 7th, 1937). See also Helvering v. Northwestern National Bank and Trust Co., 89 F(2d) 553 (CCA 8th 1937); Comm. v. Lyne, 90 F(2d) 745 (CCA 1st, 1937); Helvering v. O'Donnell, 94 F(2d) 852 (CCA 2nd, 1938); Comm. v. Strauss, 77 F(2d) 401 (CCA 7th, 1935), on rehearing aff'd 31 F(2d) 1016 (CCA 7th, 1936); Comm. v. Hallock, 102 F(2d) 1 (CCA 6th, 1939); Wainwright v. Kyle, 22 F. Suppl. 175 (E.D. Pa., 1937); Edna F. Hays et al., Ex'rs, 34 BTA 808. See the dissenting opinion of Member Harron in Thomas DeC. Ruth, et al., Ex'rs., 36 BTA 191 which was however aff'd by the Circuit Court of Appeals (appeal dismissed, CCA 5th, 1938).

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evaluated 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. Since the uncollectible claims exceeded the gross estate, there was no estate tax liability.

Recommendation Section 303 (a) of the Internal Revenue Code should be amended to provide that claims against an estate are allowable deductions only if collectible in the particular jurisdiction.

GIFT TAX[1]

31. Existing Law as to Gift Tax Exemptions (Secs. 505 (a), 504 (b) of the 1932 Act, as amended) The existing gift tax allows a cumulative exemption of $40,000, and a non-cumulative annual exemption of $4,000 per donee. This last exemption is not applicable to transfers in trust.

Discussion This $4,000 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

1. Section number references under the gift tax are to the several revenue acts and not to the new Internal Revenue Code with which latter section numbers most persons are not yet familiar.

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of property free from tax. The principal purpose of the exemption is merely to allow a reasonable latitude for inter-family gifts.

Recommendation Section 504 (b) of the Revenue Act of 1932 should be further amended so as to restrict exempted gifts at least to members of the donor's immediate family.

(sgd) Randolph E. Paul

November 13, 1939

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