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 $2500 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 $2500, 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 $2500, or $1550, 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 $2500 or $1975, 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 surtax purposes is made a credit against tax 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. Existing Law as to Stock Dividends (Sec. 115 (f)) 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 Eisner v. Macomber,[1] Koshland v. Helvering,[2] and Helvering v. Gowran.[3] In practice it means that stock dividends of the type involved in Eisner v. Macomber (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.

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

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

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 <u>prima facie</u> 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.

<u>Recommendation</u> 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 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 accomplish-

---

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 F (2d) 586 (CCA 8th, 1939); Corning v. Comm., 104 F (2d) 329 (CCA 6th, 1939); John E. Rovensky, 37 BTA 702.

ment of the 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 power 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

---

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. Clifford v. Helvering, *supra*.

3. See Meredith Wood, 37 BTA 1065, aff'd *per curiam* 104 F (2d) 1013 (CCA 2nd, 1939); Christopher L. Ward, 40 BTA 225.

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.

Recommendation Sections 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

---

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).

remembered that in 13 of the 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:

---

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).

(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 permitted to accumulate beyond the reasonable needs of the (existing) business" determinative of the purpose to avoid sur-

---

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.

tax 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 De Mille 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.

---

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.

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]

---

1. Reg. 101, Art. 23 (o)-1.

2. Paul, Selected Studies in Federal Taxation, Second Series, p. 173, note 75 (1938).

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 donor 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

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

deduction. 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.

---

1. Paul and Mertens, Law of Federal Income Taxation, Sec. 24.06 (1934).

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

<u>Discussion</u> The above provision is designed to encourage corporate financing by <u>borrowing</u>, rather than <u>by capital contributions</u>.[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 the rate of 6%, or $600,000, it is at a disadvantage as compared with a corporation which owes

---

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."

$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.

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.

---

1. 293 U.S. 465 (1935).

2. The Higgins v. Smith case, now pending in the Supreme Court, may help to settle this question.

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.

Discussion 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]

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

---

1. See Paul, Studies in Federal Taxation, p. 235 (1937).

2. Paul and Mertens, Law of Federal Income Taxation, Sec. 28.15 (1934).

10. Existing Law as to Non-Business Taxes (Sec. 23 (d)) 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 business property or dealings.

Discussion 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 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 ordealings 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.

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

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).

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. 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

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

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 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. <u>Existing Law as to Taxation of Interest from Governmental Obligations</u> <u>(Sec. 22 (b)(4))</u> 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 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).

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

<u>Recommendation</u> Interest upon all bonds, state and Federal, issued after the date of introduction into Congress of a new act should be taxed directly and com-

---

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).

pletely. 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 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 (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.

Discussion 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 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.

---

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.

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.

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]

---

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.

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[1] that this provision 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

1. G.C.M. 13,796, CB XIII-2, p. 41.

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]

Recommendation Section 22 (b)(1) should be amended in such a way as plainly to incorporate the principles announced in G.C.M. 13,796.

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

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

double loss deduction may be secured upon the liquidation of the corporation.[1]

<u>Discussion</u> 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 <u>W. & K. Holding</u> case and the case may be reversed on appeal, there is a substantial possibility that it reflects a correct interpretation of the present statute.

<u>Recommendation</u> The statute should be amended to prevent this double loss deduction.

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

<u>Discussion</u> 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

---

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).

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 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 vivos* 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

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.

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 which is confined to making loans to members.

Discussion 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.

Recommendation 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

---

1. See Reg. 80, Art. 37.

building and loan associations of a genuine cooperative character, the activities of which are primarily related to financing home ownership.

20. Existing Law as to Mutual Casualty and Fire Insurance Companies (Secs. 101 (11), 207 (c)(3) 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 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

---

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 byFire, 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 CB XIII-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.

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 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 employed, 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.

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

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. Olsted, 32 BTA 670.

exceed 50% of the net income of the taxpayer from the property. In the case of <u>coal mines</u>, the percentage of gross income is 5%; in the case of <u>metal mines</u> it is 15%; in the case of <u>sulphur mines</u> 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.

<u>Discussion</u> 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 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[2] the elimination of these provisions, but the recommendation was not adopted.

<u>Recommendation</u> You will no doubt wish to urge once more the elimination of these special depletion allowances.

---

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

2. 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).

Of course, depletion on the basis of cost or value at March 1, 1913, should be retained in the statute.

23. <u>Existing Law as to Development Expense</u>

Under the regulations now outstanding[1] 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 wells for the production of oil or gas.

<u>Discussion</u> Expenditures of the type mentioned result in a capital asset, which in the case of productive properties continues to produce income throughout the life of the property. The so-called option is only an option in an artificial sense,[2] 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.

---

1. Reg. 101, Art. 23 (m)-16.
2. See Government Brief in the Wilshire case, p. 9.

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.[1]

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 Security & 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 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

---

1. Helvering v. Wilshire Oil Co., U.S. (1939); cf. Helvering v. R. J. Reynolds Co., 306 U.S. 110 (1939).

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.

<u>Recommendation</u> 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.

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 take out insurance policies of $40,000 not because they are interested in insurance,

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 pesons are not yet familiar.

2 Possibly an even greater exemption should be allowed in the case of small estates.

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 defined 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;

(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]

---

1. Reg. 80, Art. 25, as amended by T.D. 4729, CB 1937-1, p. 284.

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.

Discussion 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.[1] 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.

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

---

1. See Wright and Lowe, Selling Life Insurance through a Tax Approach.

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.

<u>Recommendation</u> We may be precluded from amending outstanding regulations retroactively.[4] Regulations 80, Article 25, as amended, should be further amended at least <u>for the future</u>. 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

---

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.

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 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 same property in default of appointment. For instance, if a power is given to A, and in default of his

---

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.

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

---

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.

special power may be used which in no way will affect the desired purpose of the donee. 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 appoint-

---

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).

ment under a special power after a single life tenancy can be exercised only among the children of the donor or donee, and where the 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

---

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).

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 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

1. 296 U.S. 39 (1935).

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:[1]

> "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."

<u>Discussion</u> 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,

---

1. Reg. 80, Art. 17 (1937 Ed.)

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.

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.

---

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

<u>Discussion</u> 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 <u>United States v. Wells</u>[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]

<u>Recommendation</u> 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 <u>Heiner v. Donnan</u>.[4]

---

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).

While the 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 <u>Existing Law as to Elimination of Estate Tax Against Insurance Proceeds by Reason of Uncollectible Claims (Sec. 303 (a))</u> 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.

<u>Discussion</u> 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 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.

---

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 81 F(2d) 1016 (CCA 7th, 1936); Comm. v. Hallock, 102 F (2d) 1 (CCA 6th, 1939); Wainwright v. Kyle, 22 F. Supp. 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).

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 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.

Randolph E. Paul

November 13, 1939

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.

MEMORANDUM A-1

QUESTIONS AS TO THE EFFECT ON THE REVENUE

OF THE POINTS MADE IN MEMORANDUM A

Referring to Mr. Paul's accompanying memorandum marked "A", question arises as to how much additional tax will be derived from the suggestions made as follows:

1. The making of some appropriate provision to the end that the personal exemption and credit for dependents will be changed from its present form to a credit against tax, under which equal benefit would be given to taxpayers in the low brackets and taxpayers in the high brackets. This might be accomplished by an amendment to the statute delimiting the present personal exemption and credit for dependents to a credit for normal tax purposes only.

2. The taxation of all stock dividends not presently subjected to income tax and particularly common stock dividends upon common stock, there being no other class of stock outstanding at the time of the declaration of the dividend.

3. The taxation of short-term and other trusts of a character exempted from tax to the grantor in such cases as the Meredith Wood case,[1] in which title to the trust property is transferred for a limited term to the trust, and the trust becomes a taxpayer in a lower bracket than would be the

---

1. 37 BTA 1065, aff'd per curiam 104 F (2d) 1013 (CCA 2nd, 1939), cert. granted, Oct. 9, 1939.

grantor if he were charged with the income of the trust.

4 (a). The strengthening of Section 102 by a provision that the facts recited in Memorandum A, page 8, shall be regarded as constituting prima facie evidence of a purpose to avoid surtax upon shareholders.

(b). The strengthening of Section 102 by a provision that the word "existing" be inserted before the word "business" in subdivision (c) of Section 102 to prevent avoidance of the De Mille type described on pages 8 to 9 of Memorandum A.

(c). The lengthening of the statute of limitations as suggested in the same memorandum with respect to Section 102 cases.

5 (a). A provision to the effect that deductible religious, charitable, scientific, literary and educational and other contributions of the type deductible under Section 23 (o) be limited, when paid in the form of property, to the cost basis of the property to the donor or its value at the date of gift, whichever is lower.

(b). An alternative provision allowing no greater deduction than would be allowed if the donor sold the property and contributed the proceeds less the capital gains tax.

6 (a). An elimination of the deduction now contained in Section 23 (e)(3) applicable to losses arising from

fire, storm, shipwreck or other casualty, or from theft.

(b). Treatment of such deduction as a capital loss instead of an ordinary loss.

7. A limitation of the allowance for the deduction of interest on non-business individual borrowings to a fixed amount of $500.

8 (a). An elimination of the deduction provided in Section 23 (b) of the Internal Revenue Code for interest paid or accrued on funded corporate indebtedness.

(b). A restriction of the reorganization provision so that it will not apply to recapitalizations having as their principal purpose the tax avoidance motive of substituting borrowed capital for an equity contribution by stockholders.

9. An elimination of the provision contained in Section 23 (k) for the deduction of non-business bad debts except bad debts when not exceeding $1,000 in the case of each debtor.

10. A limitation upon the allowance of deductible taxes as provided in Section 23 (d) in respect to property held for the taxpayer's own use to taxes on small homes not exceeding $10,000 in cost to the deducting owner, or value in the taxable year of deduction.

11. A provision to the effect that where the optional valuation privilege granted by Section 302 (j) of the estate tax statute is used, the basis for the property valued pursuant to this election shall be the same for purposes of capital gains or losses as the value used in the estate tax return.

12 (a). A provision denying to husband and wife living together the privilege of filing joint returns.

(b). A provision generally adopting the British method of taxation of husband and wife as outlined in Memorandum A, assessing the joint income at surtax rates based upon the combined income of both husband and wife.

13 (a). An amendment of existing law along the lines suggested in item 13 of Memorandum A with particular respect to taxing the interest on all state or Federal bonds issued after the passage of a new Congressional amendment.

(b). An amendment of the existing law, as proposed by Senator Glass 20 years ago, which would measure the surtaxes applicable to non-tax-exempt income in relation to taxpayer's total income, including tax-exempt income.

14 (a). A flat increase in capital gain rates of 50% of the existing rates with a provision that capital gains shall not be recognized to the extent that the gains are reinvested within 12 months in risk-bearing equities in new enterprises.

(b). An amendment of capital gains provisions so as to make capital gains taxable at the highest rate (not exceeding 50%, however) applicable to taxpayer's income, exclusive of capital gains, with a provision for a credit against the tax to the extent that the gains are reinvested within 12 months in risk bearing equities in new enterprises.

15. A provision revoking the exemption now granted by Section 115 (b) of the Internal Revenue Code to corporate distributions of earnings or profits or increase in value of property accrued prior to March 1, 1913.

16. A provision in the statute incorporating the general principles of G.C.M. 13,796, CB XIII-2, p. 41, discussed under item 16 of Memorandum A.

17. A provision discountenancing the doctrine of the W. & K. Holding case, 32 BTA 830.

18 (a). A provision that the basis for gain or loss and depreciation and depletion shall be, in the case of property transmitted at death, the adjusted cost basis in the hands of the decedent, rather than the value at the date of death.

(b). A provision along the lines of Section 42 of the Internal Revenue Code generally to the effect that death shall constitute a closed transaction with respect to property transmitted by the decedent at death.

19. A provision limiting the exemption now accorded to domestic building and loan associations along the general lines indicated at page 28 of Memorandum A.

20. A provision limiting the exemption and deductions granted to mutual casualty and fire insurance companies along the lines indicated at page 29 of Memorandum A.

21. A provision limiting the deduction for payments made by employers to pension trusts to a fixed amount per annum of $5,000 for any one employee.

22. A provision eliminating the "bonus" deduction on account of discovery value and percentage depletion now allowed to mine owners and oil and gas well owners, to the general end that such taxpayers shall be limited to cost depletion, or depletion on the basis of value at March 1, 1913.

23. A modification of the existing regulations granting the option as to the expense deduction or capitalization of intangible drilling and development costs as outlined at page 33 of Memorandum A.

24 (a). The elimination of the exemption from capital gains tax on sales consummated within the United States

now granted to non-resident aliens and foreign corporations having no office or place of business within the United States.

(b). A general provision placing foreign nonresident corporations upon a basis of taxation similar to that employed with respect to domestic corporations.

25 (a). A modification of the $40,000 general estate tax exemption (and also the $100,000 estate tax exemption granted by the 1926 Act) so that an equal benefit is derived from the exemption by both large and small estates.

(b). An elimination of the $40,000 general estate tax exemption (and the $100,000 estate exemption) in the case of estates exceeding $1,000,000 in net value excluding the exemption.

(c). A redevelopment of the estate tax structure so that the effect of the $40,000 general estate tax exemption (and the $100,000 exemption granted by the 1926 Act) is limited to a normal estate tax not exceeding 20%.

(d). A provision similar to that mentioned in (a), (b) and (c) above with respect to the insurance proceeds exemption of $40,000 on policies payable to named beneficiaries.

26(a). A prospective provision generally to the effect that the proceeds of life insurance shall be subjected to estate tax to the extent that the decedent has paid premiums on the insurance or in their full amount where he possesses at the date of his death some incident of ownership over the policies.

(b). A provision as to cross-insurance policies along the lines suggested in Memorandum A, page 39, subjecting the proceeds of such policies to income tax at the regular rates, or to a special excise tax at a flat rate of 10%.

(c). A comparative statement showing the effect of this amendment generally as compared with an amendment modified on the basis of cash surrender value or ratio on the time basis, as described on page 39 of Memorandum A.

27 (a). A provision limiting the tax exempting effect now applicable in the case of special powers of appointment as indicated on page 43 of Memorandum A with an exception that special powers made thereunder can be exercised free from estate tax only among the children of the donor or donee and where the property in default of appointment is to be distributed among that class.

(b). A provision imposing a succession or inheritance tax on the value of remainders under a will, to be imposed at the death of the life tenant at rates equal to the existing estate tax rates.

28. A provision subjecting reverter interests to estate tax taxation where the decedent retains any valuable interest in his property by which he postpones final disposition thereof until his death, such as the interest involved in the St. Louis case mentioned on page 43.

29. A provision that gifts by persons over 60 years of age shall be subject to an irrebuttable presumption that they were made in contemplation of death.

30. A provision precluding the estate tax deductibility of uncollectible claims.

31. A provision limiting the $4,000 gift tax exemption to gifts to members of the donor's immediate family.

MEMORANDUM OF TRANSMITTAL OF
B AND B-1

TO: Honorable Henry Morgenthau
Secretary of the Treasury

FROM: The White House

I am enclosing herewith a second memorandum, marked B, also prepared by Mr. Randolph E. Paul, listing a number of situations in which the tax laws might possibly be amended in the interest of taxpayers. I would like to have from you an estimate of the loss in revenue, if any, which would result from the adoption of Mr. Paul's suggestions. For your convenience I enclose a memorandum of specific questions keyed to Mr. Paul's memorandum, marked B-1.

As with respect to the accompanying memorandum, I again realize the impossibility of answering these questions with mathematical accuracy, but I would like in all cases to have your best estimate.

MEMORANDUM B

MEMORANDUM OF POSSIBLE CHANGES IN THE TAX LAW WHICH WOULD ELIMINATE CERTAIN INJUSTICES TO TAXPAYERS TO SOME EXTENT RESULTING IN DECREASE OF REVENUE

INCOME TAX

1. Consolidated Returns
2. Intercorporate Dividends
3. Mitigation of the Statute of Limitations in Certain Cases
4. Mortgage Transactions
5. Taxation of Alimony
6. Cancellation of Indebtedness in Corporate Reorganizations
7. Ascertainment of Earnings or Profits Available for Corporate Distributions
8. Taxation of Undistributed Profits Despite Impairment of Capital
9. Personal Holding Company Tax Where Dividends Cannot Be Distributed
10. Res Judicata
11. Credit for Dependents
12. Personal Medical Expenses

GIFT TAX

13. Gifts in Trust
14. Gift Tax on Tenancies by the Entirety

GENERAL

15. Interest on Deficiencies and Refunds

MEMORANDUM OF POSSIBLE CHANGES IN THE TAX LAW WHICH WOULD ELIMINATE CERTAIN INJUSTICES TO TAXPAYERS TO SOME EXTENT RESULTING IN DECREASE OF REVENUE

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

---

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%).

1. This percentage was formerly 90%.

<u>Discussion</u> The purpose of the legislative change of policy in 1936 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]

---

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 the 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 & 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

---

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

actually became worthless in a year prior to the taxable year and also prior to the period within which refund claims are possible.

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.

<u>Recommendation</u> 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 mortgagee, 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]

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 Ins. Co., 37 BTA 1041.

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

---

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 92 F(2d) 999 (CCA 6th, 1937).

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

preciable 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.[1]

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 re-sale. 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

---

1. 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).

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]

---

1. Gould v. Gould, 245 U.S. 151 (1917).
2. Douglas v. Willcuts, 296 U.S. 1 (1935).

<u>Discussion</u> 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 <u>Gould</u> case was that alimony was not income, but rather a transfer to her of <u>capital</u> 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 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 party in 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

1. Fitch v. Comm., 105 F(2d) 702 (CCA 8th, 1939) cert. granted Oct. 9, 1939.

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 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 receives 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. <u>Existing Law as to Cancellation of Indebtedness in Corporate Reorganizations</u> 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 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.

<u>Discussion</u> 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

---

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

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 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

---

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.

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 on 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,[2] although unrealized increment has never been considered taxable income.

Discussion Cases like F. J. Young Corporation 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 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

---

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).

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.[1]

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 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

---

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).

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

---

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

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

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]

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

(continued on following page)

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

---

(continued from previous page)
at the beginning of the same year. It distributed approximately $42,000 to escape the personal 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.

earnings or profits available.[1] Even complete liquidation would possibly not serve to remove the strait jacket; even here the dividends paid credit might be limited.[2]

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 re-litigated, is applied by the courts in tax controversies.[3] The doctrine involves special

---

1. Ways and Means Committee Report No. 1860, 75th Cong., 3rd Sess., pp.24-25 (1938); Reg. 101, Art. 23(c)-1.

2. 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.

3. 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).

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.

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

---

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).

case had expired) the same Circuit Court of Appeals in a different case,[1] involving a substantially identical alimony trust held that the husband was not taxable and expressly overruled its prior decision in the *Brooks* case. 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 as applied to tax cases under our system of courts, the 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.

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

<u>Recommendation</u> 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 <u>res judicata</u> 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 <u>res judicata</u> applies and permitting such motions to be defended on the ground of additional or different facts or a new rule of law.

11. <u>Existing Law as to Credit for Dependents</u>. 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.

<u>Discussion</u> 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

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

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 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.

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

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 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 com-

---

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

2. Sec. 302 (e).

pleted 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,[1] the gift tax should not be interpreted as covering transfers which are explicitly covered by the estate tax. 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.

---

1. 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).

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%.

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.

MEMORANDUM B-1

QUESTIONS AS TO THE EFFECT ON THE REVENUE OF THE POINTS MADE IN MEMORANDUM B

Referring to Mr. Paul's accompanying memorandum marked "B", question arises as to how much loss of revenue will result from the suggestions made as follows:

1 (a). A provision requiring affiliated corporations (defining those terms as they were defined in the income tax acts immediately prior to 1934) to file consolidated returns, the rates of taxation to remain unchanged.

(b). A provision granting permission to file consolidated returns (1) upon condition that under a consolidated return there should be added an additional rate of 1% to the tax generally provided with respect to corporations, and (2) without such a 1% differential.

2. A provision modifying the present taxation on 15% of the amount received as intercorporate dividends in the following respects:

(a). An elimination of this tax where the dividends were received from a subsidiary company the formation of which was necessary to carry on business activities in a particular state.

(b). Eliminating the tax completely where the corporation has reasonably invested surplus in another corporation without acquiring a controlling interest.

(c). Raising the tax (by imposing it upon 25% instead of 15% of the dividends received) in the case of complicated corporate structures involving a sub-subsidiary.

3 (a). A provision amending Section 820 added by the Revenue Act of 1938 and giving the Commissioner discretion to allow adjustments back to 1932 for worthless stock or bad debts when there has been a determination resulting in a double disallowance of such a deduction.

(b). A provision eliminating from the statute (retroactively to 1932) the requirement that bad debts ascertained to be worthless during the taxable year must be charged off on the books of the taxpayer.

4. A provision amending Section 117 of the Internal Revenue Code to provide that neither a mortgage foreclosure nor any conveyance in lieu of a foreclosure should be regarded as a sale or exchange within the meaning of Section 117 and that the loss of either party upon such transactions should be ordinary, rather than capital, losses.

5 (a). A provision which would prospectively amend the income tax statute by rejecting the Supreme Court cases of <u>Gould v. Gould</u> and <u>Douglas v. Willcuts</u> and which would impose income tax upon a divorced wife with respect to amounts hereafter received by way of alimony or trust pay-

ments in lieu of alimony, allowing the husband to deduct such amounts from his gross income.

