MEMORANDUM B

MEMORANDUM OF POSSIBLE CHANGES IN THE TAX LAW

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TO SOME EXTENT RESULTING IN DECREASE OF REVENUE

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INCOME TAX

1. Existing Law as to Consolidated Returns. The income tax law since 1934 has abolished the privilege of filing consolidated corporate returns, except with reference to railroad corporations.[1]

Discussion 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

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1. See Internal Revenue Code, Sec. 141.

experience. Little or no loss of revenue would be involved, since it is impossible to administer Section 45 with thoroughness.

Recommendation 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.

2. Existing Law as to Intercorporate Dividends For nearly twenty years the income tax statutes, until 1935, exempted intercorporate dividends. Recipient corporations were required for information purposes to report dividends from domestic corporations, but were allowed to deduct such dividends to their full extent in determining taxable net income. Section 26 (b) of the Internal Revenue Code now has the effect of relieving intercorporate dividends from double taxation only to the extent of 85%,[1] while tax is imposed upon such dividends to the extent of the remaining 15%. This means a normal tax of 2.7% on intercorporate dividends under the 1940 rates (18% of 15%).

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1. This percentage was formerly 90%.

Discussion The purpose of the legislative change of policy in 1935 resulting in partial taxation of intercorporate dividends was partly a revenue purpose,[1] and was also derived from a desire to discourage complicated networks of holding companies. This purpose has, of course, been partly achieved in the case of management and holding companies by the Wheeler-Rayburn Law. A Congressional purpose to discourage personal holding companies has also been achieved by a very drastic special provision applicable to personal holding companies first inserted in the 1937 Act and now part of Title I A and Supplement P. However, there still remains a necessity of discouraging over-complicated corporate structures, particularly structures involving the use of a triple tier of corporations. On the other hand, there are undoubtedly many situations in which subsidiaries are a legal necessity, as for example where a railroad is compelled to incorporate in a number of states as the price of doing business.[2]

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1. Apparently another purpose in 1936 was to prevent avoidance of tax by dividing the income of a corporation among several subsidiary corporate units. But see Twentieth Century Fund, Facing and Tax Problem, p. 179 (1937): "However, substantial avoidance would be unpractical for a large corporation since its business would have to be divided among numerous small subsidiaries. Furthermore, such avoidance could be prevented by taxing subsidiaries at the highest rate of taxation applicable to the whole affiliated group."

2. Various useful and necessary purposes of holding and subsidiary corporations are set forth in Berle and Means, Modern Corporation and Private Property (1932).

It would be a happy solution if we could devise some method of taxing intercorporate dividends which, in accomplishing desirable objects, did not penalize cases where a minor degree of corporate complication is unavoidable. It might also be advisable to eliminate from this double taxation intercorporate dividends where the receiving corporation has merely reasonably invested a surplus in the stock of other corporations and has a small interest which has no real controlling power in the corporation whose stock is owned.

Recommendations Recommendations have to be vague on this point but certainly certain aspects of the problem may be canvassed as follows:

(a) The possibility of the elimination of this type of double taxation where a subsidiary corporation is a matter of necessity or requirement, as in the railroad cases mentioned.

(b) The possibility of the elimination of this type of double taxation in cases in which a corporation has merely more or less temporarily invested surplus as above.

(c) The possibility of stiffening the tax in cases of inexcusably complicated corporate structures which have no reasonable business purpose or foundation.

3. Existing Law as to Mitigation of the Statute of Limitations in Certain Cases Section 820 was added to the income tax

statutes by the Revenue Act of 1938 to prevent the possibility of double deductions or double taxes based upon the same items. Under this Section if there is a determination under the income tax laws subsequent to August 27, 1938, resulting in an inconsistent treatment of a prior item - either as to the identification of the taxpayer or when an item is taxable - then the item can be corrected by taxing the amount correctly and allowing a deficiency assessment or refund, except that no adjustment can be made for years previous to 1932.[1]

Discussion Some of the worst types of inconsistency are not covered by this Section. The statute treats of the double allowance of a deduction, but does not affect the double disallowance of a deduction. The chief examples of this category are deductions for worthless securities or bad debts. Neither taxpayers nor government officials are entirely innocent of inconsistent footballing regarding such items. The government often claims, and frequently with success, that the stock or bad debt claimed as a deduction by the taxpayer actually became worthless in a year prior to the taxable year and also prior to the period within which refund claims are possible.

