Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date July 24, 1940

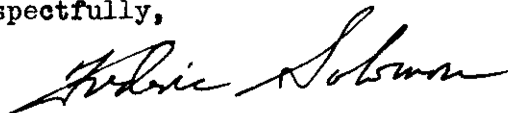
To Chairman Eccles

Subject: Tax Proposals

From Mr. Solomon, Assistant Counsel.

At Mr. Despres' suggestion there is attached a memorandum summarizing those proposals in Mr. Randolph Paul's "A" and "B" memoranda of November 13, 1939 that Mr. Paul has suggested for present consideration.

Respectfully,



Frederic Solomon,
Assistant Counsel.

Attachment

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C O P Y

LORD, DAY & LORD
25 Broadway
New York

July 20, 1940

Mr. Emil Depres,
Federal Reserve Board,
Washington, D. C.

Dear Depres:

In Memorandum A it seems to me that the following points are the most important for present consideration:

Nos. 2, 5, 11, 13, 14, 15, 18, 22,

23, 25, 26, 27, 29, 30 and 31.

In Memorandum B I would select points 1, 3, 4, 8, 9, 10, 11, 12 and 15.

Of course the importance of the above points varies as does also the degree of clarity as to whether action should be taken and what should be done.

Sincerely yours,

(sgd.) Randolph E. Paul

REP:JK

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PAUL PROPOSALS OF JULY 20, 1940

("A" and "B" References are to items in PAUL'S "A" and "B" Memos.)

INCOME TAX

Income Taxed at Privileged Rate or Not at All

Capital Gains (A14) The President has stated his opinion that Congress went too far in the 1938 Act in reducing taxes on capital gains. The point is emphasized in an inflationary period. Present provisions seriously discriminate against earned income. Subject to certain variations due to credits for dependents, etc., an individual with an earned income of about $100,000 now has to pay more than 3 times as much tax as one with the same income from long-term capital gains.

Paul believes the claim that taxation of capital gains impedes the mobility of capital and discourages it from venturing is grossly exaggerated. He favors increasing the rate on capital gains, or perhaps relating the rate to other income of the taxpayer. He says some favored treatment might be given for reinvestment of capital gains in equities of new enterprises.

Interest on Governmental Obligations (A13) The loss of Federal Revenue and the unfortunate economic effects of exempting this income is well known. Paul would make all future issues of State and Federal obligations fully taxable, and as to outstanding issues would adopt Senator Glass' proposal that income from such issues be taken into account in determining the surtax rates on the taxpayer's other income.

Stock Dividends (A2) At present stock dividends upon common stock with no other class of stock outstanding, the type involved in the famous Macomber case, are not taxed. Paul proposes that such dividends be taxed along with other taxed types, such as (a) preferred on common and (b) common on preferred. It is not clear whether the change could be best accomplished by change in the statute, change in the regulations, or seeking reversal of the Macomber case.

Corporate Distributions from March 1, 1913 Surplus (A15) Corporate distributions from pre-March 1, 1913 earnings have had 25 years of exemption. Paul suggests that consideration be given to making such distributions taxable.

Credit Giving Undue Benefit to Large Incomes

Credit for Dependents (B11) Since the surtax rate increases with the size of the income, any flat deduction from the taxable income -- such as the $400 credit for each dependent -- will grant far more tax reduction to a large taxpayer than a small one. To a taxpayer with net income of about $4,000 the exemption means a tax saving of about $16. If he

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has an income between $100,000 and $150,000 it means a tax saving of about $250, or roughly 15 times as much as for the small taxpayer. Paul proposes to alter this by putting the credit for dependents in the form of a flat deduction from the tax, or by making it a credit for normal tax purposes only. He thinks it would be equitable, however, to have the credit apply until the dependent is 21 rather than having it stop at age 18 as at present.

Artificial Tax-Reductions by Juggling Capital Assets

Charitable Deductions (A5) When a taxpayer makes a charitable contribution in the form of property he now gets a deduction equal to the value of the property at the date of the gift. By making the contribution in the form of property instead of cash he can escape a capital gains tax on the property. For example, if he contributes securities that he bought at $1,000 but are now worth $5,000, he gets a deduction for a $5,000 gift and escapes tax on his $4,000 capital gain. Paul suggests that charitable contributions of property be deductible only in the amount of the cost to the donor or value at date of gift, whichever is lower. As an alternative he suggests that the deduction might be limited to the amount that would be allowed if the donor sold the property and contributed the proceeds less the capital gains tax.

