

LORD, DAY & LORD

25 BROADWAY

NEW YORK
CUNARD BUILDING

LUCIUS H. BEERS
HENRY DE FOREST BALDWIN
FRANKLIN B. LORD
ALLAN B. A. BRADLEY
ALLEN EVARTS FOSTER
GEORGE DE FOREST LORD
PARKER MCCOLLESTER
RANDOLPH E. PAUL
SHERMAN BALDWIN
JOHN H. VINCENT
JAMES S. HEMINGWAY
HERBERT BROWNELL, JR.
THOMAS F. DALY
HARRY J. RUDICK

CABLE ADDRESS
LORDATTY
NEW YORK

WASHINGTON OFFICE
SOUTHERN BUILDING

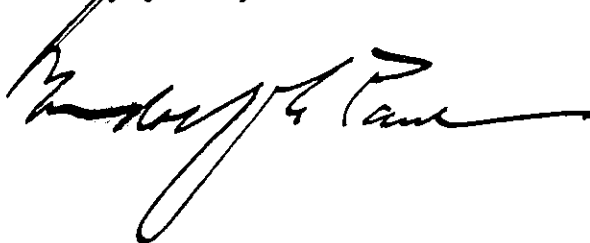
July 22, 1940

Marriner Eccles, Esq.
Chairman of Federal Reserve Board
Washington, D. C.

Dear Mr. Eccles:

Would you look over the enclosed draft of a preface to my next studies and give me your suggestions? In spots I am in territory better known to you than to myself, and I particularly want to make no economic breaks. Will you particularly note my paragraph in the middle of page 2 on the subject of which I am pretty ignorant.

Sincerely yours,



REP:A

*Dismissed when
Paul was in the
office 8/9/40
N.E.*

This third group of tax studies has been written in the shadow of grave emergencies. A little more than a year ago none but the bold imagined a fraction of what has happened since August, 1939. Now only the ostrich-minded can escape the grim reality that we are in times that will try every institution in our national structure. The strain will not be casual. It will not be limited to the military and naval front line. Defence is not so narrow a term. The test of unpredictable events will hardly miss any essential part of our civilization. Certainly it will not pass by something so near the front line as our tax system.

One must pay unreserved respect to a tax system which in comparative youth raises nearly 7 billion dollars annually from a public subject to a burden of more than 8 billion of state and local taxes. To accomplish such a result with nothing but vocal protest is almost a miracle. But a deserved sense of accomplishment need not soothe us into complacency. For our tax system is full of soft spots that enervate its

effectiveness. Ineffectiveness works in two directions. Sometimes there is palpable failure to reach available revenue; sometimes an inept statute cruelly carves out its pound of flesh. Our whole tax system demands reanalysis in the light of its effect upon our economy and in the light of its technical qualification to perform its critical task.

From the standpoint of general policy there are two vital questions. The first is how much shall be collected, and how much shall be left as a mortgage upon future generations. Here we have the peril of war millionaires, and inflation raises an ugly head. Wise men are warned that present payments have many high values. It may not be healthy to tax only life and to leave profits unscathed. Payments left to the future may easily be more than the future can bear.

Governments must live more fully when national life is threatened. The second policy question is who shall pay what must be collected. Upon whom shall the extraordinary burden fall?

Taxes have been described by the greatest of ~~economists~~¹ jurists as the price we pay for living in a civilized society; with them, as Holmes - who liked to pay taxes - told his astounded secretary, we buy civilization. A word "may vary greatly in color and content according to the circumstances and the time in which it is used,"² and Holmes's description of taxes takes on a new value in an emergency. For the price of living in a civilized society is soaring without discernible limit. It is inevitably so. The only question for discussion is willingness to pay. If that does not correspondingly increase, we may be sure that no bargain is possible by which our American civilization may be saved. Unprecedented taxes are the price of survival of the capitalistic system. The question is whether that system can take what alone will make it endure.

1. Holmes, J., dissenting in *Compania de Tabacos v. Collector*, 275 U.S. 87, 98 (1927); *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 313 (1927).

2. *Towne v. Eisner*, 245 U.S. 418, 425 (1913).