(b). A provision which would subject to existing gift tax rates the creation by a husband of an alimony trust which completely discharged the husband's obligation of support towards his divorced wife.

6. A provision amending the Chandler Act to provide that the cost basis of assets in the hands of a corporation reorganized under Section 77 B should be reduced only by the amount of the debt cancellation which would have constituted taxable income except for the statutory exemption in the same Act.

7. A provision that the earnings or profits of corporations available for dividend distribution shall not be affected by any increase or decrease in the value of assets, or on account of a tax-free reorganization, which are not recognized for income tax purposes.

8. A provision retroactively reducing the undistributed profits tax in the case of corporations which were unable to make legal distribution of dividends under local law because of capital deficits, to a flat tax of 5%.

9 (a). A provision removing the 65% or 75% tax on the undistributed income of personal holding companies where the company has no earnings or profits available for the dis-

tribution of a dividend.

(b). A provision imposing the personal holding company surtax upon taxable income without regard to the existence of earnings or profits, but extending the consent dividends credit provided in Section 28 to permit shareholders to consent to the taxation of undistributed income even though such amounts would not have been taxed to them as a dividend if actually distributed.

10. A procedural provision requiring all tax suits or proceedings to be instituted against the United States rather than the Collector or Commissioner and conferring upon the Board of Tax Appeals and the courts a broad discretion in tax cases to disregard the principle of res judicata, where the facts or the law as announced by the courts is changed in the subsequent year.

11. A provision allowing the $400 credit for dependents to be claimed with respect to children of the taxpayer until the children reach the age of 21, instead of 18.

12. A provision allowing a maximum deduction of $100 for medical or dental expenses per year paid on behalf of the taxpayer or any of his dependents.

13. A provision once more granting the $4,000 gift tax exclusion to gifts in trust, but with a limitation that only one such exclusion should be recognized in any year with

respect to gifts in trust for the same beneficiary.

14. A provision amending the gift tax law to the effect that conveyances by way of tenancies of the entirety of the type involved in Lilly v. Smith should not be subjected to gift tax where the same property will later be taxed for estate tax purposes.

15. A provision reducing the interest on deficiencies and refunds to 4%, rather than 6%.

OPY:FE:MHP)

No. 15

AMERICAN CONSULATE

Hanoi, Indochina, November 14, 1939

Subject: Movement of Cargo from Haiphong
by Lighters.

The Honorable
The Secretary of State,
Washington.

Sir:

I have the honor to refer to my despatch no. 5 of October 13, 1939, in which mention is made of the plan of a British concern to establish a lighterage service from Haiphong to the nearest port in China in order to assist in clearing the congestion of cargo awaiting transit to China. This plan has been definitely abandoned but a lighterage service has been inaugurated between Haiphong and Phu Lang Thuong, a point about half way between Hanoi and Dong Dang. The British company has already put two lighters in service and is attempting to establish a schedule which will enable the movement of approximately 700 tons a month. This amount is, of course, relatively small but it will relieve to a certain extent the over-taxed capacity of the railway to Dong Dang.

To date, however, the British company hasnot had much success in securing cargo for its lighters. The representative of the company has expressed his confidential opinion that the "transitaires" at Haiphong and presumably the railway company are not anxious to see even this small amount of lucrative business go into otherhands. This may be a correct interpretation of an anomalous situation - the French express great concern over the congestion of cargo at Haiphong, they are constantly urging that something be done to clear the congestion, and yet they do not take advantage of an opportunity to assist this clearing.

Curiously enough, I am told that even the Chinese shippers have shown no great enthusiasm for this plan.

Respectfully yours,

CHARLES S. REED
Charles S. Reed II,
American Consul.

Original and 2 copies to the Department
Copies to Embassy, Chungking and Peiping
Copy to Consulate General, Hongkong.
Copy to Consulate, Saigon

815.4

HSM

PLAIN

London

Dated November 14, 1939

Rec'd 10:34 a. m.

Secretary of State,

Washington.

2350, November 14, 4 p. m.

FOR TREASURY.

Today's press quotes a stock exchange notice clarifying the existing regulations affecting the sale by non-residents of securities subject to regulation of the defence (finance) regulations. Briefly the notice makes it clear that securities subject to the restrictions cannot be sold by a non-resident except to another non-resident; an exception to this rule allows residents of British dominions including India, the colonies and protectorates (excluding Canada, Newfoundland and Hong Kong) and residents of British mandates, Egypt, Anglo-Egyptian Sudan and Iraq to sell restricted securities to a United Kingdom resident but not (repeat not) to purchase such securities from a United Kingdom resident.

KENNEDY

DDM

74(c)

296

FEDERAL RESERVE BANK OF NEW YORK

FICE CORRESPONDENCE

DATE November 14, 1939.

CONFIDENTIAL FILES

L. W. Knoke

SUBJECT: TELEPHONE CONVERSATION WITH BANK OF ENGLAND.

I called the Bank of England at 10:58 a.m. and in Mr. Bolton's absence I spoke to Mr. Siepmann. In discussing yesterday's sterling market, I stated that it had been about as thin on the up-swing as it had been on the downward movement. Foreign buying orders seemed to have exceeded foreign selling orders. Selling orders from Japan appeared to have dried up. Siepmann confirmed my statement about Japanese orders. They had had £900,000, he thought, and very little of that was left by now. I referred to the International Tel. & Tel. business and Siepmann replied that the International Tel. & Tel. people would have to decide by tomorrow night. He confirmed that the British subsidiary had been permitted to cover £150,000, that is the first maturity, in the open market. The total was $4,000,000 and he had told them that he would not deal with them at any other than the official rate and that he expected them to deal with him in London. If they did not comply with his request, he would reek his vengeance on the British subsidiary. As a result he hoped that the transaction would be concluded at the 4.02 rate. If the International Tel. & Tel. had gone in at the rate of a week ago, they figure it would have cost them a loss of £60,000 and they had not wanted to get stung for that. Siepmann had spoken to them this morning and was trying to get them to deal with the control. If the subsidiary chose to go the other way, he could not help it.

ICE CORRESPONDENCE

CONFIDENTIAL FILES

L. W. Knoke

DATE November 14, 1939.

SUBJECT: TELEPHONE CONVERSATION WITH BANK OF ENGLAND.

I suggested that the Rumanians seemed to be through with their selling. Siepmann stated that he had spoken to them severely and told them that they were doing damage to themselves as well as to the British. I asked where did the Rumanians get their sterling [redacted] and he replied that it was the result of shifting the whole of their European assets.

With regard to today's market, I mentioned that we had been up to 3.96, following Amsterdam, which seemed to be the principal buyer here. The local demand for sterling, I thought, was just about satisfied and a further upward movement of the rate, if any, was likely to be less abrupt than in the last few days. Siepmann asked whether Brazil had been a seller of sterling and I repeated what I had told Bolton a few days ago, namely, that all the information which we had been able to gather seemed to deny that.

I asked whether he would venture a guess as to foreign balances left in England. He replied that it was really difficult to say but there was very little left that was not Empire money. "To what extent do foreigners hold sterling securities," I asked, and his answer was "A great deal." The thought that foreigners could build up their sterling balances as a result of security sales was one that would disturb him. At the moment he was not troubling about our free market but if foreigners should begin selling sterling securities the situation would be difficult.

FEDERAL RESERVE BANK
OF NEW YORK

[OFF]ICE CORRESPONDENCE

DATE November 14, 1939.

CONFIDENTIAL FILES

L. W. Knoke

SUBJECT: TELEPHONE CONVERSATION WITH BANK OF ENGLAND.

I referred to his lengthy cable No. 1067 of November 8 and told him that we would cable him tonight about certain difficulties which we were experiencing. Meanwhile would he please have somebody send us by airmail copies of these certificates. That, I said, would probably make it unnecessary for us in future to send a cable similar to the one we were dispatching tonight. Siepmann promised that he would see to that.

LWK:KW

ADDRESS THE COMMANDANT, U. S. COAST GUARD
AND REFER TO NO. OP-71
650
63

299

HEADQUARTERS

TREASURY DEPARTMENT
UNITED STATES COAST GUARD
WASHINGTON

14 November, 1939.

MEMORANDUM FOR: The Secretary of the Treasury.

The attached self-explanatory letter from Admiral Harold R. Stark, Chief of Naval Operations, U. S. Navy, dated 9 November, 1939, is forwarded for your information.

R. R. Waesche
R. R. WAESCHE,
Rear Admiral, U. S. Coast Guard,
Commandant.

NAVY DEPARTMENT
OFFICE OF THE CHIEF OF NAVAL OPERATIONS
WASHINGTON

9 November 1939

Dear Admiral Waesche:

Shortly after arrival of the IROQUOIS in New York I received a letter from Captain L. E. Denfeld, U. S. Navy, who at that time was commanding the Grand Banks Patrol. In this letter he stated:

> "I cannot comment too favorably in regard to the performance of the CAMPBELL and her commanding officer, Commander Greenspun. He contacted the IROQUOIS under very difficult circumstances as the visibility was not good and the IROQUOIS was not using her radio due to fear of being found by a possible enemy. The CAMPBELL performed her duties in the inner anti-submarine screen faultlessly. It certainly is a pleasure having coast guard cutters, so ably commanded under my command."

It was my intention to forward this information to you immediately but the letter in which this statement was made was given to one of the officers in my office who mislaid it and it has only now been returned to me. I wish, even though belatedly, to forward to you these comments on the excellent relationships between Naval and Coast Guard Forces.

With kindest personal regards

Yours sincerely,

/s/ H. R. STARK

Rear Admiral R. R. Waesche,
Commandant, U.S.Coast Guard,
Washington, D.C.

"C-O-P-Y"

H. White
Mr. Cochran

Noted
H. M. Cochran

Farm

301

FEDERAL RESERVE BANK

OF NEW YORK

November 14, 1939

Dear Mr. Secretary:

For your information I enclose an excerpt from a strictly confidential letter received by me from Mr. Ivar Rooth, Governor, Sveriges Riksbank, which I think you will be interested in reading.

Sincerely yours,

George L. Harrison

George L. Harrison,
President.

Hon. Henry Morgenthau, Jr.,
Secretary of the Treasury,
Washington, D. C.

M-RC 140 6 5M 12-39

SVERIGES RIKSBANK

Stockholm, 25th October, 1939

302

Strictly Confidential

Mr. George L. Harrison,
President,
Federal Reserve Bank of New York,
N e w Y o r k, N.Y.

Dear Mr. President,

As I told you in my letter of April 12th regarding our foreign exchange policy we were increasing our holdings of gold. Up to now there has during this year been an increase in our gold holdings by about 160 million kr. The gold is held as follows /figures in millions of Swedish kronor at actual gold price/:

	24/10 1939
Gold in Sweden	1.030
" " England	96
" " U.S.A.	375
	1.501

Since the outbreak of the war there has been a heavy drain on our dollar and sterling balances. Owing to the fact that Swedish importers have been buying dollars partly for payments of goods already delivered and partly for anticipated payments of imports, and that foreign banks have withdrawn their balances in Sweden, our dollar assets have been reduced from 143 million dollars at about the 20th of August to 87,5 million dollars yesterday. That is the reason, why we asked your Bank to sell part of our gold against dollars in order to increase our dollar holdings.

We are now sending some gold from Sweden to U.S.A.

. . . .

With kind regards,

I remain, dear Mr. President,

Faithfully yours,

(signed) Ivar Rooth

November 17, 1939

My dear Mr. Harrison:

This will acknowledge receipt of your letter to Secretary Morgenthau, dated November 14th, with its enclosure.

I shall be glad to bring this to his attention as soon as he returns to the office. We are expecting him back on Monday.

Sincerely yours,

(Signed) H. S. Klotz

H. S. Klotz
Private Secretary

Mr. George L. Harrison,
President, Federal Reserve
Bank of New York,
New York, New York.

JI

GRAY

Paris

Dated November 14, 1939

Rec'd 4:55 p.m.

Secretary of State

Washington

2753, November 14, 7 p.m. (SECTION ONE)

FOR THE TREASURY.

After an absence of several months due in part to illness Frederic Jenny, LE TEMPS' well known and influential collaborator, has returned to that journal with a timely article in the November 13 issue entitled "War Finances". It is an error, he says, to think that financial and economic problems are of second place importance in war time: on the contrary the success of modern warfare depends on immense financial resources. The primary question is to find these resources rather than to adjust "public expenditure to permanent receipts". He then reviews the year's expenditures as follows: The total 1939 budget voted by Parliament carried expenditures of the State (not including those of local governments nor the budget of the amortization fund) of a little over 100,000,000,000 francs of which 66,500,000,000 constitutes the ordinary

budget

-2-2753, November 14, 7 p.m. (SECTION ONE) from Paris

budget balanced by revenues and the other 35,000,000,000 consisting largely of national defense expenditures were to be covered by borrowing.

(END OF SECTION ONE)

BULLITT

EMB

JI

GRAY

Paris

Dated November 14, 1939

Rec'd 7:05 p.m.

Secretary of State

Washington

2753, November 14, 7 p.m. (SECTION TWO)

After the Germans marched into Prague in March, these expenditures were materially increased bringing the total to between 110 and 115,000,000,000 francs. In the war session of September 2, Parliament voted additional credits of 69,000,000,000 of which approximately 45,000,000,000 were "payment credits" and 24,000,000,000 authorizations (our telegram No. 1742, September 2, 7 p.m.). Reynaud (who is due to present his budget to the Finance Commission of the Chamber Friday) will set forth his estimates for the coming year (it will be recalled from our telegram No. 2215, September 27, 8 p.m. that war expenditures will be voted only by quarters in view of the impossibility of estimating needs for a year ahead). The question arises, continues Jenny, as to how these expenditures are to be covered.

BULLITT

NK:EMB

JI

GRAY

Paris

Dated November 14, 1939

Rec'd 7:10 p.m.

Secretary of State

Washington

2753, November 14, 7 p.m. (SECTION THREE)

He urges that the revenue from taxation should be as large as possible (given the adverse effects on revenue of mobilization on the country's economy) to facilitate the managing of the money market and to safeguard the stability of the currency. Additional sacrifices should be asked of tax payers and consumers and at the same time the maintenance of productive economic acts should be stimulated to prevent the drying up of sources which feed the Treasury. He admits that, "It is a delicate problem in the first place to strengthen the tax system sufficiently to permit a satisfactory flow of revenues without exceeding the point where the spirit of enterprise becomes discouraged and losses are registered rather than the desired increases"; on the other hand to bring about possible economies and to fight ceaselessly against waste and

thirdly

-2-2753, November 14, 7 p.m. (SECTION THREE) from Paris

thirdly to reconcile the maintenance of an economic life as active as possible to military necessities.

BULLITT

EMB

JI

GRAY

Paris

Dated November 14, 1939

Rec'd 5:36 p.m.

Secretary of State

Washington

2753, November 14, 7 p.m. (SECTION FOUR)

Turning to exceptional resources, he says they are two: inflation and borrowing. Inflation is the easier, but its abuse inevitably has repercussions on the currency and on prices. It should therefore be avoided as far as possible. There must, however, be some recourse to the creation of money, given the rapidity with which massive war needs materialize. It was for this reason that the Bank of France opened the Treasury's 25,000,000,000 credit. In this connection, he says it is worth noting that the State's authorized advance up to November 2 was drawn on only to the extent of 7300 millions and that "apparently this money was utilized less for current expense expenditures than to permit the Treasury to cover advances which it was obliged to make to the stabilization fund for gold purchases. In the last analysis, therefore,

-2-2753, November 14, 7 p.m. (SECTION FOUR) from Paris

therefore, this inflation, so moderate under the circumstances, is guaranteed at least in part by metallic money (gold)"

BULLITT

NK:EMB

JI

GRAY

Paris

Dated November 14, 1939

Rec'd 5:20 p.m.

Secretary of State

Washington

2753, November 14, 7 p.m. (SECTION FIVE)

Turning to borrowing, he says that borrowing will be called upon to provide the Government with the greater part of its war resources which is why a policy of borrowing designed to safeguard the credit of the state is of such importance. He points out that French rentes today are higher in spite of the war than in 1938 and expresses the belief that the present policy of catering "to the public preference for short term loans" is sound. Consolidation operations will come later from time to time "to ease the short term money market and reconstitute circulating funds".

BULLITT

EMB:NK

JI

GRAY

PARIS

Dated November 14, 1939

Rec'd 8:16 p.m.

Secretary of State

Washington

2753, November 14, 7 p.m. (SECTION SIX)

In the monetary field, he says, it is important in war time (firstly) to prevent the outflow of gold except for the Government's arms purchases abroad; (secondly) to prevent exchange rates "which are no longer 'regularized' by gold movements from losing their stability and finally to assure that all national and foreign exchange resources are placed at the disposition of the country. Hence complete control of exchange, of foreign trade and the requirement for declarations of holdings abroad. He concludes:

"Behind the barriers of exchange control, that expedient so abhorrent in time of peace but a measure of precaution so necessary in time of war there is established a capital circuit strongly primed by the return of funds, largely maintained by savings placed at the service of the country in peril, a circuit

which

-2-2753, November 14, 7 p.m. (SECTION SIX) from Paris

which brings to the coffers of the Treasury under the form of loan subscriptions a large part of the sums expended by the State. For this reason borrowing takes in effect, among the immense resources which the financing of a war necessitates, the predominant place which it must occupy.

BULLITT

EMB

REB

GRAY

Paris

Dated November 14, 1939

Rec'd 8:22 p. m.

Secretary of State,

Washington.

2753, November 14, 7 p. m. (SECTION SEVEN)

We have reported in past telegrams (for example telegram No. 2632, November 1, 7 p. m. and 2707, November 9, 7 p. m.) the natural emphasis being placed here on the need to export and the difficulties and obstacles in the way of exports -- concerning the progress or lack thereof no statistics are available. The press is beginning to discuss the question more freely and last night's LE TEMPS contained a leading article on the subject. It pointed out that export enterprises need labor, raw materials, and plants; that it is useless to invite them to export if in the first place they cannot produce. Doubtless the necessities of national defense writes LE TEMPS take precedence over everything but exportation is one of these necessities. "We must not forget that our exports are composed largely of luxury articles, the creation of which requires that our artists and our artisans work in an atmosphere that it is difficult

to

REB -2- #2753, From Paris, Nov. 14, 7 p. m. (Section Seven)

to maintain in war. It is all the more necessary that the population lead a life as approaching normal as military necessities will permit." To export, LE TEMPS continues, both a seller and a buyer are necessary and unfortunately the difficulty of communications is seriously hindering French exporters.

BULLITT

LMS

EMB

JI GRAY 316

Paris

Dated November 14, 1939

Rec'd 8:29 p.m.

Secretary of State

Washington

2753, November 14, 7 p.m. (SECTION EIGHT)

Neutrals complaining of French delays in export authorizations and communications report on the other hand that relations with Germany are much quicker and easier. "The necessity for controlling correspondence with the outside world is easily understandable. The enemy must be prevented from receiving information which is precious to him; against this disadvantage must be placed those which result in the stopping of our exports. In order to blockade Germany must we go to the extreme of blockading ourselves? If that is the case it is necessary to choose between postal control and export, but we do not believe we are condemned to this alternative. Is it really impossible to organize control so that urgent communications with neutrals are not subject to delays? Such is the problem it is urgent to solve if one believes that export is in war time, even more than in peace time, a vital necessity for the country".

BULLITT

PG:EMB

REB

GRAY

Paris

Dated November 14, 1939

Rec'd 8:35 p. m.

Secretary of State,

Washington.

2753, November 14, 7 p. m. (SECTION NINE)

This is the first somewhat timid following in France of the more outspoken complaints appearing in the British press on war time controls and restrictions there and it is probable that the French press responding to the complaints which in spite of the more disciplined attitude of a country schooled by universal military service may become more vocal as time goes on. Both LE TEMPS for example and LA JOURNEE INDUSTRIELLE sound warnings at the "danger" of increased Government controls as evidenced by the proposed departmental groups to assure supplies of foodstuffs and agricultural products (please see our telegrams Nos. 2632, November 1, 7 p. m. and 2644, November 2, 6 p. m.) the latter journal protests that while producers beg for more "liberty" the State threatens more and more control and predicts that the State will pass away from "regulated liberty" to "controlled economy".

BULLITT

EMB

PAP

GRAY

PARIS

Dated November 14, 1939

Rec'd 8:50 p.m.

Secretary of State

Washington

2753, November 14, 7 p.m. (SECTION TEN).

The securities market showed a firmer tone yesterday and this tendency continued on an increasing scale today. Practically all along the line gains were registered and rentes advanced on the average over one half a franc. The two exchange guaranty issues of 1925 and 1937 gained 1.70 and 4.10 respectively. The improved tone of the markets the past two sessions is largely due to the public belief that the danger of a German invasion of Holland and Belgium is somewhat lessened.

The Journal Officiel today carries a decree increasing cigarette prices by the tobacco monopoly on the average about one franc twentyfive per package.

The Belgian National Bank statement for the week ending November 8 shows gold holdings at 18,029,000,000 up 8,900,000; foreign exchange holdings down 167,000,000 to 3,925,000,000, Belgian commercial advances up 519,000,000 to 3,296,000,000 and commercial advances abroad up 39,000 to 18,539,000.

Advances

PAP -2- 2753, November 14, 7 p.m. (SECTION TEN) from Paris

Advances on public funds are down 276,000,000 to 761,000,000. Note circulation is up 51,000,000 to 27,195,000,000. The treasury account is down 1,500,000 to 7,200,000. Gold coverage is 64.20 as against 64.24%.