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1. See generally Maguire, Surrey and Traynor, Section 820 of the Revenue Act of 1938, 48 Yale, L. J. 509, 719 (1939).

The new statute thus is inconsistent in its condemnation of inconsistencies. Stock losses may not be claimed by the taxpayer because of reasonable doubt as to the facts, rather than any culpable negligence on the taxpayer's part; and if the debt or stock is finally held to have become worthless in an outlawed year, then the error is irretrievably perpetuated. The explanations offered informally for this incompleteness of Section 820 are not wholly satisfactory. It is stated that if an adjustment were here permitted, the statute of limitations would be virtually abolished. But at least some permissive machinery might be set up to permit the Commissioner to do justice in these excluded cases.

Recommendation Section 820 should be extended so as to give discretion to the Commissioner to allow adjustments back to some appropriate date for amounts which would otherwise be completely lost as deductions. Also, the requirement in Section 23 (k) that a debt ascertained to be worthless must be "charged off within the particular year" should be removed from the statute, and this elimination should be made retroactive to the extent outlined above.

4. Existing Law as to Mortgage Transactions A great number of opportunistic decisions made by a bewildering variety of administrative and judicial officials has completely confused the whole field of transactions involving mortgaged property. This confusion

involves questions both as to the recognizable date of the loss suffered by the mortgagor or mortgagee and the nature of such losses (whether capital or ordinary).[1]

Discussion Where the mortgagee bids in mortgaged property at a price which happens to include interest accrued on the mortgage, the Supreme Court has decided that the "interest" is constructively received and constitutes taxable income to the mortgages, even though the fair market value of the property at the time of the sale may have been far less than the bid price and the mortgagee therefore had an actual loss.[2] On the other hand, if the property is "voluntarily" conveyed by the mortgagor to the mortgagee in satisfaction of the debt without the formality of a foreclosure, the mortgagee is not treated as having received taxable interest unless the fair market value of the property transferred is equal to the principal debt plus interest.[3]

The Board of Tax Appeals has held that the mortgagor's loss on foreclosure is realized only when the redemption period expires

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1. See generally Paul, Federal Income Tax Problems of Mortgagors and Mortgagees, 48 Yale L. J. 1315 (1939).

2. Helvering v. Midland Mutual Life Insurance Co., 300 U.S. 216 (1937).

3. Manhattan Mutual Life Insurance Co., 37 BTA 1041.

under local law.[1] In view of the comparative infrequency of redemptions, such a rule is decidedly arbitrary. Moreover, it causes complicated questions where the period of redemption is different with respect to different parties in interest. It would be far more convenient, and certainly more realistic, to provide that the loss is realized at least as soon as the foreclosure sale occurs.

The nature of any loss suffered by the parties (as to whether an ordinary or capital loss for income tax purposes) has also been a fertile field of disagreement. The Treasury regulations[2] permit the mortgagee to deduct as an ordinary bad debt the uncollectible deficiency upon a foreclosure, to the extent that the mortgage notes have not been applied on the bid price. But the regulations go on to provide that where the mortgagee bids in the property, he realizes a capital gain or loss measured by the difference between the bid price and the fair market value of the property. It is also ruled by the Bureau and the Board of Tax Appeals that except as to depreciable property a capital loss occurs (as to both mortgagor and mortgagee) where property is conveyed in satisfaction of the debt without a foreclosure by a mortgagor personally liable for the mortgage debt.[3]

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1. J. C. Hawkins, 34 BTA 918, aff'd 91 F(2d) 354 (CCA 5th, 1937); Derby Realty Co., 35 BTA 335, dismissed without opinion.

2. Reg. 101, Art. 23 (k)-3.

3. See for example Betty Rogers, et al., 37 BTA 897, aff'd 103 F(2d) 790 (CCA 9th, 1939), cert. den. Oct. 9, 1939; but see Bingham v. Comm., F(2d) (CCA 2nd, July 26, 1939).

There should certainly be no taxable gain from the purchase of property by the mortgagee. Nor should the loss of the mortgagee upon a foreclosure, or the loss of either party upon a "voluntary" conveyance of the mortgaged property, be treated as a capital loss. Such a conveyance is not a "sale or exchange" except in the most technical sense of the term; the parties are in the position of debtor and creditor rather than of seller and purchaser. It is a medieval play with words to say that a foreclosure sale is involuntary but that a conveyance under threat of foreclosure is voluntary. The mortgagor's equity is usually wholly worthless in either case.