Basis of Property Transmitted by Death (A11, A18) When a taxpayer has property that was transmitted to him by death (acquired by him through inheritance or the like), the cost basis of the property is very important in determining his income tax. If Y holds property that was transmitted to him at death by X, and the property cost X $100,000 and is worth $500,000 at X's death, Y is now permitted to use $500,000 as his basis upon a sale of the property. If he sells for $500,000 he has no taxable gain. $400,000 of appreciation has never been, and never will be, subjected to income tax. The rule must cause great loss of revenue, and have a freezing market effect by discouraging sales by persons late in life. (A18)

A similar question arises in connection with the permission given executors to elect to value the decedent's estate as of a year after the decedent's death rather than at the time of such death. This has the sound purpose of preventing a large estate tax when the estate has shrunk in value during administration. There is an error, however, in continuing to permit the persons to whom the property is distributed to use as their cost basis the value as of the date of death. (A11).

Paul would correct the first difficulty by applying a rule similar to that now applicable to similar situations involving property received by gift, that is, he would require the beneficiary to use the same basis the property had in the hands of the decedent (A18). To

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correct the second difficulty he would require the beneficiary to use the basis chosen by the executors in paying the estate tax. (All).

(Since both problems might arise in a single case it might be desirable to combine the solutions by requiring that the basis be the same as in the hands of the decedent, except that when the executors use a lower basis for paying the estate tax such lower basis should apply.)

Special Tax Privileges to Oil, Gas and Mining Industries

Percentage Depletion (A22) Special depletion allowances are provided for oil and gas wells and various types of mines. In the case of oil and gas wells the allowance is 27-1/2% of the gross income from the property (excluding rents and royalties), but not exceeding 50% of the net income from the property. The allowance is 5% of gross for coal mines, 15% for metal mines, and 23% for sulphur mines, each being limited to 50% of net income. Other mines get an allowance of 50% of net income. These percentage allowances go on indefinitely and not merely until a definite capital sum is exhausted.

The special allowances originated during the World War as special discovery value deductions intended to encourage resource development, particularly oil wild-catting. In 1926, because of valuation difficulties, the percentage allowances were substituted. Paul apparently favors the elimination of these special allowances, as recommended by the President and Secretary of the Treasury in connection with the 1937 Tax Evasion Hearings.

Development Expense (A23) Under present regulations oil and gas companies are permitted to deduct as an expense intangible drilling and development costs (including wages, fuel, repairs, etc.) incident to drilling wells and preparing them for production. This means that such items can be deducted all at once as "expenses" instead of having to be considered capital items and deducted over a period of years as "depreciation". This probably could be changed by amending the regulations without a change in the statute. Paul suggests reconsideration of the privilege. He also suggests that consideration be given to limiting depletion and depreciation deductions to those reported in annual reports to stockholders and, conversely, that consideration be given to requiring listing applications to the Securities and Exchange Commission to show the amount of such allowances that are taken for income tax purposes.

Miscellaneous Adjustments

Consolidated Returns (1B) Since 1934 the privilege of filing consolidated corporate returns has been abolished, except as to railroads.

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It seems to be generally accepted good accounting that accounts of affiliated corporations should be computed on a consolidated basis. Separate returns often mean multiple taxation of the same earnings, and put an irrestible premium on artificial intercompany transactions to reduce taxes. Paul would <u>require</u> affiliated companies to file consolidated returns, or as an alternative would <u>permit</u> such consolidated returns on condition that the corporations pay a higher rate and agree to certain regulations.

<u>Mortgage Transactions</u> (B4) There is great confusion as to the tax effects of transactions involving mortgaged property. This confusion involves questions both as to the date of the loss suffered by the mortgagor or mortgagee and the nature of such losses -- whether they are capital losses (deductible at a reduced rate), or ordinary losses (deductible at the regular rate). Paul would clarify the status of such transactions and apparently would treat the losses as ordinary rather than capital.

<u>Undistributed Earnings Tax on Corporation with Impaired Capital</u> (B8) Although the undistributed profits tax expired at the end of 1939 certain problems remain from earlier years. Among these is the fact that corporations that had impaired capital, and hence could not distribute earnings under State law, apparently will have to pay heavy taxes. Paul would, in effect, grant retroactive relief to such corporations, if not in the form of an exemption, then in the form of a special reduced flat rate.

<u>Personal Holding Companies</u> (B9) In order to prevent "personal holding companies" from being used for tax evasion, there are heavy taxes on the undistributed income of such companies (65% tax on first $2,000 of undistributed income and 75% tax on remainder). However, there are differences between the provisions relating to taxable income of these companies and the provisions relating to the credit they get for dividend distributions. These differences sometimes make it impossible for the company to distribute its taxable income in a form that will give it credit for a distribution. Paul would permit the company to get the credit for amounts which the stockholders include in their individual returns even though such amounts would not have entitled the company to a credit if they had been distributed.

<u>Medical Expenses</u> (B12) All personal living expenses are now disallowed, and this disallowance extends to medical expenses -- money spent in protecting the taxpayers chief income-producing asset. A farmer may deduct the expense of veterinarian service to his cattle, but cannot deduct medical expenses to protect the health of himself and his family. An experiment in permitting such deduction has worked successfully under some State income tax laws. Paul would permit a maximum deduction of

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perhaps $100 a year for medical or dental expenses paid by the taxpayer for himself or his family.