BULLITT

REP:EMB

REB

GRAY

Paris

Dated November 14, 1939

Rec'd 8:11 p. m.

Secretary of State,

Washington.

2753, November 14, 7 p. m. (SECTION ELEVEN)

The Belgian Treasury has issued 40,000,000 francs of three months Treasury bills at an average rate of 2.75% per annum against 2.74% previous.

The Belgian Finance Ministry has issued a statement concerning proposed new taxes. Excess profits tax will be 70% and the remaining 30% will be subject to the "taxe mobiliere". There were likewise increases in a number of indirect taxes designed to produce 1,443,000,000 francs additional revenue while maintaining approximately the present proportion between indirect taxes, consumption taxes, and stamp taxes. The statement estimates the cost of Belgian mobilization at 8,500,000,000 francs of which 4,500,000,000 is actual mobilization costs from October 19, 1939 to December 31, 1940 and 1,500,000,000 the estimate of reduced revenues. The extraordinary budget for 1940 is expected to total 2,500,000,000.

The French financial press takes pleasure in announcing the establishment of the agency of the Societe Generale at New York.

(END OF MESSAGE)

BULLITT

EMB

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE November 14, 1939

TO Secretary Morgenthau

FROM Mr. Cochran

The foreign exchange market was thin with rates moving in an erratic manner. In Amsterdam this morning, sterling was quoted at 3.92-13/16 and, prior to the beginning of business here, it was 3.93-7/8. In New York the opening quotation was 3.94-3/8 and at that time the Chase Bank reported that it was purchasing sterling in Amsterdam. The Irving Trust Company received an order from Sweden to sell £50,000 which was not offered in the market but taken by the Irving into its own position. The Guaranty Trust Company reported that it had received both buy and sell orders for sterling in small amounts from banks in Paris. About mid-morning, sterling was quoted at 3.96. It then began to recede and shortly after noontime reached the low of 3.93-1/8. It subsequently recovered to 3.94-3/8 and closed at 3.93-3/4. The market in sterling was so small that at times the rate moved a penny per pound on small orders, either way.

The discount for one month's sterling widened to 1-1/2¢ per pound, equal to 4-9/16% per annum. For three months, the discount was 4-3/8¢ per pound, equal to 4-7/16% per annum.

Sales of sterling by the four reporting banks in New York totaled £449,000 from the following sources:

By commercial concerns	£ 206,000
By foreign banks (Far East, Europe and South America)	£ 243,000
Total	£ 449,000

Purchases of sterling amounted to £505,000, as indicated below:

By commercial concerns	£ 289,000
By foreign banks (Europe and South America)	£ 216,000
Total	£ 505,000

The banks also reported that the British Control purchased sterling amounting to £77,000 at the official rate of 4.02. All of this sterling represented cotton bills.

The other important currencies fluctuated rather widely and closed as follows:

French francs	.0223-1/2
Guilders	.5309-1/2
Swiss francs	.2247-1/2
Belgas	.1633
Canadian dollar	12-1/4% discount

The discount on the Cuban peso continues to increase and was today quoted at 14-7/8%.

The Dow Jones ticker carried an Associated Press despatch from Madrid stating that the Spanish government again has corrected the peseta rate to conform to the decline of the British pound and the French franc in relation to the U. S. dollar. In the future, U. S. dollars resulting from Spanish exports will be worth 10.05 pesetas ($.0995 per peseta). Dollars which are voluntarily returned to Spain will be worth 12.56 pesetas ($.0796 per peseta). The former rates were 9.90 pesetas ($.1010 per peseta) and 12.37 pesetas ($.0808 per peseta) which were in effect for the last two months.

We purchased the following amounts in gold from the earmarked accounts of the banks indicated:

$8,000,000	from the Netherlands Bank
993,000	from the National Bank of Belgium
350,000	from the Bank of the Republic, Colombia (consummated late on November 13)
$9,343,000	Total

The Federal Reserve Bank reported to us the following shipments of gold:

$1,663,000	from Canada, shipped by the Bank of Canada, Ottawa, consigned to the Federal Reserve Bank of New York, for sale to the U. S. Assay Office at New York.
1,130,000	from Switzerland, shipped by the National Bank of Switzerland for the account of the BIS, consigned to the Federal Reserve Bank of New York for the account of the BIS, the disposition of which is unknown to us at the present time.
22,000	from England, shipped by Samuel Montagu & Co., consigned to the Bankers Trust Company, New York, for sale to the U. S. Assay Office at New York.
$2,815,000	Total

On the report of November 8 received from the Federal Reserve Bank of New York, giving the foreign exchange position of banks and bankers in its district, the total position of all currencies was short the equivalent of $16,934,000, a decrease of $1,780,000 in the short position for the week. The net changes in position are as follows:

COUNTRY	SHORT POSITION NOVEMBER 1	SHORT POSITION NOVEMBER 8	DECREASE IN SHORT POSITION
England	$5,049,000	$ 4,190,000	$ 859,000
Europe	8,345,000	8,898,000	553,000 (Increase)
Canada	932,000	515,000	417,000
Latin America	291,000	363,000	72,000 (Increase)
Far East	4,056,000	2,937,000	1,119,000
All Others	41,000	31,000	10,000
Total	$18,714,000	$16,934,000	$1,780,000

The equivalent of today's London spot silver price was 41.23¢ and the forward price 40.97¢. The price paid by Handy and Harman for foreign silver was unchanged at 34-3/4¢. The Treasury's price was also unchanged at 35¢. In New York, we made five purchases of silver totaling 375,000 ounces under the Silver Purchase Act. We also purchased 350,000 ounces of silver from Canada making a total of 495,000 ounces purchased during November under our agreement to buy 1,200,000 ounces monthly.

Mr. Knoke told me at 11:15 this morning that he had just spoken with Mr. Siepmann of the Bank of England, and had told Siepmann about the New York exchange market. Siepmann thought the Japanese were practically through selling sterling. Siepmann had talked with the Rumanians and had hinted to them that sales of sterling such as they had been making had not been in their own interest. The Rumanians indicated, in reply to Siepmann's query, that the sterling which they had sold represented foreign exchange balances. In reply to Knoke's question as to the extent of foreign balances in England, Siepmann replied that these were very small outside of British Empire balances. Continuing the question as to the foreign-held British securities that could be liquidated, Knoke was informed by Siepmann that this was an entirely different question, and that the volume might be substantial. Siepmann hinted that if signs of important liquidation of British securities developed, they might be called to take some action. Siepmann stated that a decision would be taken by tomorrow with respect to the £1,000,000 maturity of the I.T.T. which has been mentioned in earlier conversations between the Federal Reserve Bank and the Bank of England. Siepmann said that £165,000 would probably be acquired on the New York market and the remainder would be given by him in London at the official rate. In closing his talk with me, Knoke expressed the opinion that the New York sterling market was a little tired, having absorbed about all the sterling it could, and that either buying or selling might have a marked effect on the rate.

Leroy-Beaulieu telephoned me yesterday from New York. He stated that the French Consul General had that day endeavored to sell to the Chase Bank a sight draft drawn by the Consul General on the Ministry of Foreign Affairs of France to cover salaries and running expenses of the French Consulate General. The Chase Bank had refused to buy the draft, stating that the Bank would have to communicate with the State Department at Washington to see whether such a transaction would be permissible under the Neutrality Act. Leroy-Beaulieu told me that Pinsent was in his office and was much interested in this case, since the British Embassy and consular officers in this country would have the same problem. I let Leroy-Beaulieu know that this was not a Treasury matter. I tried, without success, to learn from the State Department who was handling this matter. I called Leroy-Beaulieu back and told him that if he learned when, and to whom, and how, the Chase had referred this matter, I would see if anything could be done to expedite a decision.

Mr. Knoke spoke with me at 4:45 yesterday evening. He mentioned that Pinsent had telephoned him in regard to the question above described as raised by Leroy-Beaulieu, and that Knoke had advised contact with the State Department.

Mr. Leroy-Beaulieu telephoned me at 3:30 this afternoon to the effect that Pinsent had telephoned him today that the British Consul General in New York had experienced the same difficulty as the French Consul General when endeavoring to sell a draft to the Chase Bank. Leroy-Beaulieu told me that two lawyers representing the Chase Bank, Messrs. Millbank and Sargent, will come to Washington on

Thursday to see the Department of State, and will call on me. I explained to Leroy-Beaulieu that with both him and Pinsent in New York, I had done what I could yesterday to find how the matter stood, but that since the Treasury itself is not handling this matter, the lawyers should look to the State Department for advice, or for reference by the State Department to the competent authorities in Washington.

Knoke gave me the following item with respect to the Reichsbank account with the Federal Reserve Bank. He said that between October 21 and 27, $3,975,000 had been drawn out of this account with the Federal and paid to the Chase Bank. The Chase Bank had then transferred $3,230,000 to the Stockholm's Enskilda Bank for the Reichsbank. The Swedish Bank had then credited about the same amount to the Russian State Bank account with the Chase. The German funds thus proceeded in this roundabout channel to the Russian State Bank.

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE November 15, 1939

TO Secretary Morgenthau

FROM Mr. Cochran

The foreign exchange market was quiet. Sterling opened in New York at 3.93-1/2 and declined to 3.92-1/2 on small selling orders from abroad received by the New York banks. After absorption of this sterling by the market, good commercial buying appeared and the rate gradually strengthened to the high of 3.94-5/8 shortly before noon. Thereafter the quotation moved in a narrow range and closed at 3.94.

The discount on forward sterling widened to 2-1/8¢ per pound for one month and 5-1/2¢ per pound for three months. The Chase Bank received orders from London this morning to sell forward sterling but, as there was no demand for forwards at that time, it returned the orders to London unexecuted. During the course of the afternoon, it was reported that the Japanese were offering forward sterling in small amounts for three months at 5-1/2¢ per pound discount. The yield on one month's sterling is 6-1/2% per annum and three month's, 5-9/16% per annum.

Sales of sterling by the four reporting banks in New York and the Federal Reserve Bank of New York totaled £533,000 from the following sources:

By commercial concerns..	£ 302,000
By foreign banks (Europe, Far East and South America)......	£ 181,000
By Federal Reserve Bank of New York (For Norway)...........	£ 50,000
Total.....	£ 533,000

Purchases of sterling amounted to £680,000, as indicated below:

By commercial concerns..	£ 525,000
By foreign banks (Europe, South America and Far East)......	£ 155,000
Total.....	£ 680,000

Of the four reporting banks, the Guaranty Trust Co. was the only one that sold sterling to the British Control. It sold a total of £45,000 at the official rate of 4.02. All of this sterling represented cotton bills.

The Federal Reserve Bank purchased 65,000 belgas for the Bank of Latvia.

The other important currencies closed as follows:

French francs	.0223-1/2
Guilders	.5310
Swiss francs	.2246
Belgas	.1638
Canadian dollar	12-1/4% discount

CONFIDENTIAL

We sold $2,357,000 in gold to the National Bank of Rumania. This makes a total of $11,545,000 in gold sold to the Rumanian bank and completes their request to buy gold valued at approximately $11,000,000, which request was mentioned in a previous report.

We purchased the following amounts of gold from the earmarked accounts of the banks indicated:

$10,000,000	from the Bank of France
4,200,000	from the Netherlands Bank
727,000	from the National Bank of Belgium
$14,927,000	Total

The Federal Reserve Bank reported to us the following gold shipments:

$ 2,974,000	from England, shipped by the Bank of England, consigned to the Federal Reserve Bank of New York for account of the Netherlands Bank, the disposition of which is unknown at the present time.
980,000	from England, shipped by Samuel Montagu and Co., consigned to the Chase National Bank of New York for account of the Rotterdam Bank, for sale to the U. S. Assay Office at New York.
249,000	from England, shipped by the Midland Bank to the Guaranty Trust Company of New York for the account of a Canadian resident, for sale to the U. S. Assay Office at New York.
33,000	from England, shipped by the Banque Belge pour l'Etranger, consigned to the Banque Belge pour l'Etranger of New York, for sale to the U. S. Assay Office at New York.
$ 4,236,000	Total

We have received a cable advice from the American Consul at Bombay, India, that he had invoiced for shipment to this country $630,000 in gold, shipped by the National Bank of India to the Guaranty Trust Company of New York at San Francisco. It is assumed that the gold will be sold to the U. S. Mint at San Francisco.

The equivalent of today's London spot silver price was 41.39¢ and the forward price, 41.19¢. Handy and Harman's price for foreign silver remained unchanged at 34-3/4¢. The Treasury's price was also unchanged at 35¢.

In New York we made four purchases of silver totaling 175,000 ounces under the Silver Purchase Act.

Mr. Johnson, Manager of the Foreign Department of the Chemical Bank, telephoned me from New York this morning in regard to the desire of one of the bank's customers to export tin. Mr. Johnson inquired as to whether the bank should endeavor to discourage the export of such an essential commodity. I told him that I knew of no restrictions imposed by the Customs authorities of the United States upon such export, and I told him that the Treasury Department would not take the responsibility of stating that such an export should be discouraged as a matter of national policy. I told him that if he wished to pursue the matter further, he should speak directly with Mr. Green of the Department of State.

CONFIDENTIAL

Mr. Pinsent telephoned me from Washington this afternoon. He had just returned from New York. Before leaving that city he had learned through Mr. Loree that the lawyers of the Guaranty Trust inclined to the opinion that British banks authorized to deal in foreign exchange under the British regulations must be considered agents of the British Government as a consequence, with the further result that they are not free to participate in the private credit operations allowable under our Neutrality Act. Pinsent said this would be a much more serious matter than that of the pay drafts which Leroy-Beaulieu had mentioned to me. At the suggestion which I made, after consulting with Mr. Bernstein, Mr. Pinsent stated that he would talk with either Mr. Green Hackworth of Mr. Bert Hunt in the legal division of the Department of State.

Chairman Ida Pruitt of the Hong Kong Promotion Committee, Chinese Industrial Co-operatives, called on me this afternoon. I learned subsequently from Mr. Penfield of the Department of State that she had called at that Department, being personally acquainted with several of the officers who had served in China, and had been referred to me when she sought the name of someone in the Treasury Department who might consider her request for possible financial assistance to the organization which she represents. The visitor hoped to be able to tell Secretary Morgenthau her impressions of China, having resided there many years and having returned only recently. I told her that the Secretary was kept up to date on China. When I sought the exact purpose of her visit, and found that it was with the idea that she might get some financial assistance for business enterprises in China, I told her that the Export-Import Bank was the only government institution which might at the present time give any consideration to her request. I gave her Mr. Pierson's name and address. Since she was interested in talking with Mr. Arthur N. Young, I gave her his address, the Mayflower Hotel, after learning from the State Department that he had returned today from Washington. She had Mr. Archie Lochhead's name, and said that she was to see him in New York next week.

H.M.F.

CONFIDENTIAL

MA

GRAY

Paris

Dated November 15,1939

Rec'd 4:47 p.m.

Secretary of State

Washington

2765, November 15, 7 p.m.

FOR THE TREASURY.

Today's Journal Officiel carries a decree postponing from November 15 to December 31, 1939 the date on which the required declarations of holdings abroad are to be based and postponing from December 1, 1939 to January 15, 1940 the date on which such declarations are to be filed. (Embassy's telegrams numbers 2028, September 18, 1 p.m. and 2394, October 9, 7 p.m.) the accompanying explanatory memorandum states that repatriation of capital has been so substantial since September 10 that it has been possible " to meet the first expenditures abroad which the country's requirements have made necessary" while foreign exchange reserves have continued to increase.

(END OF SECTION ONE)

BULLITT

EMB

JT

GRAY

Paris

Dated November 15, 1939

Rec'd 3:34 p.m.

Secretary of State

Washington

2765, November 15, 7 p.m. (SECTION TWO)
The memorandum adds that there are signs that this return flow of capital is likely to continue and that therefore the Government does not wish to stop such repatriation by the November 15 deadline especially as delays in transportation, etc., under existing circumstances may have hindered the return of holdings abroad where already decided upon. You will recall (for example, our telegram No. 2635, November 2, 3 p.m.) that the attitude of the French financial authorities is that while much of this capital would sooner or later be made available to the Government anyway, it is more satisfactory to obtain as much as possible voluntarily.

BULLITT

EHB

JI

GRAY
Paris
Dated November 15, 1939
Rec'd 4:22 p.m.

Secretary of State
Washington

2765, November 15, 7 p.m. (SECTION THREE)
On the other hand the postponement of the date for filing declaration means a delay in reaching an approximate estimate of the extent of French holdings abroad.

We learn that a recent confidential instruction has been issued the "approved intermediaries" by the Foreign Exchange Office permitting them to grant, with reference to the Foreign Exchange Office, authorization for non-resident foreigners to carry with them on leaving France the sum of 25,000 francs or its equivalent in foreign currencies, travellers checks etc. instead of the previous maximum of 5000 francs. For sums above that amount approval of the Foreign Exchange Office was formerly necessary.

BULLITT

EHB

JI

GRAY

Paris

Dated November 15, 1939

Rec'd 4:40 p.m.

Secretary of State

Washington

2765, November 15, 7 p.m. (SECTION FOUR)

To bring existing practice into conformity with the cash and carry provisions of our Neutrality Act we understand that dollar exchange to cover imports from the United States for which licenses have been approved may be cabled through an "approved intermediary" to its correspondent in the United States. Thus payment may be made to the American exporter at the time of transfer of the title of the goods in question in the United States. On the other hand for imports from a number of other countries payment is not approved until the goods have actually arrived in France or documents presented.

Finance Minister Reynaud returned from his London conversations this morning.

(END SECTION FOUR)

BULLITT

NPL

JI

GRAY

Paris

Dated November 15, 1939

Rec'd 4:55 p.m.

Secretary of State

Washington

2765, November 15, 7 p.m. (SECTION FIVE)

A joint British and French communique has just been issued here that reads as follows in translation from the French:

"On the invitation of the Chancellor of the Exchequer, Monsieur Paul Reynaud came to London on the 13th and 14th of November accompanied by representatives of the Ministry of Finance. The two ministers recognized the necessity for a close and constant cooperation in the economic and financial spheres. They examined the arrangements which have existed for some time to assure this cooperation. They decided to maintain it and extend it even further. Different questions some of which concern general financial and economic policy and other of which present a more technical character were discussed and on all these questions the existence of a common point of view was evident.

(END SECTION FIVE)

BULLITT

NPL

MA

GRAY

Paris

Dated November 15, 1939

Rec'd 6:35 p.m.

Secretary of State

Washington

2765, November 15,7pm (SECTION SIX)

When these consultations were finished Monsieur Paul Reynaud proposed further meetings of a similar nature in order to maintain permanent contact between the two treasuries. The Chancellor of the Exchequer gave his complete assent to this suggestion".

On the securities market today variable revenue issues were firm particularly internationals Suez advancing 455 francs. Most rentes advanced fractionally the 1937 exchange guaranty issue gaining 70 centimes. The fortnightly liquidation passed off easily with carryover money again at one-half per cent. (END SECTION SIX).

BULLITT

NPL

MA

GRAY

Paris

Dated November 15, 1939

Rec'd 6:40 p.m.

Secretary of State

Washington

2765, November 15, 7 p.m. (SECTION SEVEN). Exchange rates have undergone no change since our telegram Number 2707, November 9, 7 p.m. last paragraph with the exception of the belga which dropped to 718 - 724 during last week's crisis and has remained at that figure.

The Netherlands Bank statement for the week ending November 13 shows a reduction in gold reserves from 1,104,000,000 florins to 1,059,000,000. Total liabilities are 1,357,000,000 as against 1,387,000,000. Gold coverage dropped from 79.60 to 78.05 %.

(END OF MESSAGE)

BULLITT

NPL

JR

PLAIN

London

Dated November 15, 1939

Rec'd 12:53 p.m.

Secretary of State,

Washington.

2363, November 15, 6 p.m.

FOR TREASURY.

In view of the comments on the necessity for curtailing wage earners' consumption and the mention of compulsory saving as a method on page 13 of the Embassy's memorandum of October 7 on the British war budget, it is of interest that two articles in the TIMES of yesterday and today by Keynes advocate and outline a scheme for forced savings.

Keynes argues that through longer working hours, dilution of labor and wage increases (the latter tendency having already appeared, see my No. 2167 of October 25) "an increase in the purchasing power of wage earners by at least pounds 500 million a year must be expected" and when maximum effort is reached a larger increase will be inevitable; that if the government policy of holding down prices of certain goods succeeds working class purchasing power will command more goods; and that if wages are allowed to rise the situation will be further aggravated

and

and the vicious spiral of inflation induced.

Keynes examines alternative remedies:

(1) rationing though desirable for other reasons is no remedy against a general increase of purchasing power as it merely diverts demand from the rationed to the unrationed article.

(2) Antiprofiteering measures "exault into undue prominence the least significant cause of rising prices."

These two methods he characterizes as "psuedo remedies." Three genuine remedies he considers must all be applied but the degree is important:

(1) A rise in prices which he argues is desirable insofar as the rise represents increases in costs, rise in world prices and depreciation of exchange. "It is unlikely that we can avoid some further rise up to (say) 20 per cent above pre-war", but while a price rise sufficient to restore equilibrium between purchasing power and the supply of goods would enhance the yield of the excess profits duty it "would be beyond all reason and endurance", and the vicious spiral of rising prices and wages could not be avoided. The control of consumption by a rise in prices would be "largely futile unless we re-cast our wages system. The rise in prices helps only

to

to the extent that it is greater than the rise in wages".