Calculations of gain or loss upon foreclosure raise further problems as to the mortgagee's cost basis for gain or loss upon a resale. The regulations now provide that the mortgagee's basis is the fair market value at the time of foreclosure (which is taken to be the bid price in the absence of clear contrary evidence). However, considerable doubt has been cast on the validity of these regulations by the Midland Mutual decision. The Supreme Court's refusal in that case to consider fair market value on the question of interest income may mean that the mortgagee's basis is the price which he bid at the foreclosure, regardless of actual value.

Recommendation There should at least be added to Section 117 (as was done in the case of redemptions of corporate bonds) a provision that neither a foreclosure, nor a conveyance in lieu thereof, is to be deemed a sale or exchange for income tax purposes.

Such a provision might be merely part of a general revision of Section 117, in so far as it relates to transfers which are essentially involuntary, such as losses on corporate liquidations.

5. Existing Law as to Taxation of Alimony The Supreme Court several years ago committed itself to the view that alimony does not constitute taxable income to the divorced wife.[1] This principle has been further extended to exempt from income tax in the hands of the wife trust payments provided in lieu of direct alimony payments; the income from such trusts remains taxable to the husband on the ground that he is receiving its economic benefit through the discharge of his legal obligation of support.[2]

Discussion It does not seem constitutionally necessary to continue granting divorced wives this freakish exemption from income tax either upon direct alimony payments or upon distributions from an alimony trust set up by the husband. The theory of the Supreme Court in the Gould case was that alimony was not income, but rather a transfer to her of capital to take the place of the support which the husband would have given her in future years if the parties had continued living together. But while it is true that the value of the support given by a husband to his wife is not taxable to her while the parties

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1. Gould v. Gould, 245 U.S. 151 (1917).

2. Douglas v. Willcuts, 296 U.S. 1 (1933).

are living together, there seems no conclusive reason why the same exemption should be granted to the pecuniary substitute which the law grants to the wife upon her divorce, and which she is free to use for any purpose she desires.

The existing treatment leads to endless complications and controversies as to who shall be taxed on the trust income under varying sets of facts, as where the husband dies before the ex-wife but the alimony trust for her benefit continues, or where the wife was the guilty partyin the divorce proceeding and was not legally entitled to alimony, or where the very creation of the alimony trust completely relieves the husband under local law from any further obligation to his ex-spouse. A typical case in this field is now pending before the Supreme Court[1] but is unlikely to afford a complete solution. The liabilities of the present system, in the form of uncertainty and of the heavy burden of litigation which it throws upon the courts, more than outweigh its assets, since taxing the wife rather than the husband would cause little if any decline of revenue.

Recommendation The income tax statute should be amended to tax the wife upon alimony payments or trust payments in lieu of alimony, and the husband should be allowed to deduct such amounts from his own taxable income. The revenues could be completely protected by imposing a gift tax upon the creation of alimony trusts; this could be

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1. Fitch v. Comm., 103 F(2d) 702 (CCA 8th, 1939) cert. granted October 9, 1939.

accomplished by inserting into the gift tax sections a provision that release of marital rights to alimony should not be considered an adequate consideration in money or money's worth for a transfer of property.

The alimony situation is, of course, only a segment of the whole field of trusts set up by a husband for members of his family. Where such a trust is set up for a child or wife living harmoniously with the husband, the existing cases are so confused that one never knows when the grantor will be taxable upon the income and when the beneficiary who received the income. The model of the English income tax law certainly deserves careful consideration here; the grantor might be taxed by express statutory provision on the income from any trust set up for a wife living with him, or for a minor child, unless a full life estate in the income is given in trust for the child rather than a mere term of years. If deemed desirable, this new statutory scheme could be made applicable only for the future, and the old scheme could remain for cases in which alimony arrangements have been based upon existing law.

6. Existing Law as to Cancellation of Indebtedness in Corporate Reorganizations The Chandler Act,[1] recently passed to clarify and amend certain portions of the National Bankruptcy Act, contains a provision that no income tax shall be levied upon any release of indebtedness occurring when a company is reorganized and returned to

1. Pub. No. 696, 75th Cong., 3rd Sess., c. 575 (1938).

business under Section 77 B. A large reduction of fixed indebtedness usually occurs, since that is the very purpose of a corporate reorganization. The Act, however, goes on to provide in Section 270 that the cost basis of the assets in the hands of the reorganized company shall be reduced by the full amount of the indebtedness cancelled or reduced. This sweeping income tax provision crept in almost in the still of the night, through the Judiciary Committee rather than the Ways and Means Committee.