Administrative Provisions

Mitigation of Statute of Limitations (B3) The taxpayer or the Government often disagree as to the date as of which a given loss or gain should be allowed. For example, a loss often is held to have occurred prior to the period within which refunds are permitted. In such a case the taxpayer never gets to deduct the loss unless some provision is made for relaxing the statute of limitations for such situations. The statute already makes provision for a portion of such cases, but Paul would broaden it to cover more of the field.

Res Judicata (B10) The general judical doctrine of res judicata is that given issues of law or fact determined in a suit between given parties cannot be re-litigated. It is obviously sound as a general proposition, but it produces some unusually harsh results in income tax matters, since the income tax involves items such as trust income, depreciation and many others which recur annually year after year. In one case a husband who created an alimony trust in behalf of his divorced wife was held to be taxable on the trust income. Several years later in a different case, the court overruled the first case and held that the income from a substantially identical alimony trust was not taxable to the husband who litigated the later case. Nevertheless, because of the operation of res judicata, the unhappy husband in the first case apparently must continue to pay tax on the trust income. Paul would authorize the courts and the Board of Tax Appeals to relax the rule of res judicata in meritorious cases.

ESTATE TAX

Estate Transfers that Escape Estate Tax

Life Insurance (A26) and Powers of Appointment (A27) The estate tax is designed to tax transfers of property that occur at the death of the owner. But many transfers have substantially this effect in practice although they do not have the ordinary legal form of a transfer by will. Among such alternative legal forms are life insurance and powers of appointment (that is power to specify who shall receive property). The present statute attempts to apply the estate tax to certain types of insurance and certain powers of appointment, but defects in the language of the provisions permit much tax-avoidance. Insurance is sold to large customers on a tax-avoidance selling appeal. Paul would broaden the provisions relating to insurance (A26) and powers of appointment (A27) to cover more of the cases.

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Gifts in Contemplation of Death A gift made in contemplation of death is another type of transfer that is much the same in substance as a transfer by will. Hence the statute purports to apply the estate tax to such gifts, and it establishes a presumption that gifts made within two years of death were made in contemplation of death. But in deciding whether this presumption is rebutted courts tend to be extremely liberal in favor of decedent estates. In one case a gift by a person over 90 years of age was held not to be in contemplation of death. Paul would add to the present presumption a conclusive provision that any gift made by a person 60 years old, or over, be subjected to the estate tax as having been made in contemplation of death. (A29).

Uncollectible Claims Against Estate (A30) A related but slightly different reduction in estate taxes arises from the fact that claims against the estate are deductible in determining the net estate for tax purposes even though the claims are not enforceable against certain assets of the estate. In many States proceeds of life insurance payable to named beneficiaries are not subject to claims against the estate. In one case there was an estate evaluated at over $2,000,000, of which more than half consisted of the proceeds of life insurance. There were valid claims of $6,000,000 against the estate, but none of them were a charge against the proceeds of the policies. These claims were, however, deductible in computing the net estate; hence there was no taxable net estate and no tax. Paul would amend the statute so that uncollectible claims would not be allowable deductions.

Exemptions Giving Undue Benefit to Large Estates

Estate Tax Exemptions (A25) The estate tax exemptions -- the $40,000 general exemption and the $40,000 insurance exemption -- confer an undue benefit upon high-bracket estates in much the same way that the credit for dependents gives large incomes an undue benefit under the income tax. Disregarding the recent 10% defense tax, the $40,000 general exemption means $400 in tax to an estate of between $40,000 and $50,000; to a net estate between $4,000,000 and $4,500,000, it means $20,000 in tax; and to an estate in excess of $50,000,000 it means $28,000 in tax. The same figures may be applied to the additional insurance exemption of another $40,000 for the proceeds of policies payable to third persons. It is well known in insurance circles that many persons with high-bracket estates take out insurance policies of $40,000 not because they are interested in insurance, but merely to secure a $40,000 exemption. Paul would modify these exemptions so that they are of equal benefit to large and small estates.

GIFT TAX

$4,000 Gift Tax Exemption (A31) The gift tax now allows a cumulative exemption of $40,000 and a noncumulative annual exemption of

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$4,000 per donee. Large amounts of property may be transferred at any time among several persons, or may be transferred over a number of years to the same person, without any gift tax. Paul would restrict exempted gifts at least to members of the donor's immediate family.

GENERAL

Interest on Deficiencies and Refunds   Present law provides for interest of 6% both on deficiencies collected from taxpayers and refunds granted to taxpayers. This rate is out of line with present interest rates and Paul would reduce it in both cases to 4%. This would benefit taxpayers since total deficiencies collected by the Government must considerably exceed total refunds collected by taxpayers. (B15)

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