(2) Taxation would have to be direct on the working classes who consume three fifths of net consumption and whose incomes are likely to rise by upwards of 15 per cent. A turnover tax on non-essentials he considers deserves closer attention but like a rise in prices this would fall in equal proportion on all levels of income and would also have administrative difficulties. He suggests that the government might resell at a price yielding a profit some of the staple goods of which it is monopolizing the distribution. This would produce benefit to the treasury with the least addition to existing machinery. But the price and taxation remedy both deprive the working class of benefits from their increased earnings which largely represent increased effort on their part.

(3) He therefore strongly advocates a system of forced saving which would in effect give wage earners the benefit of their increased earnings at a deferred time, that is when the war is over. Though the individual may dislike postponing his own consumption, immediate expenditure of increased earnings will not benefit the individual if prices rise disproportionately or if his increased earnings are taxed away.

Keynes

Keynes therefore suggests that a percentage of all incomes over a stipulated minimum should be paid to the government, partly as compulsory savings and partly as direct taxes. The total percentage taken would rise steeply as the level of income increased. He would take 20 per cent of incomes of pounds 150 per annum and by rising proportions up to 80 per cent of incomes over pounds 200,000. Th lower ranges would see the whole amount taken put into a savings account not to be released during the war while the higher ranges would first have deducted their liabilities for income and surtax which would represent an increasing proportion the higher the income. The forced saving proportion would be credited to the individual as a deposit in the post office savings bank to carry 2 1/2 per cent interest and would not be available for current expenditure or as security against loans. The blocked savings might be used to meet pre-war capital commitments such as installments on house purchase or other hire purchase or insurance premiums, or with special permission for unavoidable expenses arising from illness and unemployment. The blocked sums would be made available after the war by a series of installments which would greatly help the transition from war to a peace economy.

Keynes states he is unable to estimate accurately the

amount

amount of compulsory savings which would result but suggests at least pounds 400 million over and above income and surtax. While a stiffer schedule might bring in a correspondingly larger return. He emphasizes that the proposal would only be supplementary to other remedies but it would be "more efficacious than any conceivable increase in taxation, and nearly as good as a 10 per cent fall in real wages while doing no lasting injury to working class consumption." He also emphasizes that the scheme would not obviate normal borrowing of voluntary savings since resources would accrue in the hands of banks, insurance offices etc. and that government loans could be subscribed from company reserves, sinking funds and capital released by the sale of foreign investments etc. "No more can be claimed for it than it would appreciably ease the Treasury's task."

Though this is the first proposal for compulsory savings to be made public, the problems of reduction of consumption and the tapping of potential savings and tax liabilities before the purchasing power is spent on consumption have been widely discussed since the comments on the budget which were attached to the memorandum on the budget referred to above. For example on October 23 the financial editors of the DAILY TELEGRAPH urged

-6- #2363, November 15, 6 p.m., from London.

urged the importance of tapping the increasing purchasing power resulting from heavy government expenditure by a savings campaign and also through the sale of bonds on tap, a method successfully used in the war of 1914-18. On November 7 the FINANCIAL NEWS published an editorial urging a tax system which would collect income tax on salaries at source from the employer, other types of direct taxation by installments at short intervals and some method of taxing those below the direct taxation level. The basic aim in borrowing as in taxation, the editorial urged, should be "to entrap purchasing power before it gets into general circulation" and the widest possible propaganda for thrift and reliance on the tap sales of securities of widely divergent types should be used to reduce the margin of bank financing of national loans.

Since the publication of the increase in the cost of living index reported in my 2167 of October 25 and the subsequent rises in wages there has been increasing interest in the whole question of prices and wages in relation to the fiscal policy of the government and a growing feeling that, as Keynes puts it, "the central problem of the home economic front, a problem which requires for its solution the coordination of price policy, budget policy,

-7- #2363, November 15, 6 p.m., from London.

policy, and wages policy--has not yet been faced".

The TIMES leading editorial today dealing with Keynes articles offers one criticism on the grounds that Keynes assumes that all productive resources are now fully occupied. "Whatever may be the case in a few months time this condition does not now prevail" as is proved by the 1,400,000 unemployed whose number would be increased by an immediate restriction on consumption. But the editorial continues, this condition will not endure as the war effort gains in momentum and "the scheme deserves to be welcomed precisely because it takes the long view, the absence of which was the outstanding defect of the last budget".

KENNEDY

CSB

HSM

PLAIN

London

Dated November 15, 1939

Rec'd 11:40 a. m.

Secretary of State,

Washington.

2373, November 15, 5 p. m.

FOR TREASURY.

The press reaction to Keynes' forced saving scheme reported in my 2363, November 15, 6 p. m., is significant.

The writer of the DAILY EXPRESS leading editorial evidently does not appreciate Keynes' concern that this war should not, like the 1914-18 war, be financed by inflation. He characterizes Keynes "an enemy of liberty" because he insults the public with a proposal for compulsion when an appeal to patriotism would have the desired result, and asks whether Mr. Keynes has forgotten the response to the war loans of the last war.

The DAILY MAIL financial editor, while admitting the soundness of Keynes' argument that the standard of living cannot be expected to improve in war time and that rising prices would deprive increased wages of much of their value, adds "but compulsory methods do not appeal to the city" and suggests a savings drive among wage earners.

The

The DAILY HERALD financial editor, admitting that Keynes' plan is preferable to a sales tax contends that his argument rests on the assumption that the output of goods consumed by the working class must actually be reduced while the war effort continues. "This cannot be proved(.....) until this doubtful point is absolutely established," this writer thinks incomes under £5 per week should not be affected, while for persons above working class level "there is much to be said for Mr. Keynes' plan," but the "bribe of interest" should not be offered to holders of big fortunes who should be subject to an annual capital tax.

The NEWS CHRONICLE financial editor reports city opinion as being not unfavorable but uncertain as to whether Labor or the Government would accept a proposal so revolutionary and adds "and that seems to show that even in the city there is as yet insufficient realization of the fact that the financial methods of the last war are going to prove completely inadequate to cope with the present war".

The MANCHESTER GUARDIAN financial editor's comment is: "There are serious objections to the particular scheme drawn up by Mr. Keynes, to which we shall return. But the general idea of paying out extra earnings during the war in the form of deferred claims on goods and amenities is undoubtedly sound."

The

ham -3- No. 2373, November 16, 5 p. m., from London

The TIMES city editor agrees that special measures are essential to prevent much of the extra purchasing power implicit in government war expenditure escaping into extra consumption but criticizes the scheme on the grounds that it would work inequitably as between salaried officials and wage earners. He characterizes the scheme as an amalgamation of two considerations (1) the need to draw off excess purchasing power, and (2) the difficulty of extending direct taxation to the working classes. "In a sense it may be conceived as an alternative to such an extension but it is not such an extension in fact and Mr. Keynes treats it as if it were". He also asks whether repayment of the forced saving is to be raised by a post-war inflation and notes that this would render negligible the inducement to voluntary subscriptions to war loans which might fall in value while compulsory savings were to receive 2-1/2 percent and to be repaid at par shortly after the end of the war. "If usual slump supervenes upon this war as it did upon the last 'reflation' need not necessarily involve a depreciation of gilt-edged".

The two financial dailies and the DAILY TELEGRAPH have not yet commented on the scheme.

KENNEDY

KLP

PARAPHRASE OF TELEGRAM RECEIVED

FROM: American Embassy, Paris

NO.: 2769

DATE: November 16, 1939, 5 p.m.

FOR THE TREASURY

This morning we were informed confidentially by Couve de Murville that (as was indicated in the last sentence of the third paragraph of our telegram no. 2707 dated November 9, 7 p.m.) there were brought to France yesterday Belgian gold reserves. At the request of the Belgians these reserves have been sent to Bordeaux, he said. He stated that it was his opinion the Netherlands still had some gold in its own country but he did not know how much. He said he thought it was foolhardy of them to keep it there at this time. It is safe to say, incidentally, that neither Couve de Murville nor any other person in France is in possession of any really well founded information today regarding the question of whether or not the Netherlands and/or Belgium will be invaded by Germany. That this will happen sooner or later is, however, the opinion of the majority.

BULLITT

EA:EB

PARAPHRASE OF TELEGRAM RECEIVED

FROM: American Embassy, Paris

NO.: 2769

DATE: November 16, 1939, 5 p.m.

FOR THE TREASURY

This morning we were informed confidentially by Couve de Murville that (as was indicated in the last sentence of the third paragraph of our telegram no. 2707 dated November 9, 7 p.m.) there were brought to France yesterday Belgian gold reserves. At the request of the Belgians these reserves have been sent to Bordeaux, he said. He stated that it was his opinion the Netherlands still had some gold in its own country but he did not know how much. He said he thought it was foolhardy of them to keep it there at this time. It is safe to say, incidentally, that neither Couve de Murville nor any other person in France is in possession of any really well founded information today regarding the question of whether or not the Netherlands and/or Belgium will be invaded by Germany. That this will happen sooner or later is, however, the opinion of the majority.

BULLITT

EA:EB

HSM

PLAIN

London

Dated November 16, 1939

Rec'd 12:54 p. m.

Secretary of State,

Washington.

2378, November 16, 6 p. m.

FOR TREASURY.

1. The stock exchange is quiet with little business but gilt-edged securities maintain their prices, war loan closing today at 92-1/2. The loans of local authorities are also working free of minimum prices, the margins between buying and selling quotations being reduced and some of the minima being raised.

2. The appreciation of the Portuguese escudo from 109 1/2-111 to 107 3/4-108 1/2 yesterday reflects the Portuguese Government's decision to leave the sterling area and tie its currency to the dollar. This rate was unchanged today. Officially fixed rates have remained unchanged this week with the exception of the belga which after appreciating on Tuesday to 24.30-60 was fixed today at 24.35-65. The Finnish exchange fixed yesterday at 197 buyers was unchanged today.

3.

hsm -2- No.2378, November 16, 6 p. m., from London

3. A small decrease in the note circulation of £728,000 is recorded in today's Bank of England return. This together with the decline in public deposits of £3.4 million and in other accounts of £897,000 and a small net increase in securities in the banking department (government securities having increased by £950,000 and other securities decreased by £821,000) resulted in an increase in bankers' deposits of £5.2 million bringing the total to £107 million.

4. Today's FINANCIAL NEWS prints a story that as a result of statements by a high official of the Czechoslovak National Bank who has managed to reach Basle, that the order to surrender the gold to Germany was made under threat and intimidation, the Bank of International Settlements has agreed to hold back £600,000 of Czech gold not yet actually delivered to Germany.

KENNEDY

RR

PARAPHRASE OF TELEGRAM RECEIVED

FROM: American Embassy, Paris

NO.: 2768

DATE: November 16, 1939, 4 p.m.

SECTIONS ONE, TWO, THREE, FOUR.

FOR TREASURY

This morning we dropped in on Couve de Murville for a chat. He returned to Paris yesterday evening after having gone with Reynaud to London. Couve de Murville said that they had had two "very friendly" talks with Sir John Simon and officials of the British Treasury. He said that the nature of these conversations was completely preliminary and general and the participants did not try to come to any definite agreement. He said that naturally there was some marchandage (in other words, horse trading) in connection with the matter of the relative participation of France and Great Britain in the granting of credits to Turkey and to other countries friendly to the Allies. He said, however, that the differences between the British and the French should not be exaggerated.

Payments for the large amounts being expended for the maintenance of the British expeditionary force in France was the other important question discussed in London

London. Further discussions will be had between the British and the French experts with reference to these two big questions as well as regarding other matters which are pending. It was mutually agreed that it was important to maintain close contact.

The grave preoccupation which the British exhibited with reference to their foreign exchange problem impressed Couve de Murville particularly. He stated that although they are making every effort to buy everything possible in sterling, they are worried over the arrival of the time when acute difficulties will be presented by having to pay for vital war supplies in dollars. During the World War, he said, it had been possible for France and Great Britain to take care of their own purchases up until 1917 (sic without loans from the United States Government presumably) but he questioned whether this time they would be able to continue on their own resources for as long a period due to different circumstances and the change in the nature of the warfare. He said that frankly he did not know what could then be done. (As time goes on we shall undoubtedly hear a great deal more about this.)

Couve de Murville was not optimistic regarding the possibility of increasing French exports to any great

extent

extent since these go principally to Great Britain and are largely articles classed as luxuries, importation of which the British Government is of course anxious to discourage at this time. (British restrictions on French imports have been criticized here.)

(END OF SECTION THREE)

EA:EB

PARAPHRASE OF SECTION FOUR OF TELEGRAM NO. 2768 OF NOVEMBER 16, 1939, 4 P.M., FROM THE AMERICAN EMBASSY, PARIS:

Concerning the budget which will be presented tomorrow to the Finance Commission of the Chamber, he stated the total of the ordinary budget as approximately 68,000,000,000 francs, which would be only for civil expenditures. He added that they would balance this budget. Regarding military expenditures, he wasn't certain yet of the estimates for the first quarter. In view of the heavy existing tax burden in France, tax levies will not be greatly increased, he reiterated; in this connection see Embassy's no. 2635 of November 2, 1939, 3 p.m.

EA:MSG

CJ

GRAY

PARIS

Dated November 16, 1939

Rec'd 3:17 p.m.

Secretary of State,

Washington.

2768, November 16, 4 p.m. (SECTION FIVE).

This morning's Journal Officiel carries a decree which lays down the policy which the government proposes to follow during the period of hostilities regarding wages and existing collective labor agreements. Briefly, it provides that for enterprises not engaged in supplying material or services for national defense, revision of collective labor contracts may be undertaken by mutual agreement of employers' and employees' organizations or by a simple and rapid arbitral procedure if desired by either party. In either case, the approval of the Ministry of Labor is requested. The Government under the blanket law of July 11, 1938 covering war time powers will fix wages and working conditions directly for national defense industries.

BULLITT

CSB

CJ

GRAY

PARIS

Dated November 16, 1939

Rec'd 5 p.m.

Secretary of State,

Washington.

2768, November 16, 4 p.m. (SECTION SIX)

Employers paying less than minimum fixed wages or more than maximum will be subject to fines to be paid into the solidarity fund (Embassy's despatch No. 4939 of September 6, 1939). The decree further provides that where paid vacations were not possible owing to war conditions this year, an indemnity equal to the period of unutilized vacation shall be paid by employers within a period of three months to workers entitled to such indemnity whether mobilized or not. In commenting on this decree, the TEMPS says: "The financial conduct of the war requires that an increase in prices be prevented. Prices in principle have been fixed at the level reached on September 1, last.

BULLITT

NK:NPL

CJ

GRAY

PARIS

Dated November 16, 1939

Rec'd 4:20 p.m.

Secretary of State,

Washington.

2768, November 16, 4 p.m. (SECTION SEVEN)

But in spite of all regulations different reasons may cause them to rise and increased wages is one of the causes of which it would be impossible to prevent the consequences. The stabilization of wages on the contrary will greatly help to stabilize prices".

The Bank of France statement dated November 9 published today shows a further increase of 1,400,000,000 francs in the provisional advance account of the Treasury making the total drawn so far since the war 8,700,000,000. Commercial advances decreased 349,000,000 to a total of 6,500,000,000. Thirty day advances decreased 140 millions.

BULLITT

CSB

CJ

GRAY

PARIS

Dated November 16, 1939

Rec'd 4:27 p.m.

Secretary of State,

Washington.

2768, November 16, 4 p.m. (SECTION EIGHT). Circulation increased 129,000,000 to a total of 146,721,000,000 . Ratio of gold cover to demand liabilities decreased slightly from 59.80% to 59.75%.

Profit taking on an inactive securities market led to moderate losses all through the first hour with the exception of certain rentes which remained steady. The 1925 and 1937 exchange guarantee issues lost 1.95 francs and 1.25 francs respectively.

Official exchange rates are again unchanged with the exception of the belga which weakened today to 714-720. (END MESSAGE).

BULLITT

CSB

DEPARTMENT OF STATE

FOR THE PRESS

NOVEMBER 16, 1939
No. 597

CONFIDENTIAL
FUTURE RELEASE
NOTE DATE

CONFIDENTIAL RELEASE FOR PUBLICATION AT 9 P.M., EASTERN STANDARD TIME, THURSDAY, NOVEMBER 16, 1939. NOT TO BE PREVIOUSLY PUBLISHED, QUOTED FROM OR USED IN ANY WAY.

ANALYSIS OF REQUIREMENTS OF SECTION 2 OF THE NEUTRALITY ACT OF 1939

(Commerce with States Engaged in War)

I. American vessels (including aircraft) are prohibited from carrying passengers or any articles or materials to any state named as a belligerent in a proclamation issued by the President.
  A. Exceptions:
    1. Transportation of any passengers or any articles or materials by American vessels (including aircraft) on or over lands, lakes, rivers, and inland waters bordering on the United States.
    2. Transportation by American vessels, other than aircraft, of mail, passengers, or any articles or materials, except arms, ammunition, or implements of war, to any port
      a. in the Western Hemisphere north of 35° north latitude and west of 66° west longitude;
      b. in the Western Hemisphere south of 35° north latitude;
      c. on the Atlantic Ocean or its dependent waters south of 30° north latitude; or
      d. on the Pacific or Indian Oceans or their dependent waters;
    provided, that no such port is included within a combat area.
    3. Transportation by aircraft of mail, passengers, or any articles of materials, except arms, ammunition, or implements of war, to any port
      a. in the Western Hemisphere; or
      b. on the Pacific or Indian Oceans or their dependent waters;
    provided, that no such port is included within a combat area.
    4. Transportation, as described in (1), (2) and (3) above, of arms, ammunition, and implements of war, if they are to be used exclusively by American vessels, aircraft, or other vehicles in connection with their operation and maintenance.

II.

II. All right, title, and interest in any articles or materials (except copyrighted articles or materials) to be exported or transported to a belligerent country must be transferred to foreign ownership at the port of lading in the United States, before the articles or materials are so exported or transported, or attempted to be so exported or transported, or caused to be so exported or transported.

A. Exceptions:

1. Transportation of articles or materials, other than arms, ammunition, or implements of war, by American vessels (including aircraft) on or over lakes, rivers, and inland waters bordering on the United States, or by vehicles or aircraft on or over lands bordering on the United States.

2. Transportation by American vessels, other than aircraft, of mail or any articles or materials, except arms, ammunition, or implements of war, to any port
   a. in the Western Hemisphere north of 35° north latitude and west of 66° west longitude;
   b. in the Western Hemisphere south of 35° north latitude;
   c. on the Atlantic Ocean or its dependent waters south of 30° north latitude; or
   d. on the Pacific or Indian Oceans or their dependent waters;

   provided, that no such port is included within a combat area.

3. Transportation by aircraft of mail or any articles or materials, except arms, ammunition, or implements of war, to any port
   a. in the Western Hemisphere; or
   b. on the Pacific or Indian Oceans or their dependent waters;

   provided, that no such port is included within a combat area.

4. Transportation by a neutral vessel to any port referred to in (2) above, of any articles or materials, other than arms, ammunition, or implements of war, provided, such port is not included in a combat area.

5. Transportation, as described in (1), (2) and (3) above, of arms, ammunition, and implements of war, if they are to be used exclusively by American vessels, aircraft, or other vehicles in connection with their operation and maintenance.

(Note: There is no exception in the case of transportation by a vessel of a belligerent state.)

B. Issuance of bill of lading under which title passes unconditionally to foreign purchaser upon delivery of the articles or materials to a carrier constitutes transfer of right, title, and interest.

C. The shipper of such articles or materials is required to file with the collector of customs at the port of lading a declaration under oath that he has complied with the requirements of law regarding transfer of right, title, and interest, and that he will comply with such rules and regulations as shall be promulgated from time to time.

III. In the event of transportation by American vessels (including aircraft) as described in I A (2) and (3), and II A (2) and (3), and by neutral vessels (including aircraft) as described in II A (4), every such vessel or aircraft shall, before departing from the jurisdiction of the United States, file

with

with the collector of customs of the port of departure, or, if no collector at such port, with the nearest collector of customs, a <u>sworn statement</u> containing

A. a complete list of all articles or materials carried as cargo, and the names and addresses of the consignees of all such articles and materials; and
B. a statement of the ports at which such articles and materials are to be unloaded and of the ports of call of the vessel.

***

NOTE: Section 7 of the Neutrality Act forbids the extension of credit to the government of any belligerent state or political subdivision thereof or to any person acting for or on behalf of such government or political subdivision. It does not forbid the extension of credit to any person in a belligerent state who is not acting for or on behalf of a belligerent government or any political subdivision thereof, except that no credit of any kind may be extended to any person whatsoever in a belligerent state in connection with the sale of arms, ammunition, and implements of war as defined in the President's Proclamation of May 1, 1937. Articles and materials other than arms, ammunition, and implements of war may, therefore, be sold on credit to private persons or firms in belligerent states, provided those persons or firms are not acting for or on behalf of a belligerent government or a political subdivision thereof.

It may be added that section 7 of the Act does not apply to the extension of credit to the governments of neutral states or to persons or firms in those states, unless those persons or firms should be acting for or on behalf of the government of a belligerent state or a political subdivision thereof.

***

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE November 16, 1939

TO Secretary Morgenthau

FROM Mr. Cochran

The foreign exchange market was very quiet. Sterling opened in New York at 3.94 and fluctuated within a narrow range to close at 3.93-1/8.