Discussion The above treatment, although seemingly fair on its face, leaves the situation worse than it was before the attempted remedy. Independently of this statute, the corporation would be taxed as having received income only in the amount by which it is left with an affirmative surplus.[1] The Chandler Act, however, appears to have the effect of imposing a deferred income tax (through a basis reduction) on the whole amount of indebtedness cancelled, even though only a part of the cancellation would have been taxable to the corporation under general income tax principles.

Thus, a corporation with a debt of $1,000,000 and assets of $800,000 which secured a $500,000 reduction of its debt, would, under general income tax principles, not be taxable upon the first $200,000

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1. Lakeland Grocery Co., 36 BTA 289. Even this rule has its qualifications. Several forms of release from indebtedness do not constitute taxable income regardless of solvency. Thus the cancellation of a debt owed by a corporation to one of its stockholders is ordinarily treated not as income, but as a contribution to the capital of the corporation. Reg. 101, Art. 22(a)-14.

of the cancellation, since that would merely leave the assets and debts exactly equal. Only the remaining $300,000 would be taxable. Under the Chandler Act, however, the whole $500,000 goes to reduce the cost basis of the company's assets for depreciation purposes and for computing gain or loss upon subsequent disposition.

Recommendation The provisions of the Chandler Act relating to income tax seem out of place, and might be transferred to the Revenue Code, with a clear provision that cost basis should be reduced only to the extent that the corporation would have received taxable income except for the statutory exemption. Section 113(b)(3) of the Code affords a precedent here, although even that Section is somewhat ambiguous in its phraseology.

There seems no reason why a similar treatment should not be extended to individuals. Extension or re-adjustment agreements with creditors, of the type here involved, are really adjustments of capital rather than the creation of income in the ordinary sense of the term.

7. Existing Law as to Ascertainment of Earnings or Profits Available for Corporate Distributions The income tax statute defines a dividend as any distribution out of "earnings or profits." The term "earnings or profits" includes many items of non-taxable income, such as interest in government bonds and dividends of domestic corporations. Numerous questions have arisen as to whether particular receipts which

would otherwise be taxable income, but which have been accorded a statutory exemption, are "earnings or profits" so that distribution therefrom to the shareholders would be taxable to them.

For example, property may be acquired by a corporation in the course of a tax-free reorganization. Company A, having property for which it paid $1,000, but which has risen in value to $1,000,000, may transfer the property to Company B in return for the latter's stock. A similar gain may, of course, arise on an exchange of stock for stock. It has been held by the Board and the courts that such a gain, though it is not recognized as taxable to the company due to the reorganization provisions nevertheless, increases the earnings or profits of the transferring company available for taxable distribution.[1]

Furthermore, at least one court has indicated that a mere rise in value of property held by the same company may constitute earnings or profits, although unrealized increment has never been considered taxable income.

<u>Discussion</u> Cases like <u>F. J. Young Corporation</u> ignore the basic theory underlying the non-recognition of gain in reorganization transactions. Section 111(c) provides: "In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be

1. F. J. Young Corporation, 35 BTA 860, aff'd 103 F(2d) 137 (CCA 3rd, 1939); Susan T. Freshman, 33 BTA 394, dismissed without opinion CCA 2nd, 3rd, 1936.
2. Binzel v. Comm., 75 F(2d) 989 (CCA 2nd, 1935) cert. den. 296 U.S. 579 (1935).

determined under the provisions of section 112." The words "for the purposes of this title" seem to compel the conclusion that the exemption from non-recognition for income tax purposes applies equally to the determination of earnings or profits. A correlation between these two concepts is essential if we are to achieve the objective of the reorganization sections, and if we are to avoid extremely difficult problems of administration and of bookkeeping for tax purposes. The decisions referred to are also contrary to the Treasury's own current income tax regulations.

Recommendation The statute should be amended to make it perfectly clear that "earnings or profits" are not increased either by appreciation, or decreased by depreciation in value, or increased by any receipts rendered tax-free by the reorganization provisions.