Willingness needs definition. There is always plenty of willingness at hand to see taxes increased out of all proportion to the worst fears of our grandfathers. But there is a vast difference between willingness to see taxes paid by others and willingness to see taxes paid out of one's own pocket.¹ In the days to come soon let no one be deceived by brave, noble, loud talk about sacrifice in terms of high taxes. Such talk will need testing against the more eloquent testimony of deeds. Are the talkers willing to pay progressive taxes out of their own incomes and estates in return for benefits received? Or do their pious words camouflage an incessant activity in favor of regressive consumption taxes? To what extent will increased burdens of government be distributed to those who are able to pay for the protection afforded by the state,² -

1. Paul, The Background of the Revenue Act of 1927, 5 Uni. of Chic. L.R. 41, 42 (1927)

2. New York ex rel. Cohn v. Graves, 200 U.S. 209/²¹³(1937).

those who by their payment do not disrupt our economy by decreasing their spending power? These are the real tax questions of the day, no matter what red herrings special interests use to confound the issue. And the answers will determine more than the sincerity of the tax talkers. They will determine whether our civilization shall be saved, and whether what is saved is worth the saving. For the kind of taxes we impose now may irretrievably condition the quality of our civilization when the crisis passes. Taxes may no longer be considered in vacuo as mere revenue-raising devices having no reference to our whole economy. They may make or break that economy. Increased regressive taxes may intensify a disturbing concentration of wealth and enervate post-war markets, ruining not only those who pay, but also those who are loath to pay the progressive taxes that will not have this result. There is nothing in the Constitution "to bar even a conscious use of the taxing power for readjusting the social equilibrium."¹

1. Frankfurter, *Law and Politics*, p. 78 (1939).

From the technical standpoint one does not have to look far to see vital defects in our tax system, only a few of which are touched in this volume of studies. We fail to deal adequately with many problems. Unreasonable corporate accumulations are freely permitted; the taxation of stock dividends is a maze of metaphysics. We contravene public interest¹ by permitting wholesale tax avoidance through the instrumentality² of trusts, ownership of state securities, life insurance cross policies and exemptions,³ gifts in contemplation of death,⁴ and special powers of appointment. There are inexcusable

1. Stone v. White, 201 U.S. 512, 537 (1927).

2. See study, Revocable Trusts and the Income Tax.

3. Paul, Life Insurance and the Federal Estate Tax, 52 Harv. L.R. 1037 (1939).

4. Professor Griswold has demonstrated this point with startling clarity in Powers of Appointments and the Federal Estate Tax, 52 Harv. L.R. 929 (1939).

blunders in the statute, such as (1) the extension of the right to deduct for income tax purposes the market value of gifts made to religious, charitable, scientific and educational institutions, (2) the failure to make the basis of property to be used by the distributees of an estate conform to the valuation allowed under Section 302 (j) added by the 1935 Act, and (3) the extension of the right to deduct for estate tax purposes claims against the estate, even though such claims may not be enforceable against particular assets of the estate, such as insurance. Capital gains enjoy an undeserved comparative immunity from tax.

On the other side of the ledger there are rank discriminations. The existing situation with respect to the taxation of undistributed profits where there has been an impairment of capital, and the personal company holding tax where dividends cannot be distributed, should be corrected. The tax effect of mortgage transactions, from the standpoint of the capital loss provision and of the bad debt provision, is almost unknowable. Should net consolidated returns be permitted, as once they were? Should we not modernize the now antiquated rule of res judicata? And why not a little generosity in the statute? It would be no more than fair to allow the dependency credit on account of dependents between the ages of 19 and 21 years, and to make some provision for the deduction of personal medical expenses.

It is understatement to call the effect of these disparate provisions unfortunate. When burdens increase, every defect in our tax system is intensified. Avoided burdens must be passed to others. The avoided burdens are heavier, and those who are obliged to carry them are less able to bear their own greater burdens. If there was ever a time for critical analysis of our tax system, it is now. The premium upon avoidance was never greater. The effects of discriminations were never so severe. And the possible repercussions upon a sensitive national economy were never so portentous. The public is never more glad to pay taxes. But that same public was never more insistent upon equitable distribution of the tax burden. At such a time postponement of the problem will be a costly luxury. It may indeed be a tragic failure. For tomorrow may be too late.

Some of the problems mentioned have clear solutions. Others are more elusive. I should be the last person to deny the virtue of research.¹ But we need to be vigilant against that type of timidity which employs the necessity for further study as a rationalization of inaction. We shall hear much talk about the need for more investigation of problems of taxation. The answer is that we cannot be too hot for certainties when emergency calls for action. Nor can we afford then to "yield to finicky limitations or doctrinaire formulas drawn from the general language of the Constitution, as a means of circumscribing the discretion of legislatures in the necessarily empirical process of tapping new revenue or stopping new devices for evasion."² The very theory and spirit of our Constitution is experiment. "Every year if not every day we have to wager our salvation upon some prophecy based upon imperfect knowledge."³ In the tax field we need not fear experiment so much as paralysis. Experiment may not win, but inaction will surely lose. The American people have never been afraid of the trial and error method, and they are not afraid today.

1. See Paul, *Selected Studies in Federal Taxation*, Second Series, Preface, p. vii (1938).

2. Frankfurter, *Law and Politics*, p. 78 (1939).

3. Holmes, J., dissenting in *Abrams v. United States*, 250 U.S. 616, 630 (1919).