Sales of sterling by the four reporting banks in New York and the Federal Reserve Bank of New York totaled £443,000 from the following sources:

By commercial concerns....................................	£ 219,000
By foreign banks (Europe, Far East and South America).....	£ 174,000
By Federal Reserve Bank of New York (For Norway)..........	£ 50,000
Total....	£ 443,000

Purchases of sterling amounted to £379,000, as indicated below:

By commercial concerns....................................	£ 244,000
By foreign banks (Europe and Far East)....................	£ 135,000
Total....	£ 379,000

Of the four reporting banks, the following sold sterling to the British Control at 4.02:

£10,000 by the Bank of Manhattan
£11,000 by the Guaranty Trust Company
£20,000 by the National City Bank

£41,000 Total

All of this sterling represented cotton bills.

The National City Bank of New York reported that £300,000 were sold to the I.T. & T. by the British Control at 4.04 through the National City Bank of London. This transaction is one of special negotiation by the I.T. & T. with the British Control. We understand that the I.T. & T. needs approximately £1,000,000 to cover maturing obligations. Of this amount, it has covered £150,000 in the market and the £300,000 mentioned above making a total of £450,000.

The Federal Reserve Bank purchased 105,000 belgas for the Bank of Latvia.

The other important currencies were fairly steady.

CONFIDENTIAL

We purchased the following amounts of gold from the earmarked accounts of the Banks indicated:

$ 1,600,000	from the Netherlands Bank
1,010,000	from the National Bank of Belgium
$ 2,610,000	Total

The Federal Reserve Bank reported to us the following shipments of gold:

$ 2,450,000	from Holland, shipped by the Netherlands Bank, consigned to the Federal Reserve Bank of New York to be earmarked for account of the Netherlands Bank.
1,184,000	from Japan, shipped by the Yokohama Specie Bank, consigned to the Yokohama Specie Bank, San Francisco, for sale to the U.S. Mint at San Francisco.
$ 3,634,000	Total

The equivalent of today's London spot silver price was 41.33¢. Handy and Harman's price for foreign silver remained unchanged at 34-3/4¢. The Treasury's price was also unchanged at 35¢.

In New York we made four purchases of silver totaling 175,000 ounces under the Silver Purchase Act.

Mr. Grosvenor Jones of the Department of Commerce asked, in behalf of a banking inquirer from the Pacific Coast, about the arrangements for carrying accounts of foreign purchasing commissions with the Federal Reserve Bank of New York. I told him that the arrangements had not yet been completed and that there had not yet been any official release on this subject.

Dr. Arthur N. Young, Financial Advisor in China, called this afternoon. He told me that he had talked with Messrs. Hanes, White, Stewart, Viner and Cotton since I last saw him in the Secretary's office. He is leaving for California (1725 Chelsea Road, San Marino) on Saturday, but will fly back if the Secretary desires to see him next week.

CONFIDENTIAL

November 16,1939

Jesse Jones' ltr to HM,Jr re conference with Mr. Jaramillo in which Jones stated his opinion was overdue interest should be refunded at 3% instead of coupon rate of 6½%; bonds should extended at 3% for 10 years and 4% thereafter, sinking fund of not less than $600,000 a year should be set up with which to buy bonds annually on tender; desirable to have some such arrangement as would permit individual bondholders to convert their bonds into milreis that could be used in Colombia for purchase of things to export, having in mind that this would result in increasing Colombian exports.

THIS LTR OF JONES IS FILED AS OF 11/22/39 as attachment to meeting held in HM,Jr's office that date at 10 am

CJ

GRAY
GUATEMALA CITY
Dated November 16, 1939
Rec'd 4:06 p.m.

Secretary of State,
Washington.

51, November 16, 1 p.m.

FOR THE ACTING SECRETARY OF THE TREASURY FROM GASTON.

The Conference opened formally at a session open to the public Tuesday morning followed by a business session in the afternoon to which press representatives were admitted. At the afternoon session I made a general statement of a noncommittal character which has apparently been well received, the atmosphere of the Conference to date being friendly and harmonious so far as I can judge. I shall send you a copy of the statement by air mail.

The Conference has now resolved itself into committee procedure to be followed by a plenary public session at the end which I anticipate at the earliest the beginning of next week. Following the general lines of the agenda three committees, monetary, banking and exchange have been created. I am on the exchange committee but procedure is informal and other members of the delegation are attending sessions of the other committees. In the committees we

are

-2- #51, November 16, 1 p.m. to Guatemala City

are now in the process of analyzing projects and suggestions advanced for consideration by the various delegates.

Numerous countries have indicated an interest in working toward uniform customs nomenclature and procedure, cooperation against smuggling, uniformity of fiscal statistics and exchange of financial information and publications. In connection with customs procedure we are going to circulate Thursday the Tariff Commission document (Legation's 49, November 13, 4 p.m. and Department's 50, November 15, 3 p.m.) A number of other countries have circulated similar documents.

In the exchange committee we have already agreed to draft resolutions bearing on these subjects. We have also engaged in some preliminary discussions of direct exchange problems but will take up the broad subject formally on Thursday.

All three committees have devoted considerable attention to proposals of Mexico and Nicaragua which would create some form of inter-American financial institution.

The Mexican proposal contemplates the creation of an institution to plan and direct all new foreign capital investment in the other American Republics the source of such capital not being specified. The institution would also act as agent for the several central banks and would assist them in exchange matters. In the exchange committee

considerable

-3- #51, November 16, 1 p.m. to Guatemala City

considerable doubt was expressed by all members as to the practicability of the proposal and in the banking committee it was decided that it should be referred to the Washington Committee. The proposal is still under discussion in the monetary committee which is considering a brief draft resolution recommending careful planning and direction of new capital investment.

The Nicaraguan proposal envisages the eventual adoption of an inter-American monetary standard and the creation of an inter-American clearing house in New York to regulate and stabilize exchanges and carry out economic studies. The proposal is being considered chiefly in the monetary committee, which will discuss it further on Friday. A general opinion has been expressed that credits are appropriate only for the elimination of seasonal and similar fluctuations, and that the only solution as opposed to palliative for exchange difficulties is to be found in long term development of industry and agriculture.

Several delegates have brought up the question of reducing tariffs and Brazil has presented an informal suggestion for inter-American tariff preferences, but it has been decided informally that such topics are not within the competence of the meeting. Almost all of the delegates have evinced interest in adequate shipping facilities and

lower

-4- #51, November 16, 1 p.m., to Guatemala City

lower rates, but again it has been decided that this matter is not within the competence of the meeting. We have indicated a willingness to transmit informally to the Maritime Commission and other appropriate agencies any written comments which any of the delegates may wish to prepare.

The Mexican proposal included incidentally a suggestion urging the greater use of silver but no interest in the matter has been displayed by any other delegates.

I should appreciate information as to the progress of the Washington Committee especially as regards overlapping study of any of the above subjects.

DESPORTES

CSB

November ~~17~~ 16, 1939

To: The Files

From: Mr. Hanes

Cabinet meeting today at 2 p.m. Present were: The President, Messrs. Welles, Hanes, Murphy, Woodring, Edison, Farley, Wallace, Ickes, Noble and Madam Perkins.

The President opened the meeting by stating that he had been hard at work on next year's budget, that he had made drastic and severe curtailment all along the line, and that he wanted each Cabinet member to have a survey made immediately of the personnel situation in his department. The President said that he felt sure the regular departments of Government had become over-manned, and he wanted all department heads to cease filling the places of those employees who have resigned, and to stop adding all personnel to their rolls. The President was specific in his request that members of the Cabinet do everything within their power to cut down the expense of running their departments.

Under Secretary Welles took up with the President several departmental matters, but had nothing to report on the foreign situation.

The President was interested in the Treasury report on markets, which had been relatively strong during the week following the last Cabinet meeting. I reported that Treasury bonds were now selling at the highest point of their recovery levels since the start of the war. I also reported that the Federal Reserve Board had sold approximately $22 million in bonds in the last three days, most of which were guaranteed issues; also, that the Treasury had sold approximately $3 million. I reported that the New York Times Index for the week of November 11 was up 1.8 from the previous week, caused largely by excessive car loadings.

The President said that he appointed me a committee of one to try to get away from Jesse Jones his surplus cash to the extent of $300 million. He said, smilingly, that if I could perform this miracle he would indeed be grateful.

The President talked at length about the price level for commodities and industrial products, stating that he was very well satisfied with the way the price level had behaved since the start of the war. The President said he felt that industry had done a good job in keeping prices down, and that unless some isolated cases came to view, such as might happen in the aluminum industry, the Government would not have to take any action. The President re-stated his belief that there would not be any material slump in business during the first three months of 1940.

Secretary Woodring had nothing to report, but requested an audience with the President after Cabinet meeting.

Attorney General Murphy reported that he had made a complete survey of the files in his department and had gotten all back files boxed up and put away, thereby making additional space available in the Department of Justice. The President told the Attorney General that he had received several complaints about conflict between the Treasury and the Department of Justice on tax cases, resulting in costly delay both to the Government and to taxpayers. He instructed the Attorney General to take this matter up immediately with the Treasury, make a thorough investigation, and report on what was causing these conflicts and delays.

The only other interesting discussion took place between the President and Secretary Wallace, who again made a plea for processing taxes. Secretary Wallace was somewhat critical of the Treasury attitude toward his farm solution. He almost persuaded the President that his certificate plan would do the trick. The President asked me what I thought of the certificate plan, and I told him that the Secretary of the Treasury and I both felt that it was just another kind of processing tax, just as vicious in its result as the direct processing tax. The President was then told by Secretary Wallace that the certificate plan would collect the revenue without its appearance in the budget. I pointed out to the President that the Secretary's objection to this was based upon the fact that it would create outside of the Treasury a second tax collecting agency, and that we felt this would be bad procedure. The President then instructed Secretary Wallace to get in touch with the Treasury and try to iron out the differences of opinion on this subject.

The Cabinet meeting adjourned at 3:45 p.m.

J.W.H.

Treasury Department
Office of the Under Secretary

Date: 11-21-39

To: Miss Chauncey

From: JR

I gave original to Mr. Kieley to place on Secy's desk - 10:00 a.m.

November 16 1939

To: The Files

From: Mr. Hanes

Cabinet meeting today at 2 p.m. Present were: The President, Messrs. Welles, Hanes, Murphy, Woodring, Edison, Farley, Wallace, Ickes, Noble and Madam Perkins.

The President opened the meeting by stating that he had been hard at work on next year's budget, that he had made drastic and severe curtailment all along the line, and that he wanted each Cabinet member to have a survey made immediately of the personnel situation in his department. The President said that he felt sure the regular departments of Government had become over-manned, and he wanted all department heads to cease filling the places of those employees who have resigned, and to stop adding all personnel to their rolls. The President was specific in his request that members of the Cabinet do everything within their power to cut down the expense of running their departments.

Under Secretary Welles took up with the President several departmental matters, but had nothing to report on the foreign situation.

The President was interested in the Treasury report on markets, which had been relatively strong during the week following the last Cabinet meeting. I reported that Treasury bonds were now selling at the highest point of their recovery levels since the start of the war. I also reported that the Federal Reserve Board had sold approximately $27 million in bonds in the last three days, most of which were guaranteed issues; also, that the Treasury had sold approximately $3 million. I reported that the New York Times Index for the week of November 11 was up 1.8 from the previous week, caused largely by excessive car loadings.

The President said that he appointed me a committee of one to try to get away from Jesse Jones his surplus cash to the extent of $300 million. He said, smilingly, that if I could perform this miracle he would indeed be grateful.

The President talked at length about the price level for commodities and industrial products, stating that he was very well satisfied with the way the price level had behaved since the start of the war. The President said he felt that industry had done a good job in keeping prices down, and that unless some isolated cases came to view, such as might happen in the aluminum industry, the Government would not have to take any action. The President re-stated his belief that there would not be any material slump in business during the first three months of 1940.

Secretary Woodring had nothing to report, but requested an audience with the President after Cabinet meeting.

Attorney General Murphy reported that he had made a complete survey of the files in his department and had gotten all back files boxed up and put away, thereby making additional space available in the Department of Justice. The President told the Attorney General that he had received several complaints about conflict between the Treasury and the Department of Justice on tax cases, resulting in costly delay both to the Government and to taxpayers. He instructed the Attorney General to take this matter up immediately with the Treasury, make a thorough investigation, and report on what was causing these conflicts and delays.

The only other interesting discussion took place between the President and Secretary Wallace, who again made a plea for processing taxes. Secretary Wallace was somewhat critical of the Treasury attitude toward his farm solution. He almost persuaded the President that his certificate plan would do the trick. The President asked me what I thought of the certificate plan, and I told him that the Secretary of the Treasury and I both felt that it was just another kind of processing tax, just as vicious in its result as the direct processing tax. The President was then told by Secretary Wallace that the certificate plan would collect the revenue without its appearance in the budget. I pointed out to the President that the Secretary's objection to this was based upon the fact that it would create outside of the Treasury a second tax collecting agency, and that we felt this would be bad procedure. The President then instructed Secretary Wallace to get in touch with the Treasury and try to iron out the differences of opinion on this subject.

The Cabinet meeting adjourned at 3:45 p.m.

REPORT OF UNDER SECRETARY HANES' PRESS CONFERENCE, NOVEMBER 16, 1939.

Hanes: I wanted to get ready for this press conference to see if I could find any news for you, but I'll be damned if I had time. I don't think I've got any news.

Q. You don't think you've got any?

A. I will have to ask the boys here.

Q. The impression has gotten out that possibly somebody at the Federal Reserve System who made a speech out at St. Louis might be representing the views of the Administration. We don't know who he is.

A. Mr. Eccles, I take it you are talking about. Well, I will say on Mr. Eccles' subject of taxation that I don't think he spoke for the Administration, I doubt seriously if he spoke for the Congress, and I am absolutely positive he did not speak for the Treasury.

Q. Mr. Secretary, you said you doubted he spoke for what?

A. The Congress.

Q. What was the last?

Definitely he did not speak for the Treasury.

If he was speaking for the Treasury what would he have said?

A. That is one I can't answer.

Duffield: That's what the President calls an 'iffey' question.

Schwarz: Why don't they ask what the Treasury has to say!

Q. What were your objections to the speech? You only said you doubted he spoke for the Administration.

A. No, I doubt if he spoke for the Congress. If you want to publish it, you can say, I am damned certain he didn't speak for the Treasury, but I don't think that's good business to be quite so strong about it as that. As I say, off the record, or for background purposes, we have made a real sincere and conscientious effort here to find out from people all over the country what they thought—these people who were paying the taxes—what were the difficulties in the system and it seems to me that having made that earnest attempt to get that information this would indicate, to the public mind at any rate, what was the use of going down there and spending all that time and money to go tell the Treasury and talk to them about this situation if their minds were already made up. Our minds were not made up at all—they are absolutely open, and we want to keep them open, but to have somebody go out with a preconceived program, which program incidentally (again I say off the record) I don't subscribe to at all. I think it would be the worst thing in the world we could do to have the Administration go up and say we are going to just raise taxes here and sock the little fellow and sock the undistributed earnings—that's what he said, put back the undistributed profits tax.

Q. What did he call it?

A. Rainy-day reserves.

Q. You could see he didn't have a good press agent.

A. Yes, that would be as popular as hell with the country!

Q. Mr. Secretary, the one statement that your mind is open on this thing, we may have that on the record?

A. Yes, I don't mind saying that because that is the absolute truth. The Administration has no definite program in mind at all. We have an absolutely open mind and we are not making any commitments of any kind, not making any statements about it.

Q. Well, I think the erroneous impression, if any, created by that speech might be that since the Treasury didn't announce its program this man, as an authority of the Government, speaking the way he did, the reason that you haven't announced the program is what you just stated--that you are saving your judgment until you have studied all the facts.

A. Another thing, again talking off the record, we would be absolutely foolish and silly at this stage of the game if we did have a program or would say we either will ask for more taxes or not ask for more taxes. Nobody can say what even the indicated return will be and this business situation is going forward so steadily that nobody but a damned fool can say I can tell you right now what revenue will be next year. We don't know whether it will be $500,000,000 more revenue or a billion dollars more revenue with the present tax system. It would be foolish, looking all the way to '41, 18 months ahead, to say we know now just what we are going to require in revenue. That doesn't make sense. I don't see how any sensible person could make such a statement.

Q. Can we say for the record that you say that it is far too early to decide on any definite tax program for next year, to hook it up with this open-mind thing?

A. I said a moment ago, I thought for the record, that we had an absolutely open mind and that we had made no recommendations and that our minds hadn't crystallized, and, under the circumstances, could not be crystallized.

Q. Mr. Secretary, Mr. Eccles' speech received favorable comment in certain sections of the press. For example, the question of financing further armament expenditures, plus relief, etc. They pointed out that higher taxes is a sound way of offsetting these deficits rather than borrowing, and in some sections of the press that received favorable comment. Would you make some statement about that? His idea, he was projecting also into the future—1941 and 1942—and taking into consideration the huge armament expenditures, plus relief and other general costs of the Government.

A. I won't make any statement for the record about that for the simple reason it gets into a subject entirely out of my province. I only have one phase of it. I am not charged with making Administration policy as to how much we are going to spend or save. Our job, as appropriations are made, is to find as much revenue as we can without distorting economy from the revenue system.

Q. Don't you think it is sound to finance expenditures from higher taxes?

A. I say, off the record, that I think it is sound to finance all expenditures of the Government through taxation as you go on. In other words, I don't believe you can go on ad infinitum spending $4,000,000,000 more than you collect. That may be an old-fashioned viewpoint that you should pay your bills, but I can't get it out of my head.

Q. Your old argument with Mr. Eccles is - - ?

A. My argument is he butted into the tax problem and he hasn't got a God-damned thing to do with it. He can holler about spending as much as he likes—that's his business. That's his viewpoint and every man is entitled to his viewpoint. I've got mine, he's got his. They don't go along parallel lines.

Q. Then you won't make any comment on the two subjects?

A. No, you understand why I can't. As I say, that is none of my damned business and he can be as critical of me when I talk about the spending program, whoever's baby that is. I try to mind my own business and all I ask him to do is mind his.

Q. Can we quote you on that? (Laughter)

A. No.

Q. He's in bad shape; he's got a bad shoulder (Mr. Hanes). I thought maybe you meant Eccles.

A. He's not here; that's the only excuse I've got.

Q. Have you had any report yet from Guatemala as to whether Mr. Gaston's pockets have been picked?

A. The only report I have had is the press reports—no direct reports.

Q. What about this central bank institution they're talking about down there? I see it was projected.

A. They are talking about a tripartite situation or something like that. It would be a 21-partite, but that I don't know anything about and I don't want to say anything about it until Herbert gets back because I am just as ignorant as I can be about what they are doing down there.

Q. Apropos of that situation how are your conferences coming along with the State Department and Mr. Jones on the Latin-American credit situation?

A. I haven't attended any of those conferences. The Secretary of the Treasury, Mr. Jones and Mr. Welles are, I think, the final committee on whatever may be done in South America, but I haven't attended any of those meetings so I am not up-to-date on them.

Q. There won't be any financing until the Secretary gets back?

A. No.

Q. Mr. Hanes, is there anything you can say for the record as to how you think general business is going along?

A. I don't know if I am prepared to give you anything very concrete at this moment.

Q. Haven't you had some reports from your experts apropos of the forecast you have to make on business conditions next year?

A. Yes, I will say the Treasury forecast for business is extremely optimistic.

Q. Are you at all concerned about the inventory situation?

A. No, I am not concerned about it; I don't see any tremendous accumulation at the moment.

Q. Mr. Secretary, when you said the forecast was extremely optimistic, does that mean over, say, the next year?

A. Well, we don't try to go that far. We are just looking now at the next six months. I would say, off the record, under normal circumstances, what I would look for (this is just purely my own personal viewpoint--don't charge this to the Treasury); I would look for a normal slackening in business which we generally have around the first of January, after the Christmas buying. I know every other citizen in the United States does the same thing I do. I call my family together and say, 'Look here! We spent a lot more money than we've got this Christmas, so we are not going to eat so good in January.' And I think in general there is a normal slackening in business, but I don't subscribe to the viewpoint, and haven't right along, of the economists who have been talking about a real slump in January, February and March. I just can't see that.

Q. Is that on the record?

A. No.

Q. How about the part you saying you personally look for a normal slackening in business right after Christmas?

A. Unless you followed it up, Sandy, that would put me in the category I don't want to be put in and that is I believe there is going to be a real slump in business in January, February and March. You see the Federal Reserve Board index is probably going to be around 123 to 125. The great weight in that average is the steel operations have moved that up tremendously. Steel is going like a house afire. I would expect some normal slackening in that level but a slackening to 118 or 115 would still be a real move forward since we have been operating around a level of 92 to 98, so whatever happens you have had a tremendous impetus given to the steel industry but this rush of orders to the automobile industry and it is quite natural—anybody in the automobile business using steel products, after the Germans marched into Poland it would be quite obvious to anybody that our steel manufacturers were going to have big business from abroad when neutrality was changed. So I think it is perfectly obvious that the prudent manufacturer would go out and supply himself with materials, knowing that the demand was just bound to come from abroad--there isn't any other way about it.

Q. You don't want to say for the record that you disagree with the forecasters of doom?

A. No, I don't want to be controversial about this.

Q. You have already said that the Treasury view for six months is extremely optimistic about business. Wouldn't you want to say that your personal opinion is that after the slackening in January business would resume?