8. Existing Law as to Taxation of Undistributed Profits Despite Impairment of Capital Though expiring at the end of the current year, 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

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1. Reg. 101, Art. 115-3. For a more complete criticism of these cases see Paul, Ascertainment of "Earnings or Profits" for the Purpose of Determining Taxability of Corporate Distributions, included in Selected Studies in Federal Taxation, Second Series, p. 149 (1938).

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,[1] and the statute so interpreted has been held constitutional.[2]

Discussion 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.

Recommendation 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

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1. Reg. 94, Art. 26-2.

2. Crane-Johnson Co. v. Comm., 105 F(2d) 740 (CCA 8th, 1939).

be given the favored treatment of a flat tax at a rate substantially below the average effective undistributed profits tax rate.

9. Existing Law as to Personal Holding Company Tax Where Dividends Cannot be Distributed Since 1934 Congress has imposed upon "personal holding companies" a tax now amounting to 65% on the first $2,000 of undistributed income, and a tax of 75% on the remaining undistributed income. Section 405(a) allows such companies the deduction of dividends paid. The current act, however, denies to such companies the benefit of the capital loss provisions which will be available to other corporations beginning next year, and also purports to deny them the benefit of the carry-over of net losses.

Discussion As a result of the above provisions, many personal holding companies are being spanked much more seriously than Congress probably intended. This is especially true in the case of corporations which have current taxable income but which have no earnings or profits available for dividend distribution, either from the current year or from past years. This situation is possible where the corporation has non-deductible capital losses, or other non-allowable expenses or losses, which eliminate "earnings or profits" within the technical meaning of that phrase but leave current taxable income.[1]

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1. See Foley Securities Co. v. Comm., F(2d) (CCA 8th, 1939). Here the personal holding company had a 1934 profit of $49,000. However, it had a deficit of about $23,000 at the beginning of the same year. It distributed approximately $42,000 to escape the personal

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Under the existing law such a corporation may be taxable at approximately 75% of its net income. It cannot escape this tax, since even if it distributes an amount equal to the total current taxable income, that amount will not be a taxable dividend because not out of "earnings or profits",[1] and therefore would not entitle the corporation to a dividends-paid credit. Nor can the tax be escaped through the mechanism of a consent dividends credit;[2] the intention of Congress, as revealed in the legislative reports and in the current regulations, was that such a credit could be obtained only to the extent that a dividends paid credit would have been possible if the actual cash had been distributed, which means that the amount of the credit is limited by the amount of earnings or profits available.[3] Even complete liquidation would possibly not serve to remove the strait jacket; even/here

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holding company surtax. Due to the prior deficit, it was held that the first $23,000 had to be used to make up that amount, and the distribution to this extent was a return of capital, not taxable to the shareholders and not available for use as a dividends credit.

This problem does not exist under the acts since 1936, since Section 115(a) now defines "dividend" to mean a distribution out of either earnings or profits accumulated since 1913 or current earnings or profits of the taxable year without regard to the existence of accumulated earnings. That is since 1936 a dividend from current profits would be taxable when distributed, even though there is a deficit, and such a dividend would be deductible by the corporation. The problem typified by the Foley case still may arise, however, where the company has current taxable income but no earnings or profits either from the current year or prior years since 1913.

1. See Internal Revenue Code, Sec. 115(a) defining a dividend.
2. See Internal Revenue Code, Sec. 28.
3. Ways and Means Committee Report No. 1860, 75th Cong., 3rd Sess., pp. 24-25 (1938); Reg. 101, Art. 23(c)-1.

the dividends paid credit might be limited.[1]

Recommendation If it is deemed inadvisable to exempt from the personal holding company surtax corporations with no current or past earnings or profits, then an alternative mechanism would be to extend the consent dividends credit to such personal holding companies for amounts which the shareholders include in their individual returns, even though such amounts would not have been taxable as dividends if actually distributed.

10. Existing Law as to Res Judicata The general judicial doctrine of res judicata, namely the principle that issues of fact or of legal rights determined in one suit cannot thereafter be relitigated, is applied by the courts in tax controversies.[2] The doctrine involves special questions with relation to the income tax for the reason that the income tax involves items such as trust income, depreciation and many others which recur annually year after year, causing each year's tax liability to constitute a different cause of action.