A. Do you think that is too far?

Schwarz: I wouldn't use the term--anything so specific.

Hanes: If you take out the extremely optimistic--because my optimism is tempered and it must be by changing events.

Q. What can we say?

A. The Treasury is optimistic about business.

Q. That is what your forecasts show?

A. Yes.

Q. How will we phrase that again? The way you just said it is the Treasury is optimistic about business conditions and then you said that applied only to the next six months.

A. Yes, we are not making any effort to look too far in the crystal.

Q. Can we say on the record that your personal viewpoint is that there is likely to be a moderate slackening after the first of the year, seasonal slackening, but that you don't look for any serious —?

A. No sustained downturn in business.

Schwarz: That relates to tax production.

Hanes: Yes.

Q. Of course, the Treasury is following the situation very closely; they've got very good contacts.

A. They are in the process of following it every day because we have got to make the estimates for the yield of this tax system and I will say again, off the record, that if you go back and look up the Treasury history of this group of fellows doing this forecasting I have been amazed by the way they have hit it on the nose; they haven't missed that thing hardly at all. I have forgotten what the figures are but they haven't been more than 1 or 2% off. I have got great confidence in them; they just haven't been wrong.

Q. Mr. Secretary, couldn't we tie these two things up and say that one reason for your optimism is that you want to see what the revenue from the existing tax structure will be?

A. And you can say that the outlook for increased yield from the present tax system is bright. That is about all I've got on my mind.

Q. Thank you, Mr. Secretary.

November 16, 1939

My dear Mr. Chen:

I sincerely appreciate your letter of November 15th, and I will be glad to pass this information on to the Secretary.

With every good wish,

Sincerely yours,

(Signed) John W. Hanes

Mr. Kwang Pu Chen
Room 1918
630 Fifth Avenue
New York, New York

jr

KWANG PU CHEN
ROOM 1919
630 FIFTH AVENUE
NEW YORK

November 15, 1939

CONFIDENTIAL

Mr. John W. Hanes
Treasury Department
Washington, D. C.

Dear Mr. Hanes:

In a recent conversation which I had with Secretary Morgenthau he inquired whether Mr. Litvinov had recently been in Chungking. He also understood that Mr. Litvinov's mission had not been a success. The Secretary asked me to wire back to Chungking for clarification.

I cabled an inquiry to Dr. H. H. Kung regarding this question, and have today received his reply. He informs me that there is absolutely no foundation for the information about Mr. Litvinov's visit to Chungking. He considers this another example of Japanese propaganda. I have also made a personal inquiry with a Chinese official recently arrived from Chungking, and he told me that he never heard of Mr. Litvinov's visit to Chungking, but there has been a Russian Trade Mission there discussing some business matters with the Government. That might have given rise to such rumors.

I shall feel thankful if you will kindly pass the above information, at your convenience, to The Secretary.

With kindest personal regards,

Very sincerely yours,

K. P. Chen

KPC:GT

Discussed at meeting in Morgy's office 11/30/39

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.

THEODOTUS A. COWELL
HARRY J. RUDICK

CABLE ADDRESS
LORDATTY
NEW YORK

WASHINGTON OFFICE
SOUTHERN BUILDING

November 16, 1939

The President,
The White House,
Washington, D. C.

My dear Mr. President:

I enclose herewith a memorandum which attempts to implement your ideas upon an excess profits tax. The memorandum discusses some of the principal problems which the drafting of a statute would involve and suggests a number of problems which need further consideration. The subject is a difficult one and requires more study than could be given to it in the limited time available, but I hope the enclosed memorandum will expedite a clarification of the subject.

Generally speaking, the memorandum adopts two of the basic factors you have suggested, namely, (1) net cost of assets, and (2) capitalized earnings. For reasons given at pages 19 and 34 appraised value and book value are not taken, but the two factors employed in ascertaining invested capital are to a large degree a duplication of the discarded factors. In other words, net cost of assets amounts to a duplication of correct book values, and capitalized earnings approximates correct appraised value. Thus, we preserve your essential thought of compensating for inaccuracies inherent in the use of one formula for the computation of invested capital or excess taxable earnings.

In a nutshell, the tax discussed is a graduated tax upon excess earnings. Excess taxable earnings are defined as earnings in excess of the earnings of a representative standard period, 1935 to 1938 inclusive, but they may not be taken at less than 8% or more than 12% of the invested capital. This minimum allowance is to protect corporations with low earnings during the representative period. The maximum allowance is to insure the collection of tax from corporations which had large earnings during the representative period, and which should be in the best position to pay.

In order to forestall criticism of the type directed against the World War excess profits tax, the device is adopted of ignoring cost of assets acquired before March 1, 1913, and taking that value. This scheme is favorable to taxpayers; its virtue is that almost all assets can be taken at their net cost basis for purposes of income tax depletion or depreciation. This enormously simplifies the tax by using to advantage computations now available to taxpayers and the Bureau of Internal Revenue. We thus eliminate one of the greatest difficulties and irritations incident to the World War excess profits tax.

Naturally, all figures used by way of suggesting rates and exemptions are tentative and illustrative.

If I have not made the subject clear in the enclosed memorandum, I shall be very glad to give any further explanations that may be necessary.

Respectfully yours,

Randolph E Paul

MEMORANDUM ON EXCESS PROFITS TAX

INTRODUCTION

The purpose of this memorandum is to summarize a general plan for the taxation of excess profits expected to be forthcoming as part of the impact of the war upon the American economy.[1] The memorandum will first set forth the fundamental proposal in broad outline; it will then attempt a slightly more detailed exposition of some of the necessary provisions of a statute imposing such a tax. The description of the tax is not intended to be complete, but a number of suggestions are offered in the hope that they may serve as a basis for the framing of a statute that will be fair and workable.

---

1. No attempt will be made to draft any precise statutory provisions.

The advisability of once more imposing a true excess profits[1] tax has frequently been stated by impartial commentators,[2] often with the further thought that such a tax, if administratively successful, might be retained as a permanent part of the tax system.

---

1. The earliest instance of such a tax in the United States, a 12½% tax on manufacturers of munitions, was imposed by the 1916 Act. A profits tax was imposed by the Act of March 3, 1917, (30 Stat. at Large 1000) which was replaced before it was ever applied by the excess profits tax of October 3, 1917 (Revenue Act of 1917, Secs. 201-210), both of which reappeared in revamped form in the Revenue Act of 1918.

This 1918 Act was a combination of two taxes: one, the excess profits tax proper, and the other, a so-called war profits tax. The first was theoretically on the excess of profits over pre-war average earnings. The two normal rates of return were deducted from actual profits to get the income subject to tax. The normal rate of return under the excess profits tax was 8% of the capital invested in the business during the taxable year. The tax was imposed on the difference between actual profits and normal profits plus an arbitrary allowance of $3,000. The normal rate of return under the war profits tax was the average profit for the period 1911 to 1913, plus or minus 10% of the increase or decrease in invested capital. The excess profits tax, in other words, assumed an 8% return on capital to be normal. The war profits tax assumed that pre-war earnings were normal, and that 10% profit during war time was normal. The method giving the higher tax was the computation to be used.

2. See, e.g., Twentieth Century Fund, Facing the Tax Problem (1937); Godfrey Nelson, War Profits Taxes and Their Records, 17 Taxes 569 (1939).

I. GENERAL DESCRIPTION OF TAX

The proposal has been made that a tax be enacted along the following general lines:

(1) Allow a return free from the tax of normal profits of the corporation.

(2) Tax any profits above the normal profits or normal return at graduated rates increasing as the profits realized in the taxable year exceeded the normal return.

(3) Profits would be defined, generally speaking,[1] in terms of "net income" for purposes of the existing income tax, thus simplifying administration by taking full advantage of work which has to be done independently of the new statute.

(4) The normal rate of return would be measured by the following factors: (a) equity capital invested in the corporation as of the beginning[2] of the taxable year, which would

---

1. Variations are indicated at p. 43 below.

2. Possibly this invested capital should be increased on account of stock dividends paid during the year. See p. 30.

The 1918 excess profits tax used the "average" of the taxable year; 1918 Act, Sec. 326 (d). The "average" of the year referred to capital paid in; no earnings of the year were permitted to be included in invested capital. This rule furnishes a reasonable precedent for the present act.

reflect assets at cost,[1] or depleted or depreciated cost as determined by the Bureau of Internal Revenue for income tax purposes; (b) the average profits over some standard representative period, such as the period from 1935 to 1938, inclusive.

(5) There would then be allowed as normal profits or normal return the average profits of the standard or representative period[2] with the limitation that these profits taken as normal and used as an excess profits tax credit,[3] might not exceed 8% of the invested capital, plus 50%, which amounts to 12%. And 8 % of the invested capital would be taken as normal profits even if the corporation had average profits[4] for the standard period of less than that amount.

For example:

(a) If a corporation has average standard period profits of $200,000, current profits of $250,000 and an invested capital of only $200,000, there would be normal earnings of only $24,000, consisting of $16,000, being 8% of

---

1. As to value at March 1, 1913, see p. 25.

2. This period is sometimes referred to below as the "standard period".

3. 1918, 1921 Acts, Sec. 312.

4. There are some who feel that these percentages of 8% and 12% should be 5% and 15%, making for a bigger spread and taking in more corporations. This is a matter which, of course, requires complete study before it is decided. The recent Canadian statute uses an optional rate of 5%.

invested capital plus an increase of 50%, or $8,000,[1] leaving taxable profits of $226,000.

(b) If a corporation has average standard period profits of $200,000, current profits of $250,000 and an invested capital of $3,000,000, there would be normal earnings of $240,000 consisting of 8% of $3,000,000, and the lower average earnings of $200,000 would be disregarded, leaving only $10,000 in the taxable class.

I.(a) Example of Computation of Tax

Before commenting on the above factors entering into the computation of the tax it may clarify discussion to set forth an example of a hypothetical tax liability as follows:[2]

1. As an alternative method there might be used as normal profits an average of the earnings of the representative period and 8% of the invested capital. For example, if a company had representative earnings of $200,000 and a capital cost of $200,000, 8% of which is $16,000, its normal profits would be 1/2 of $216,000, or $108,000.

2. The rates used in this example are merely illustrative.

Invested Capital		$10,000,000
8% of above	$800,000	
50% of this percentage	400,000	1,200,000
Average standard profits - 1935 to 1938		2,000,000
Statutory normal return		1,200,000
Actual net income, Sec. 21, Internal Revenue Code		3,000,000
Income tax liability @ 18% (approx.)		540,000
Net income after ordinary corporate tax		$ 2,460,000

	Amount of Net Income Each Bracket	Statutory Normal Return (excess Profits Tax Credit	Balance Subject To Tax	Rate of Tax	Amount of Tax
Not over 15% of invested capital	1,500,000	1,200,000	300,000	10%	30,000
Over 15% but not over 18% of invested capital	300,000		300,000	25%	75,000
Over 18% of invested capital	660,000		660,000	50%	330,000
Total Excess Profits Tax					$435,000

Average percentage of excess profits tax on excess income - 34½%

Average percentage of aggregate excess profits and income tax liability on total net income - 32½%

There is attached hereto, as Exhibit A, a computation in another case in which the taxpayer's average standard profits are insufficient to give exemption greater than 8% of invested capital.

I. (b) Necessity of Graduated Rates

Naturally the exigencies of revenue needs would be the primary factor in determining the precise rates to be used.[1] The suggested proposal involves the use of a graduated rate scale, - in this respect it is unlike the current British Act, but like the Canadian Act and the American 1918 Act.

Excess profits taxation is grounded on the assumption that extraordinary profits can be regarded as windfall gains. This assumption seems to be the more justified the higher the profits are above the "normal". Profits only a little bit higher than the "normal" may be due to windfalls from war or may be due to other reasons; therefore, it seems justified to leave a large portion of profits which only slightly surpass the "normal" in the hands of business, but to increase the tax rates with increasing profit ratio under the assumption that the higher the profitability the greater the probability that they must be[2] attributed to factors other than special skill of management.

The general rule that the ability to pay principle does not justify a graduation of corporate taxes does not hold true for the excess profits taxes. The general rule is based upon the

---

1. For example, the legislative history of the 1918 Act shows that that act was expected to yield $6,000,000,000, of which the excess profits tax was expected to yield $2,400,000,000. (Senate Finance Committee Report No. 617 (1919).

It is estimated that the 1917 excess profits tax absorbed about 44% of the increase in annual profit from $4,123,000,000 to $9,500,000,000. A group of the largest manufacturing and mining companies in the country paid in taxes (including both the normal income taxes and the excess or war profits taxes) about 25% of their net taxable income for 1917 and about 35% of the same income for 1918. For refinements of these percentages, see Report of Special Committee on Investigation of Munitions Industry, No. 944, Part 2, 74th Cong., 1st Sess., p. 14 (1935).

2. It is impossible to determine which profits are due to management and which are attributable to economic conditions or semi-monopolistic advantages.

assumption that corporate taxes are ultimately borne by the stockholder. If there should be any graduation it should be in correspondence to the income bracket to which the stockholder belongs, which of course can be done only through the individual income tax. Excess profits taxation is based on the theory that these profits should be taxed irrespective of whether they would otherwise accrue to a person in the lower or in the higher brackets.

This tax is not based on the principle of the individual ability to pay, but on the theory that gains attributable to extraneous factors be absorbed as much as possible by taxation. It is a tax on the corporation _per se_ and not a tax on individuals through the means of collection at the source.

There are some arguments against graduated rates. All excess profits taxation implies a certain crudeness in the determination of "normal" profits. If a uniform standard ratio is the criterion of "normal" profits, then corporations with a normally high ratio (for instance, because of high risk in the specific branch) would fall into a higher bracket under the principle of graduation. The necessary crudeness of the criterion thereby would be aggravated.

If standard earnings in a base period are chosen as a criterion, then corporations which happen to have extraordinarily low profits in the base period are penalized by a high bracket tax, if graduation is applied.

If an excess profits tax is proposed for a neutral country in a period of war, the rates cannot be too drastic. In such a sitgation business is not predominantly determined by the impact of the war, so that all high profits could be regarded as war profits. If the progression, therefore, should not reach very high percentages it may be more advisable to enact a flat rate with a degression for profits just above the criterion of "normal" profits. Such a degression is advisable in order to avoid a too sudden jump from the non-taxable to the taxable profits.

A flat rate tax is more easily administered than a progressive tax.

I.(c) Application of the Tax

The Act should cover virtually all corporations; segregation of war profits industries in the conventional sense of the term would be impractical, since all increased profits will be partly attributable to war activities and to the attendant rise in price levels. It is noteworthy that in the first war act of 1916 munition makers were singled out as the sole object of the tax. But other profits soared at the same time, and all industries were soon drawn within the net of subsequent acts.[1] Specific types of corporations should probably be treated as follows:

---

1. It is true that a universal application of the tax might lead to harsh consequences in particular cases. For example, in the case of gold mining it was found under the earlier acts that while gold brought the same price regardless of the war, nevertheless the cost of labor and materials went up. Therefore, such mining was exempted by special provisions in the Act of 1918 (Revenue Act of 1918, Sec. 304). There would probably be pressure at the present time for similar special exemptions wherever the prices in the industry in question are regulated by law, as for example, in the case of railroads. But in view of the allowance of a minimum return of 8% before the tax becomes operative, the need of such exemptions is far from clear.

(1) Corporations exempt from the income tax[1] should also be exempt from this tax in order to simplify administration and avoid complaint.

(2) Personal service corporations, in which capital is not a material income-producing factor, might be exempted from the excess profits tax, but might reasonably be taxed as partnerships, as was done under the 1918 and 1921 Acts.[2]

(3) Some favored treatment might be shown to very small corporations, which are not affiliated or subsidiary units of large corporations. Average statistics under the earlier acts covering profit-earning corporations show that the ratio of net income to capital varied, roughly speaking, in inverse proportion to the size of the company. Larger concerns seldom realize such a high percentage of profit as do successful concerns of moderate or small size. Therefore, to avoid an undue discrimination against small corporations, there might be exempted corporations with a net income of less than $25,000[3] or some other appropriate minimum amount.

---

1. Internal Revenue Code, Sec. 101.

2. This would be constitutionally more acceptable now than in 1918. See Helvering v. National Grocery Co., 304 U.S. 282 (1938). Moreover, it might be better statutory technique to give such corporations an option to be taxed as partnerships upon consent to certain regulations issued by the Commissioner. This technique might be especially valuable in the case of corporations engaged partly in personal service activities, where allocations of income would be necessary.

3. This was the dividing line under the undistributed profits surtax, as amended by the 1938 Act, Sec. 14(a).

(4) New corporations would also have to be treated somewhat differently, as will be discussed more in detail below. Here the reference to pre-war activities would have to fall away, and an *a priori* normal return of some figure between 8 and 12% of invested capital would have to be taken.

(5) Foreign corporations might be taxed under a provision similar to the special assessment provisions of the 1918 and 1921 Acts discussed below, or they might be given an option to use the general method of computing normal return as to any capital actually employed within the United States.[1]

(6) Personal holding companies and foreign personal holding companies should be exempted; they are now subjected to taxes calculated to compel their disintegration.[2]

---

1. Compare Canadian Excess Profits Tax Act, Sec. 2(c).
2. Titles IA, Supplement P.

(7) Successor Corporations The reorganization sections, which have been embodied in the income tax statute since 1918, render the treatment of reorganizations prior to or after the enactment of the tax much less perplexing than under the old acts. The 1918 and 1921 Acts[1] drew the line at a 50% change in interest or control in determining whether assets should be stepped up for invested capital purposes when there had been a reorganization, consolidation or change in ownership of a trade or business. In computing invested capital for the current taxable year after the imposition of the tax for any corporation reorganized or consolidated within the meaning of the tax-free reorganization sections of the income tax statute,[2] assets transferred to a new corporation may under the proposed tax be regarded, as for income tax purposes as if still in the hands of the predecessor corporate owner or at

---

1. 1918, 1921 Acts, Sec. 331
2. Internal Revenue Code, Sec. 112, 113.

the cost to such previous owner, if the previous owner was not a corporation. Generally speaking, the reorganization-basis provisions would be applicable. Proper adjustment would, of course, have to be made for any cash or property actually paid in as part of the transaction.

(8) Individuals and Partnerships No attempt need be made to apply the excess profits tax to individuals or to partnerships as under the recently-enacted British statute (except as to professions dependent mainly upon personal qualifications) and under our 1917, but not the 1918, Act.[1] While it may be somewhat illogical to exempt individuals, corporations make up the great body of American business,[2] and the individual surtaxes will take good care of the problem of excess profits so far as individuals and partnerships are concerned. Individual capital gains are another matter; if we have a substantial rise in price levels, capital gains will be war or excess profits in every true sense of the term. But the better road to the taxation of such profits seems to be

1. The excess profits tax of 1917 caused great discontent and was barely endured even as a war measure.

2. Kennedy, Dividends to Pay, p. 1(1939), stating that 385,000 corporations as of 1925 increased to 456,000 in 1939.

through the raising of capital gain rates in the Income Tax Title.[1]

The individual surtaxes will similarly prevent any gross inequality between the tax on corporate and non-corporate business such as might raise an issue of constitutionality on the grounds of arbitrary classification.

I.(d) Duration of Tax

It might be desirable to retain such a tax as a permanent part of the revenue system. Bookkeeping devices might avoid part of the incidence of any temporary excess profits tax. And it may further be said that corporations earning a very large return on their invested capital are able to bear a larger part of the tax burden than other corporations.

One technical problem which would become accentuated with a continued duration of the tax would involve the standard period of earnings to be employed. As time passed on and economic changes occurred, the use of the 1935 to 1938 period would grow more and more antiquated and out of proper comparison with present facts. The use of a moving basis (in other words, the use of the year immediately prior to the taxable year as

---

1. Sec. 117.

a part of the standard period) is a possible solution; this method, however, would give corporations a vested interest in one year's excess profits by permitting them to reduce their subsequent tax accordingly. Potential errancy in the use of a moving basis would be less serious if, as has been suggested, standard profits (or excess profits tax credit) are deemed to be not less than 8% and not more than 12% of the invested capital. An alternative, and perhaps preferable, solution would be to change the 1935 to 1938 period to some different span of years after industry had passed through a fairly normal period.

II. USE OF INVESTED CAPITAL

While average profits during the standard period would be the criterion usually employed under the suggested proposal, the invested capital would be referred to for the purpose of a minimum and maximum allowance. There is a vital reason for these minimum and maximum allowances which should be set forth at this point. Contrary to popular impression, it appears incontrovertible that a great many of the leading concerns have realized very substantial profits in the so-called depression.[1] A tax which merely reached

---

1. See Kennedy, Dividends to Pay, Ch. 1 (1939).

profits above these large depression-period profits would permit the escape of large sources of revenue by those best able to bear their share of the tax burdens. On the other hand, there are many concerns which, either because of their position in the industry or because of the nature of the industry in which they are engaged, had low profits in the depression period. Such concerns, the very concerns which should be permitted a reasonable opportunity to recoup losses, would be heavily penalized if excess profits were defined as profits of these low profit years. The only protection which can be reasonably afforded for such concerns is measurement of normal or standard profits by reference to invested capital, which in turn measured by reference to the depreciated or depleted cost of assets employed in the business.

II. (a) The Necessity of Using Invested Capital

The suggested proposal, it will be noticed, combines the concept of standard profits with that of a normal rate of return upon invested capital.[1] From one viewpoint, the value of

---

1. In this respect it is somewhat similar to the recently enacted British excess profits tax effective April 1, 1939. This tax is fixed at 60% of the amount by which the profits of the taxable year exceed the pre-war standard of profits. The standard profit is determined with reference to the profits of a standard period prescribed according to when the trade or business was commenced. If the business was commenced before January 1, 1935, the standard period as optional to the taxpayer is as follows: either 1935 or 1936, the years 1935 and 1937, or the years 1936 and 1937. In the case of a business started after July 1, 1936, the standard profits are the "statutory percentage" which is 8% of the invested capital in the case of corporations and 10% in relation to non-corporate organizations. Minimum allowances are made in lieu of standard profits. It is also provided that referees may make special allowances for lines of business involving particular risks or other conditions.

the assumed invested capital necessarily depends upon the standard earnings; from another viewpoint the exempted profits depend upon the invested capital. The construction of an "invested capital" based on earnings alone would involve a logical circle. If it were proposed to tax all excess profits on an abstract "invested capital," which itself would be found by capitalizing earnings at a certain percentage, and if that same percentage of return were then permitted to be received free from tax, we would be indulging in circular reasoning.[1] There should obviously

---

1. It is true that the use of capitalized earnings would be one method of valuing invested capital for purpose of an excess profits tax. One difficulty in this connection, however, would be the selection of the capitalization rate for each industry, considering how some businesses involve little and others a very great hazard, as well as how the earnings of some industries fluctuate widely while the profits of others are relatively stable. There would be no yardstick here except the vague general principle that high risk industries should be capitalized on the basis of a higher rate of return than more stable low risk industries. But refined differentiation would complicate administration, and it would probably be necessary to adopt a liberal capitalization rate which would be applicable to all industries. This would favor the high risk industries, which is economically desirable. However, in the interest of consistency it would then be necessary to take the same rate of capitalization in determining how much net income should be exempt from tax altogether. Thus, if it were decided to leave a 6% return free from the tax, average net income during the standard period might be capitalized by multiplying them by 16 2/3 which would certainly be a reasonably liberal rate of capitalization. The same result, however, can be reached more directly and more simply by merely using the average standard profits as the norm without any attempt at capitalization.

It is a serious question whether the old concepts of comparative risk factors are any longer valid. For instances, the old idea was that the oil and mining industries are extra-hazardous. Are they today? These industries are usually organized on a large scale which averages out dry holes and unprofitable mines; moreover, modern methods of exploration and the man of the discovery have greatly minimized old hazards.

(cont'd p. 18)

be some contributing measure of capital independent of standard profits. Moreover, as indicated above, the use of the factor of earnings alone would discriminate in favor of corporations which profited materially during the depression years, and would be especially unfair in the case of new and speculative industries. It might also over-accent the factor of good will. A very costly mine shaft may never have produced a single ton of coal during the standard period, and the corporations which achieved good will peaks in the representative period would pay no tax.

Therefore, whatever its difficulties the use of an invested capital concept similar in many respects to that of the 1918 Act seems desirable. As to most assets the invested capital computed would be related directly to the cost basis originally arrived at for depreciation or depletion[1] purposes under the income tax. The use of such a basis is better adapted to a permanent tax than any exemption related in every case only to average

---

(1 cont'd from p. 17)

street certainly no longer thinks of the stock of the Texas Oil Company as being stock of a hazardous enterprise. He may be up-to-date in his thinking and the old recapitalization formulae may be what are obsolete. On the other hand, perhaps a comparatively new company engaged in a reputedly stable industry should be regarded as subject to a high risk. The man of the street may be up-to-date in his thinking and the old recapitalization formulae may be what are obsolete.

1. See however p. 27, note 5, as to percentage depletion.

earnings. It is a more responsible figure than book value[1] and is readily available for use, since most of its underlying material has already been computed for income tax purposes.[2]

---

1. This would perhaps be the most arbitrary possible basis of value. In the case of most well-conducted corporations book values originate in cost, but many corporations even today carry assets at book values completely out of line, up and down, with depreciated costs and current values. Many assets of great value never get on the books at all; on the other hand, many assets of small value appear on the books at inflated values. Even in the case of corporations whose book values started with genuine cost there would be variances originating in differing ideas and estimates of depreciation, obsolescence, etc. Since a high book value would raise employed capital, the use of this factor would tend to penalize conservative bookkeeping, and there would be high-sounding talk of conflict between New Deal agencies.

The answer may be made that crudities inherent in the use of book values might be compensated by using book value as only one of several factors. This is true, and it is also true that book or asset values are often taken in evidence of value in the absence of other evidence. (See Paul, Selected Studies in Federal Taxation, p. 211 (1937). But this reply is only a partial answer, and any tax which was referable to book values, so often stated by the courts to be merely evidentiary, (see e.g., Doyle v. Mitchell Bros., 247 U.S. 179 (1918)) would be subjected to some justifiable criticism, and much additional unjustifiable criticism as well.

2. True, the use of value at March 1, 1913, for income tax purposes somewhat complicates the point, but this complication need not trouble us. See p. 24

II.(b) Criticism of Earlier Excess Profits Taxes

Before defining invested capital in more explicit terms, it may be well briefly to dispose of the criticisms made of the World War excess profits taxes.[1] Lack of administrative experience, deficiencies in bookkeeping records and unavailability of detailed factual information made invested capital under the old acts an unpopular institution. The computation of invested capital was irritating and costly to taxpayers and delayed the collection of revenue under a procedural system which put a premium on under-payment of tax in the original return. However, the Government and taxpayers were just beginning to understand the statute and its application when Congress repealed the tax, thus throwing away the knowledge we had gained. The old tax had a sound principle underlying it. If we had left it in the revenue laws,

1. Invested capital under our earlier excess profits acts was defined as (a) cash paid in, (b) the actual cash value of tangible property paid in, and (c) paid-in or earned surplus employed in the business. (1918, 1921 Acts, Sec. 326) Patents, trademarks, good will, copyrights and other intangible assets were included up to an amount not exceeding the actual value of such property when paid in, the par value of the stock issued therefor, or 25% of the total par value of the corporation's shares, whichever was the lowest.

its administration would have become relatively simple by this time. Moreover, its graduated rates might have diminished the incentive for tax avoidance by corporate surplus accumulation.

Without attempting at the moment any discussion of such technical problems as the exclusion of borrowed capital,[1] the limitations to be put upon the inclusion of intangible property,[2] and inadmissible assets,[3] and the treatment of reorganizations,[4] reference may be briefly made to the troublesome problem of valuation for purposes of invested capital. There was no special difficulty under the old acts with respect to cash paid in, but corporate stock is frequently issued for property, both tangible and intangible. The method of computing invested capital used under the earlier acts therefore involved a valuation of property paid in to the corporations at the time paid in. Such a valuation, as

---

1. Holmes, Federal Taxes, p. 1275 (1923 Ed.); see p. 32

2. Holmes, Federal Taxes, p. 1257 (1923 Ed.); see p. 28

3. Holmes, Federal Taxes, p. 1255 (1923 Ed.); see p. 34

4. Holmes, Federal Taxes, p. 1291 (1923 Ed.), See also discussion of the Old Dominion case, Report of Special Committee on Investigation of Munitions Industry No. 944, Part 2, 74th Cong., 1st Sess., pp. 19, 21 (1935).

of the time paid in, even though previous to March 1, 1913, was presumably once made by the Treasury for corporations old enough to have been subject to the tax imposed by the 1918 and 1921 Acts (except corporations granted special assessments), though it may be a question to what extent details of the valuations so made could now be recovered from old files. There would not be the same problem in the case of newer corporations since the Bureau of Internal Revenue presumably has sufficient cost records. But for reasons indicated below, these difficulties may be avoided by ignoring acquisition cost before March 1, 1913.

Unless we do so, the violent, and often bitter, criticism of the old excess profits tax, particularly in its use of invested capital as a base for the exemption and, again, particularly in connection with the difficulties involved in valuations, made by such experts as Mr. Arthur Ballantine, former Assistant Secretary of the Treasury, the late Dr. Thomas S. Adams, former Advisor to the

---

1. Another more theoretical problem under this method of computation would be the determination of a basic theory of value. The 1918 and 1921 Acts used the term "actual cash value" (Sec. 326 (a)), and perhaps this term is as good as any that may be found, for in the end value is a question of fact the answer to which can never be determined with mathematical accuracy; the question must always be determined by a process of compromise with practical reference to a composite of complex circumstances, and the basic terms used in the statute are a generality of little practical consequence. (Paul, Selected Studies in Federal Taxation, p. 168 (1937)).

Treasury, and others would no doubt be repeated.[1] This criticism seems to have been considerably exaggerated, but it was sufficiently telling to accomplish the repeal of the old excess profits tax. The task of government and taxpayers under a new act would not be as difficult as it was under the 1918 and 1921 Acts for several reasons, among which are:

(a) Corporate records are in better shape than they were in the last war;

(b) The Bureau is more adequately manned and more experienced than it was in the last war; corporate advisors in the legal and accounting fields are also more competent and experienced;

(c) It should be possible to re-utilize considerable old valuation work; and

(d) The Bureau of Internal Revenue is in the posession of much data which would be useful, and so perhaps are other branches of the government, such as the S.E.C.

---

1. See Report of Special Committee on Investigation of Munitions Industry No. 944, Part 2, 74th Cong., 1st Sess., p. 19 (1935).

II.(c) The Influence of Depreciated Cost

There is a further and more fundamental reason why the determination of invested capital will be easier today than it was in the World War years. The capital (including paid-in surplus) and earned surplus[1] of a corporation, or its net worth,[2] consist, when all is said and done, of nothing else but the difference between (a) the cost of the corporate non-depreciable and non-depletable assets plus (b) the net cost of the corporate depletable and depreciable assets after depletion and depreciation and (c) the borrowed capital of the corporation, both funded and current. The conventional approach is from the liability side of the balance sheet. But there is another

---

1. Of course, adjustment of earned surplus has to be made for reserves which are mere subdivisions of the surplus account. Reserves for contingencies, reserves for self insurance and reserves for Federal income and profits taxes are properly to be considered parts of surplus. This is not generally true of any reserves the additions to which may be deducted in computing net income. Among such latter type of reserves are reserves for depreciation (which are presumed to offset the loss in value of assets) and reserves for state or local taxes where the corporation reports on the accrual basis and the amounts carried to such reserves have been deducted. (See generally on this subject Reg. 45, Art. 839).

2. The "net worth" of a corporation consists of the excess of assets over liabilities (to creditors, as distinguished from the proprietorship account). See Kohler and Morrison, Principles of Accounting (1931) p. 33; Kester, Accounting (1925) Vol. II, pp. 398, 412; Kester, Advanced Accounting, 3rd Ed. (1933) Ch. 21. In its broadest sense, "surplus" represents the excess of net worth over the capital stock of the corporation, with certain exceptions (as where the capital stock was originally issued at a discount). Hatfield, Accounting (1931) p. 296; Kester, Accounting (1925) Vol. II, p. 439. See also Kester, Advanced Accounting, 3rd Ed. (1933) Ch. 25.

approach - namely, from the asset side of the balance sheet. The capital and earned surplus may more easily be determined today than in the World War years, because we are dealing in the main with assets purchased or acquired during a period in which cost depreciation affected net income. For most corporations the Bureau and taxpayers must be in the possession of data fixing the cost of assets,[1] including assets purchased with stock. Valuation problems are therefore reduced, and we have available a current depreciated cost of assets on the asset side which fixes the surplus on the liability side. Where property was acquired before the advent of the income tax, the basis used should be the 1913 value (unlike the treatment under the old act which took original acquisition cost in the case of assets acquired prior to March 1, 1913) rather than attempting any retrospective appraisal as of the date contributed. No similar net cost basis may be currently available as to hon-

1. In some cases the basis may be the March 1, 1913 value.

depreciable assets, such as non-mineral lands and stocks representing the assets of subsidiary or other corporations. But undepreciated cost is a safe enough basis for such lands, and gross cost will usually be available, particularly where there has been a reorganization.[1] Where such cost was not available, the figure at which non-mineral land is carried on corporate books is usually not unrepresentative of its current value; and in the interest of simplicity the book value of the land at the date of the introduction of the bill into Congress might be used for this purpose, although this would work occasional injustice where a company had rigorously scaled down its book value without obtaining any income tax benefit from the reduction.[2] If we disregard cost of assets acquired prior to March 1, 1913, an asset-side amount is therefore reasonably available as to a large proportion of corporate assets, which establishes a firmer surplus account than was available at the time of administration of the earlier acts and thus minimizes to a remarkable degree the difficulties of computing invested capital which made these earlier acts so unpopular.

---

1. See Reg. 101, Art. 112(g)-6.

2. Stocks, or inadmissible assets, will be dealt with separately below.

III. THE CALCULATION OF INVESTED CAPITAL

(a) In General

Reference has been made to the simplicity of determining the first element of invested capital, - cash paid in. Apart from intangibles the paid-in and earned surplus accounts are plainly referable to the assets of the corporation; if these assets are correctly valued, surplus is a balancing figure.[1] For purposes of computing the correct surplus such assets as cash, and notes and accounts receivable, could be taken at their face value;[2] inventories might be valued, as for income tax purposes and as for purposes of invested capital under the old excess profits tax,[3] at cost, or cost or market, whichever is lower.[4] All depletable[5] and depreciable property, including the fixed property account, could be taken at the net original cost

---

1. See authorities cited in note 2, page 24.

2. There should perhaps be some discount for accounts and notes receivable which were not worth face value, but this is a matter of detail.

3. Holmes, Federal Taxes, p. 1268 (1923 Ed.)

4. Variations might be allowed where some other inventory basis is allowed to the taxpayer.

5. A special problem is presented by the percentage depletion deduction allowed to oil and gas producers and certain mining companies. (Sec.114 (b)). It is a question to be decided whether the excess of percentage depletion over cost or March 1, 1913, value depletion should be allowed as part of invested capital. The same question arises as to discovery depletion.

for income tax purposes, or net value at March 1, 1913,[1] a figure already generally available to the Bureau of Internal Revenue and taxpayers. This would leave such non-depreciable and non-depletable assets as land (except mineral lands) to be taken at book value. Any assets, such as tax-exempt bonds, the income from which is exempt, should, of course, be inadmissible as part of invested capital.[2]

III(b) Intangibles

The question of including intangible assets, such as patents, good will, etc., also needs special consideration. Intangibles, as well as tangibles, may contribute materially in some industries to the profits of a corporation. Where intangible values are in large part the result of deductible advertising and promotional expense, then inclusion beyond the recognition they obtain through the profits formula is hardly justified by considerations of equity. A better case can be made out for the inclusion of intangibles purchased for cash or stock, the value of which the taxpayer has not built up by deductible expenses. Such intangibles should be to some extent included in invested

1. This alternative basis for property acquired prior to that date is not a significant complication. It helps corporations organized prior to that date, but simplifies administration enormously.

2. This was done under the 1918 Act.

capital, perhaps to a greater extent than is recognized in the standard earnings formula.[1] This may lead to some discrimination between a corporation which acquires such assets by outright purchase, securing a substantial allowance therefor, and a corporation which has built up similar good will gradually by enterprise and activity; and with a heavy tax such discrimination, may, of course, cause serious inequity. But it must be remembered that most intangibles (such as patents, copyrights or franchises) purchased for cash or stock have a depreciable basis for income tax purposes. To fail to allow the inclusion of such intangibles would make for a departure from income tax practice.

Intangible values are to some extent recognized through the use of standard profits in the cases of corporations which have had earnings attributable to intangibles in the years prior to the incidence of the tax. But there are many instances in which a corporation did not own, or had not sufficiently developed intangible assets to produce earnings in the representative period. There are also cases in which intangibles might have been dormant in the standard or re-

---

1. If standard earnings reflect earnings on intangibles, as they will in the case of many corporations, the result under the proposed tax approaches the inclusion of intangibles *pro tanto* in invested capital.

presentative period. It seems desirable, therefore, to give greater recognition to intangibles than is afforded by the use of the standard profits formula. On the other hand, the arbitrary par value formula for the recognition of intangibles contained in the 1918 Act seems highly undesirable. A compromise would be the allowance of the entire amount of intangibles acquired for cash and the partial inclusion of intangibles acquired for stock. The inclusion of intangibles acquired for stock might be limited to the actual value of any stock given in exchange or by a provision that the figure used as their cost basis should not exceed 20%, or some other proportion, of the total cost basis.

III (c) Capitalized Earnings ofTaxable Year

As an incentive to equity financing, and the distribution of stock dividends, earnings capitalized during the current taxable year, at least up to the middle of the year,[1] might be included in invested capital by an express statutory provision, though this was not done under the earlier acts.[2] Such a provision would recognize, to the extent of capitaliza-

---

1. See page 3
2. Reg. 45, Art. 850.

tion, the indubitable fact that undivided profits of the early part of a taxable year contribute to the production of the profits of the later part of the year. The addition would contemplate the addition only of earnings of the current year, since the earnings of past years are already in invested capital. It must be admitted, however, that this mechanism involves difficulties of proof as to the amount of earnings, which difficulties might be excessive in comparison with what could be achieved. The inclusion of earnings capitalized during the first 6 months of the year should be limited to cases in which the capitalizing stock dividend was taxable to stockholders.

III. (d) Assets Not Employed in the Business

A further question arises as to whether there should be included in invested capital only assets which are actually employed in the business, which might in many cases be far from equal to the totality of assets. It may be plausibly argued that in a tax intended to fall upon the excess profits of business, only business assets should be considered. Also, a corporation with large accumulations of surplus would otherwise have an undue advantage, since it could invest that surplus in bonds yielding only a small but safe percentage of return and offset the high returns from its business operations with the relatively low return from investments. However, previous acts attempted no such differentiation and the attempt should be avoided due to the insurmountable practical difficulties which it would entail.

III (e) Borrowed Capital

Borrowed capital should be excluded from invested capital as under the earlier acts,[1] since the bondholders are not the equity owners or the distributees of the corporation. It is true that if borrowed capital is excluded, there is likely to be a considerable number of corporations with no invested capital or not more than a relatively nominal capital - for example, concerns with large intangible assets built up by deductible expenses, or those whose tangible property has appreciated hugely since the original investment. However, to permit the inclusion of borrowed capital would confer an unmerited advantage upon corporations deriving large profits from funds borrowed at a low rate of interest, which would be deductible in computing the taxable income.[2] Moreover, from the incentive standpoint

---

1. Section 209 of the 1917 Act provided that where the corporation had no invested capital or only a nominal capital, the net income in excess of a stated exemption should be taxed at 8%. Using this provision was jumping out of the frying pan into (not the fire) relative immunity. A rate of 8% would be much too low in many instances. The 1918 Act provided that where the amount of borrowed capital was abnormal, the taxpayer might apply for special assessment under Section 328.

2. This deduction would, however, be paralleled in the case of other corporations if a dividends paid credit is allowed in computing income subject to the excess profits tax. See page 50

it is desirable to encourage equity financing, and a corporation with a large funded debt should be tempted to retire the debt in favor of a stock issue. Therefore, borrowed capital should be excluded.

The exclusion of borrowed capital would be only of the actual amount borrowed, including both funded debt and current indebtedness; any assets purchased out of profits from borrowed capital would be included in invested capital. Any so-called "preferred stock" should be treated as borrowed capital if the holders rank either with or prior to general creditors as to either "dividend" payments or principal amount; this involves esentially the same considerations as the frequently-litigated question whether the annual payments on such securities are to be treated as dividends or deductible interest. The hard cases of corporations with an abnormally high borrowed capital would have to be handled under a special assessment section, or by a provision giving a corporation the option of including borrowed capital as part of its invested capital provided that its standard profits should then not be permitted to exceed a lesser percentage of invested capital (such as 5%).

III (f). Stock of Other Corporations and Tax-Exempt Bonds

Under the 1918 Act stock in other corporations owned by the taxpayer was inadmissible in computing invested capital on the theory that the dividends on such stock were deductible in computing the net income of the corporation. Today, however, since 15% of the dividends received from other corporations are taxable,[1] a corresponding portion of the capital investment in such shares should be recognized in determining invested capital.[2] Other inadmissibles, including bonds the interest upon which is not required to be included in computing net income,[3] may be excluded as under the 1918 Act.

III (g). Possible Use of Appraised Value Alternative

The alternative use of standard profits or of a percentage of invested capital would greatly reduce the possible number of erratic instances in the operation of the statute. Isolated unfairness, however, might still result for the reason, among others, that the suggested proposal, like the old excess profits tax, would not take any

1. Internal Revenue Code, Sec. 25(b). See, however, following note.

2. Minor complications in connection with Supplement Q may be left for detailed consideration later.

3. See Revenue Act of 1918, Sec. 325; Reg. 45, Art. 815. Corporations engaged in buying and selling securities (dealers in securities) present a special problem here for further consideration.

consideration of appreciation of value,[1] except as appreciation in value is implicitly recognized by the allowance of an increase over 8% of invested capital if the standard or representative earnings permit. Therefore, a third possible alternative of measuring invested capital may be offered as a suggestion, consisting of the appraised value of the corporate assets at the beginning of the taxable year.