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1. See Gaston & Co., 39 BTA 640, involving Section 351 of the 1934 Act and holding that a liquidation distribution, not being taxable to the shareholders except to the extent that it exceeded their basis, could not be deducted by the corporation in computing the personal holding company tax. Under present law, however, it is possible to obtain a dividends paid credit for some liquidation distributions; Reg. 101, Art. 27(g)-1.

2. Tait v. Western Maryland Ry. Co., 289 U.S. 620 (1933), discussed in Paul, Selected Studies in Federal Taxation, Second Series, pp. 104, 106 (1938); Griswold, Res Judicata in Federal Tax Cases, 46 Yale L. J. 1320 (1937).

As applied to tax cases the doctrine is further complicated by the fact that tax suits may sometimes be brought against the Collector of Internal Revenue and sometimes against the Commissioner or against the United States. On this point the law may be summarized by stating that decisions in the cases involving the United States or the Commissioner as a party may be res judicata as to later actions involving the Collector, whereas the converse of this proposition is not true.[1]

Discussion The application of res judicata causes some startling instances of martyrdom as tax law progresses and changes. Consider the plight of the unhappy husband in Helvering v. Brooks.[2] The Second Circuit Court of Appeals in this case held that a certain husband who had created an alimony trust in behalf of his divorced wife was taxable on the trust income upon the ground that the income operated to discharge his legal obligation towards the ex-spouse. Several years later (long after the time for any direct appeal in the Brooks case had expired) the same Circuit Court of Appeals in a different case,[3] involving a substantially identical alimony trust held that the husband was not taxable and expressly overruled its prior decision in the Brooks case.

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1. Cf. Bankers Pocahontas Coal Co. v. Burnet, 287 U.S. 308 (1932) and Tait v. Western Maryland Ry. Co., 289 U.S. 620 (1933).

2. 82 F(2d) 173 (CCA 2nd, 1936).

3. Helvering v. Leonard, 105 F(2d) 900 (CCA 2nd, 1939).

Nevertheless, because of the operation of res judicata, Mr. Brooks must apparently continue to pay income taxes upon the trust income so long as the trust endures. An error has been perpetuated which neither the Court, nor the taxpayer, nor the government can do anything to alleviate.

The doctrine has further complications in tax cases due to the system of Supreme Court certiorari. The United States Supreme Court rarely grants certiorari in tax cases unless the lower courts are in conflict; but conflict may develop only after it is too late for the original taxpayer to petition for certiorari. The purposes of the doctrine of res judicata, namely, to lessen litigation is, of course, a worthy objective, but objectives of the doctrine are defeated instead of achieved. In cases decided adversely to the particular litigant, whether government or taxpayer, every avenue of appeal must be exhausted, however small the amount involved, since otherwise the original decision will result in a binding adjudication which may be conclusive as to all future tax liabilities relating to the same item.

Recommendation The existing distinction between suits involving the United States, the Commissioner and the Collector is highly artificial, and there is no reason why all tax suits and proceedings should not be required to be brought against the United States, the real party in interest.

It also need not be too loose a remedy to authorize the courts and the Board of Tax Appeals to relax the rule of res judicata in meritorious cases upon a showing of additional or different facts in the subsequent year or upon a showing that the rules of law as announced by the courts have changed since the prior determination. This can be accomplished procedurally by permitting motions to strike out pleadings on the ground that res judicata applies and permitting such motions to be defended on the ground of additional or different facts or a new rule of law.

11. Existing Law as to Credit for Dependents. 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.

Discussion 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 many families dependents become most expensive and the credit for dependents is most needed.

Recommendation 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.

12. Existing Law as to Personal Medical Expenses The present statute expressly disallows all personal living expenses[1] and this disallowance includes any amount expended for medical services.

Discussion It would be wholly logical and fair to allow taxpayers some deduction for expenses incurred in protecting their own health - their chief income-producing capital asset. It is plainly inconsistent to permit a farmer to deduct the expense of veterinarian service to his cattle, but not to deduct medical expenses made to protect the health of himself and his family. A deduction here would encourage the obtaining of adequate medical attention by taxpayers in the lower-middle income brackets. An experiment in permitting such a deduction has worked successfully under some of the state income tax laws.

Recommendation A maximum deduction of perhaps $100 a year should be allowed for medical or dental expenses paid by the taxpayer on behalf of himself or any member of his family.

GIFT TAX

13. Existing Law as to Gifts in Trust Section 505(a) of the 1938 law amended Section 504 (b) of the 1932 law by providing that the $4,000 annual exclusion allowed generally for gift tax purposes shall not apply to gifts in trust.

Discussion This amendment was inserted to remedy the evil of creating a number of trusts for the same beneficiary in order to

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1. Internal Revenue Code, Sec. 24(a)(1).

secure the benefit of more than one exclusion. The calculation of the exclusion in this situation has been the subject of a difference of opinion between the Board of Tax Appeals and the courts; the courts have finally held[1] under the laws prior to 1938 that the beneficiaries are the true donees rather than the trustees, and therefore the tax avoidance which the 1938 amendment was assigned to prevent has proven illusory. At any rate the remedy adopted in the act amounts to burning down the house to destroy the rats. Trusts for minor children and other members of the family are a useful social device, and it seems unwise to give them a virtual death blow by completely removing the exemption.

Recommendation The $4,000 gift tax exclusion should be restored to gifts made by way of trust, with the limitation that only one trust should be recognized for each beneficiary in computing the tax. The exclusion, in other words, should be in all cases determined according to the number of beneficiaries rather than the number of trusts. If one exclusion is claimed with respect to a gift in trust for a certain beneficiary, no additional exclusion should be allowed in the same year for a gift made directly to the same beneficiary.

14. Existing Law as to Gift Tax on Tenancies by the Entirety. The existing regulations under the gift tax provide that if ~~a~~ husband purchases property and causes title to be conveyed to himself and his

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1. Welch v. Davidson, 102 F(2d) 100 (CCA 1st, 1939); Rheinstrom v. Comm., 105 F(2d) 642 (CCA 8th, 1939).

wife as tenants by the entirety, then the transaction amounts to a taxable gift to the wife, consisting of the value of her interest in the property. This position has been upheld by the courts.[1] However, the estate tax law provides that upon the death of the husband in such a situation, the whole value of the property is includible in his estate for estate tax purposes.[2]

Discussion The above treatment means that the government inconsistently treats such a conveyance as a completed transfer to the wife for gift tax purposes, but disregards the transfer for estate tax purposes. The gift tax rule, moreover, involves considerable difficulties of valuing the wife's right to the joint use of the property for life and her contingent right to become sole owner of the property in case she survives the husband; and it is possible that refined distinctions may have to be drawn according to the exact legal rights which the law of the particular locality gives to the wife as one of the joint owners.

Since the estate tax and gift tax were clearly designed as supplementary to one another,[3] the gift tax should not be interpreted as covering transfers which are explicitly covered by the estate tax.

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1. Lilly v. Smith, 96 F(2d) 341 (CCA 7th, 1938) cert. den. 305 U. S. 604 (1938).

2. Sec. 302 (e).

3. The precise extent to which this is true will be further illuminated by the decision in Sanford Estate v. Comm., U.S. (1939) aff'g 103 F(2d) 81 (CCA 3rd, 1939).

The more significant shift of economic interests occurs at the husband's death; and here, as elsewhere, the imposition of tax should be laid upon economic realities rather than artificial legal technicalities. The gift tax upon the type of transfer in question would, of course, be an allowable deduction in computing the estate tax; but due to the methods of computing such a credit, this is an inadequate protection. Moreover, the husband may not consciously have intended to make a gift to the wife in the sort of transaction here involved, and imposing a gift tax traps the unsuspecting taxpayer.

Recommendation Assuming, as we apparently must, that Lilly v. Smith is a correct interpretation of the statute, the gift tax law should be amended to provide that no transfer (except gifts ultimately determined to have been made in contemplation of death) should be subjected to gift taxation where the same property would be included in the transferor's taxable estate upon his death.

GENERAL

15. Existing Law as to Interest on Deficiencies and Refunds. The present law allows interest of 6% upon the amount of any deficiencies, and also allows the same rate of interest upon any refunds found to be due the taxpayer.

Discussion These percentages are out of line with present interest rates and should be reduced. Such a reduction would benefit taxpayers since the amount of deficiencies collected by the government must considerably exceed the amount of refunds collected by taxpayers.

Recommendation The interest rate on both deficiencies and refunds should be lowered to 4%.

(sgd) Randolph E. Paul

November 13, 1939

Note: Section number references under the gift and estate taxes are to the several acts and not to the new Internal Revenue Code with which latter section numbers most persons are not yet familiar.