The alternative would, however, be impractical as a compulsory provision. Even if the data relevant to a current valuation were readily available, which is to be doubted, appraisal would necessitate fixing upon some general principles of valuation; and the use of this factor, to some extent justifiably and to a perhaps greater extent because of wide-spread taxpayer prejudice against valuation necessities, would be an unpopular provision if made compulsory. Moreover, the Government would have its problems; counter-proof in valuation cases is expensive and beyond the ordinary facilities of administration. Again, we would have the factor of delay in

1. La Belle Iron Works v. United States, 256 U.S. 377 (1921).

the collection of revenues. Taxpayers would claim high values and the inevitable process of horse-trading would have to be endured. It should also be noted that the use of appraised value is to some extent a duplication of the use of average earnings, for one of the principal methods of appraisal is to capitalize earnings.

For these reasons I would advise against the use of appraised value as an invested capital factor. If this alternative is used, its use should be optional to the taxpayer. This would certainly diminish criticism, since any taxpayer which then chose to use this method would be doing so in order to diminish tax liability. Moreover, if the alternative is adopted, appraised value should be operative onlyby way of refunds, and should not be permitted to be employed in computing original tax liability payable in theyear of filing returns.

IV <u>DETERMINATION OF STANDARD PROFITS</u>

As set forth above, many of our largest business units were making substantial profits during the period from 1935 to 1938, inclusive, and to use average earnings as an exclusive test of tax liability would mean virtual exemption for many of our largest corporations. A similar situation was the very reason why Congress, in passing the 1917 Act, did not use the principle of pre-war profits as standard profits. A ceiling limitation, based upon some percentage of invested capital, seems necessary to prevent a serious loss of revenue on account of the escape from the operation of the tax by the very corporations the tax should most fairly reach, and a cellar limitation is necessary to prevent an excessive burden being placed upon corporations making less than a fair return on their capital during the representative period.[1] As has been noted, it is proposed

---

1. Such a treatment would be very similar to the 1917 law in computing excess profits. That tax took the excess over a so-called normal amount consisting of a fixed sum ($3,000 for domestic corporations or $6,000 for partnerships, citizens or residents) together with an amount equal to the percentage of the invested capital represented by the average annual income during the pre-war period, provided that in no case should this percentage be less than 7% nor more than 9% of capital. The years 1911 to 1914 were used as the pre-war period. If the business was not in existence during those years, the deduction was fixed at 8% instead of 7% to 9%. If there was no income or a very low income during the pre-war period, the criterion was the percentage of capital earned by similar or representative business. (Sec. 209).

An alternative possible limitation would be that the normal rate of return might not exceed the amount necessary to pay 6% dividends on the paid-up capital stock of the corporation (or in the case of no-par stock to pay the rate of dividends paid in some representative year). Cf. Part III, Sec. 13 (7) of the English Excess Profits Tax. This alternative would be simpler, but less satisfactory, since it would unduly favor over-capitalized corporations.

that standard profits, which are exempted from the operation of the proposed excess profits tax by the mechanism of an excess profits tax credit, be computed on an alternate basis. They may consist of (a) 8% of the invested capital, or (b) the standard profits of the representative period up to 8% of the invested capital plus 50% thereof, or in other words, 12%. Stating this thought in positive form, there would be an excess profits tax credit consisting of the standard average profits, but this credit would not be less than 8%, or more than 12% of the invested capital for the taxable year. Thus, a corporation is always entitled to an exemption of profits up to 8% of its invested capital, and may be entitled to an exemption of a greater amount if the standard profits of the representative period exceed 8% of the invested capital. But the exemption is limited to 12% of invested capital.

The determination of standard profits involves the further problems indicated in succeeding paragraphs.

IV (a) The Choice of a Representative Period

The cardinal problem in the use of average earnings over a representative period as the basic measure of standard profits is to choose some fairly representative period. For this purpose the years 1935, 1936, 1937 and 1938 are perhaps the best available, since the use of earlier years would lead back to the pit of the depression. At least one of the above years would be a high income year for many industries, and more than one would be a high income year for some industries.

Criticism of this period as unrepresentative may be anticipated, particularly from corporations which found the period one of lean earnings. This criticism is answered by the fact that a corporation is in all cases entitled to a minimum earnings exemption of 8% of its invested capital. There is the further possible expedient in this connection of allowing the taxpayer the use of some other fairly representative consecutive period upon a showing that the years 1935 to 1938, inclusive, were in its particular case not a fair period. This expedient has been used in connection with the Agricultural Adjustment Program and the Sugar Act.[1]

Taxpayers which commenced operation too recently to have had existence during the full standard period could be given the option of taking the average of the last two years, or merely of the single year, prior to the enactment of the tax. Here the minimum return based upon the percentage of invested capital would afford an adequate protection against unfairness in most cases. The same protection would apply where the net result of operations during the whole standard period was a loss. Here, however, any part of the current profits applied to the extinction of losses suffered during the standard period might well be an allowable deduction for purposes of computing the excess profits tax.

---

1. The taxpayer might be given the option of using 3 out of 4 years in certain exceptional cases where one particular year was not representative.

IV (b) Adjustment of Standard Profits to Invested Capital of Taxable Year

It would, of course, be an over-simplification to average the profits of the representative period and to ignore the average invested capital employed in producing such earnings. Such a procedure would be unfair to concerns which had increased their invested capital in the period, and would unduly favor concerns which had decreased their invested capital. It is, therefore, suggested that the average invested capital be taken into the equation by increasing or decreasing standard profits for the representative period in the proportion which the invested capital at the beginning of the taxable year bears to the average invested capital during the standard or representative period. Thus, if the invested capital at the beginning of the taxable year was double the average invested capital in the standard or representative period, the normal or standard profits of the taxable year to be free from the tax for the period would be double the standard profits of the representative period, but the standard profits to be used as an excess profits credit could not exceed 12% of the invested capital for the taxable year.

The formula involves the reasonable assumption that capital added during the standard or representative period would have earned ordinary profits at the same ratio as did the original capital. However, as to additional capital investments after the enactment of the tax, a somewhat higher percentage might be used, due to the reasonable assumption that fair profits during a war period would be somewhat higher than fair profits during the standard or representative period.

IV (c) New Corporations Organized after the Representative or Standard Period

New corporations organized after the representative or standard period present a peculiar problem. In their case no standard profits are available to be taken into the equation, and it seems necessary to rely wholly upon the 8% invested capital formula. The only alternative is perhaps to increase this formula in such cases by an arbitrary percentage, say 25% (which is halfway between the straight invested capital formula and the highest standard profits available to other companies) making the percentage 10%. This arbitrary increase is justified by the consideration that most of these new corporations would be in a relatively unsafe ecoonomic position and should be favored from a tax standpoint as compared with older established corporations.

IV (d) The Effect of Fiscal Periods Differing from the Calendar Year

Another complication arises from the fact that many corporations keep their books on a basis of fiscal periods differing from the calendar year. In such cases the calendar years of the standard period will not actually have been used as an accounting year by the taxpayer. There is some anomaly in treating corporations otherwise similar differently simply because of accidental differences in fiscal periods. Theoretically all profits should be subject to the same tax irrespective of past accounting period. It would be possible to accomplish this by providing for an apportionment of profits or losses to translate the profits of a fiscal year into the years used, either in computing the standard profits or in computing the excess profits tax. Such an apportionment, if used, would normally be on a time basis.[1] It might, however, involve complications and additional expense to taxpayers, and I am inclined to prefer the more practical expedient of resorting instead to those established fiscal years which most closely coincide with the calendar years specified in the statute.

---

1. Cf. Part III, Sec. 14 (1) of the British Act and Sec. 335 of the Revenue Act of 1918.

V. DETERMINATION OF PROFITS SUBJECT TO TAX

In determining what profits should be subject to the excess profits tax, net income for income tax purposes would be the natural and efficient starting point.[1] For example, investment income, as pointed out above, should be included.[2] The statute should perhaps expressly incorporate by reference methods of determining net income stated in the income tax regulations to cover instances in which methods are not expressly provided for in the income tax

---

1. There probably should be no special provision as in the 1918 Act with respect to Government contracts; the income from such contracts should be kept at the level of other profits. Of course, many such contracts are treated specially by the Vinson Act. An excess profits tax would in fact be illusory here, since the excess profits tax would itself be taken into account in arriving at the contract price. In other words, the manufacturer would strive to obtain a price which would leave him after paying the tax in about the same profit position as he would have achieved had the tax not been in existence. The Government would itself be creating with one hand the excess profits which it would be taxing with the other.

2. But compare British Excess Profits Tax, Seventh Schedule, Sec. 6; see also Canadian Excess Profits Tax, Sec. 4(1)(e), exempting from the Canadian tax any dividends received from domestic Canadian corporations.

statute itself. For example, the income tax regulations[1] have a special provision - not appearing in the statute itself - as to apportioning income from long-term contracts, permitting the income from such contracts (a) to be taxed when received or (b) apportioned over the life of the contract. Consolidated returns would be very desirable in the case of subsidiary or affiliated companies, since the duplication of tax upon the same earnings which otherwise ensues is especially burdensome when the rates of tax reach the brackets suggested in this proposal.[2] However, the use of consolidated returns for this purpose would not be desirable unless the income tax statute were also amended to permit the general use of such returns.[3]

Some variations from net income for income tax purposes would, however, be necessary to conform to the peculiar characteristics of an excess profits tax. Most of these modifications would take the form of additional deductions.

---

1. Reg. 101, Art. 42-4.

2. Decentralization of the Bureau of Internal Revenue emphasizes the necessity of consolidated returns.

3. They are now used only by railroad corporations; Internal Revenue Code, Sec. 141.

V. (a) Deduction of Income Tax

Clearly the ordinary income tax of the corporation should be a proper deduction. This was not done under the 1918 Act; that act conversely allowed the excess profits tax as a credit in arriving at the amount subject to income tax.[1]

V. (b) Additional Losses

The act should also be liberal as to the deduction of losses. Deduction for amounts used to restore previous losses during the standard period might be desirable. The importance of such a relief provision is obvious; it would help in hard cases and silence complaints. Also, losses occurring in a year after the enactment of the excess profits tax should be carried forward as under Section 211 of the Revenue Act of 1939. The 1918 law, in Section 204, had a special relief provision somewhat along this line to take care of losses[2] ensuing from a termination of the war. That act provided that net losses for 1919 could be charged back to 1918 and forward to 1919, if the taxable year chanced to begin between certain dates. Such a relief provision should be repeated and extended in any present law.

---

1. 1918 Act, Sec. 236 (b). This method would be an acceptable substitute.

2. Sec. 204 (b).

V.(c) Inventories

Inventories present a special problem in connection with an excess profits tax, since one should be prepared for a large fall in values following the war. The increased value of inventories at the present time may thus eventually prove illusory. The Revenue Act of 1918[1] permitted rebates in case of inventory shrinkages under certain narrowly-defined restrictions, but did not go far toward a complete solution of this problem.

If inventory losses are allowed to offset the gains of a prior year, grounds for complaint are greatly reduced. Under the 1918 treatment the loss could not be claimed in the subsequent return itself, but had to be obtained by way of a refund claim, and the taxpayer's money was therefore withheld from the time of collection of the tax until the ultimate refund. But this is a relatively unimportant procedural item, and is probably necessary to preserve the orderly audit of returns. The allowance of an offset against the inventory gains of a prior year should be combined with a carry-over of the loss to subsequent years as under Section 211 of the

1. Sec. 214 (a)(12) and Sec. 234 (a)(14); Reg. 45, Art. 261-8.

1939 Act. As an alternative, corporations might be permitted to set up a reserve allowance of some percentage to guard against a possible fall in values.

The last-in - first-out inventory principle, allowed for a few industries by the 1938 Act and extended by the 1939 Act, might be enough to cover the case of goods actually taken out of inventory during the taxable year. In an inflationary period this provision generally has the effect of adding to the actual cost of goods sold during the year the higher-price goods purchased later, and thus would be a shock-absorber of a useful character, because it would relate high costs to high gross income with a tapering off of costs as the income tapers off in the deflation period. Such a provision, however, should be coupled with the net-loss provision mentioned above. It might not be enough alone, since its operation would be somewhat haphazard, depending on when goods were purchased and when prices happened to change. Standing alone, it might also have the undesirable effect of encouraging taxpayers to engage in a scramble of end-of-the year sales, thus intensifying any possible deflationary movement.

V.(d) Amortization

The 1918 Act contained an amortization provision, supplementary to the general provision for the deduction of the depreciation and obsolescence, which provided that: (a) in the case of buildings, machinery, and equipment or other facilities constructed, erected, installed, or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the War with Germany, and (b) in the case of vessels constructed or acquired on or after April 6, 1917, for the transportation of articles or men contributing to the prosecution of the War,[1] there should be allowed a reasonable deduction for the amortization for such part of the cost of such facilities as had been borne by the taxpayer.[2]

This provision, founded in the idea that equity required a recognition of the substantial risk involved in war

---

1. This feature of amortization is obviously inapplicable to the present situation.

2. 1918 Act, Sec. 214(a)9, 234(a) 8. See Holmes, Federal Taxes, 1923 Edition, p. 852, for a discussion of this provision.

time construction, proved very difficult of administration.[1] Perhaps a substitute for the word "amortization" should be found. The amortization allowed under the 1918 Act was nothing more than extraordinary depreciation or obsolescence, and the essential problem is to relate that depreciation or obsolescence, chiefly the latter, to a short period of earning capacity. What really happens is that certain facilities lose their earning power as soon as the war has ended; all that an amortization provision means is that certain war facilities may be depreciated over the period of their extraordinarily short useful life with proper allowance for subsequent non-war usefulness, which is really salvage value.

It should be noted that amortization may be thought of in terms of a deduction for both income tax purposes and war tax purposes, or it may be regarded as a special deduction for war tax purposes. The old amortization provision was for both purposes.

If it is practicable, some more flexible amortization provision than was contained in the 1918 Act should be devised; its virtue would be that it would be adaptable to incentive taxation and an encouragement of capital investment in industries where expansion is thought desirable.

---

1. Report of Special Committee on Investigation of the Munitions Industry, No. 944, Part 2, 74th Cong., 1st Sess., p. 30 (1935).

V.(e) Dividends Paid Credit

One of the principal functions[1] of the tax under consideration is to tax excess profits in corporations because of our knowledge that such corporate profits will not be sufficiently distributed to permit them to be subjected, as they should be, to the individual surtaxes.[2] The suggestion may, therefore, be made of the advisability of permitting a limited dividend paid credit of the kind now allowed for purposes of the domestic personal holding company provisions[3] and for purposes of section 102. Such a credit would tend to encourage the distribution of corporate earnings to stockholders, some of whom would be taxable at reasonably high brackets, and the remainder of whom would enjoy increased spending power. The extent to which this credit would be availed of would, of course, depend upon the rates adopted in the excess profits tax.

---

1. True, the tax would also have some non-revenue, regulatory, effects in connection with price control. See Report No. 944, Special Committee on Investigation of The Munitions Industry, pp. 8, 55, 74th Cong., 1st Sess. (1935).

2. The personal holding company provisions do not reach the majority of corporations, and Section 102, applicable to improper surplus accumulations by corporations generally, has been a conspicuous failure.

3. Internal Revenue Code, Sec. 405. Such a credit was also allowed for purposes of the discarded undistributed profits tax. Id., Sec. 27.

The credit might, perhaps, depending upon the amortization provision adopted, discourage new construction, but any such effect might be obviated by allowing a credit in respect to taxable stock dividends. The credit might also be allowed only as against the 50% surtax on income in excess of 18% of the invested capital. So limiting the credit would obviate the objection that the tax in effect required a corporation to distribute funds needed in the business. For no corporation which can earn and retain more than 18% of its invested capital in any one year can complain if a tax induces it to distribute the balance.

If any such provision is made a part of the law, it should allow a reasonable period (say 2½ months) after the close of the year for the declaration of dividends, and perhaps also a deficiency dividends paid credit. This would obviate much criticism of the type leveled with justice and effect against the undistributed profits tax. It would, of course, mean some revenue lag, since stockholders would report dividends paid after the close of the corporate fiscal year in a later taxable year. Permission might also be granted to obtain the credit through the mechanism of a consent dividends credit without actual distribution.

VI. ADMINISTRATIVE PROBLEMS

VI. (a) Assessment and Collection

The provisions as to assessment, collection, and refund should be the same as those existing in the ordinary income tax field, probably including the privilege of appealing to the Board of Tax Appeals or the courts even from the special assessments suggested below.[1]

VI. (b) Possible Avoidance

Methods of attempting to avoid an excess profits tax would undoubtedly be as limitless as the infinite ingenuity of taxpayers and their advisors;[2] they would vary all the way from the petty device of putting relatives of the officers on the payroll of small corporations at exorbitant salaries, or the postponement of profitable activities in the hope that the tax might disappear, to spending excess profits (otherwise subject to the tax) for excessive advertising and every other imaginable purpose which could conceivably be justified as a business expense. However, it is unlikely that any great amount of wasteful expenditures would result, or that avoidance would be effective enough to hamper administration very seriously.

---

1. One additional suggestion with respect to the administration of the tax would be a lengthening of the statute of limitations upon assessment and collection and possibly also upon refunds.

2. See Paul, The Background of the Revenue Act of 1937, 5 Univ. of Chicago L.R. 41, 44 (1937).

Salaries present no very grave problems where the tax is not made applicable to individuals or partnerships. Exorbitant salaries could be treated under the limitation as to reasonableness laid down in the income tax provisions without any further statutory provisions. Many of the devices common under the older acts were designed to postpone profits until the abolition of the tax;[1] if the statute were passed as a permanent part of the tax system, the efficacy of such methods would largely disappear. Moreover, avoidance and evasion are less likely to be rampant if the rates of tax are kept fairly moderate.

VI.(c) Special Assessment in Cases of Peculiar Hardship (Secs. 327 - 328 of the 1918 Act)

The Revenue Acts of 1918 and 1921 contained the famous Sections 327 and 328 which the framers of the 1918 Act wisely inserted in the statute to cover peculiar cases which would not fit into the general pattern of the act without undue hardship. These sections gave to the Commissioner of Internal Revenue a wide discretion to adjust profits tax on a special

---

1. See, e.g., Report of Special Committee on Investigation of Munitions Industry No. 944, Part 2, 74th Cong., 1st Sess., p. 34 (1935).

basis in cases in which invested capital could not be satisfactorily determined and in cases in which abnormal conditions affected the capital or income of the corporation. In such cases the Commissioner had the task of fixing the tax of the corporation affected by such conditions by reference to the taxes paid by representative corporations engaged in a like or similar business.[1]

The administration of these provisions put a great burden upon the Commissioner. Many taxpayers in the course of the war paid tax without protest in accordance with the conventional standards of invested capital set up in the act. These same taxpayers later, with some abatement of patriotic fervor, made application for revision and reduction of the taxes they originally computed on the ground of alleged abnormal conditions affecting capital or income. If the Commissioner decided that such conditions existed, he was faced with the problem of assessing a fair tax. He was handicapped in this task by the fact that in the first few years after the war the taxes of "representative" corporations computed in the ordinary way had not yet been finally determined. Moreover, from time to time rumored scandals were rife in connection

1. For a consideration of these sections by the Supreme Court, see Williamsport Wire Rope Co. v. United States, 277 U.S. 551 (1928); Blair v. Osterlein Machine Company, 275 U.S. 220 (1927).

with the special assessment section which handled these cases, and there is no doubt that many corporations not entitled thereto received the benefit of the provisions.

However, there seems to be no escape from the necessity of some such relief provision, perhaps somewhat more circumscribed than that contained in the 1918 and 1921 Acts. The wisdom of too much inflexibility is dubious, and in the end the legislative branch will probably have to trust the administrative authorities once more.[1] It is literally impossible to frame a broad comprehensive statute such as the one under consideration without working undue hardship in many meritorious cases. No reasonable

---

1. It would theoretically be very desirable to exclude the possibility of a judicial review regarding such assessments. But our greater reluctance to permit administrative finality, as compared with the English practice, would make such an attempt very unpopular. Moreover, it is at least conceivable that some of our Supreme Court cases might be interpreted to impose a constitutional requirement of judicial review regarding income tax valuation questions. See Ohio Valley Water Co. v. Ben Avon, 253 U.S. 287; Crowell v. Benson, 285 U.S. 22; cf. Anniston Manufacturing Co. v. Davis, 301 U.S. 337 (1937).

person expects a statute of universal application to be perfect,[1] and occasional hardship must be disregarded.[2] But the door should be left open to prevent irreparable damage in extreme situations. Difficulties arise from the fact that in so many businesses the profits may fluctuate very widely from year to year. Also, the profits of 1940 may be merely the fruit of expensive activities long antedating that year. Therefore, as under the 1918 Act, some safety-valve must be provided for cases in which taxable income is seriously disproportionate to capital as well as cases in which invested capital is for some reason difficult to determine.

Randolph E. Paul

November 16, 1939.

---

1. See, e.g., Purity Extract & Tonic Co. v. Lynch, 226 U.S. 201, 204 (1912); Tyler v. United States, 281 U.S. 497, 505 (1930); Milliken v. United States, 283 U.S. 15, 20 (1931).

2. Cardozo, The Paradoxes of Legal Science, p. 69 (1927).

Exhibit A

Computation Based Upon
8% Normal Return

rackets	Amount of Net Income Each Bracket	Statutory Normal Return	Balance Subject to Tax	Rate of Tax	Amount of Tax
over 15% of vested capital	1,500,000	800,000	700,000	10%	70,000.
r 15% but not er 18% of vested capital	300,000		300,000	25%	75,000
r 18% of vested capital	660,000		660,000	50%	330,000
al Excess Profits Tax					$475,000