Federal tax revision program

American Institute of Accountants. Committee on Federal Taxation

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FEDERAL TAX REVISION
PROGRAM

Submitted by the
COMMITTEE ON FEDERAL TAXATION
AMERICAN INSTITUTE OF ACCOUNTANTS

SEPTEMBER 18, 1939
Federal Tax Revision Program

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Prior to the enactment of the revenue act of 1932 and the N.I.R.A. in 1933, the federal income-tax laws were comparatively liberal in their provisions. These laws were gradually making things smoother for the taxpayer by eliminating inequities and by basing tax policies upon recognized business procedure, while at the same time closing loopholes and raising revenue.

The first revenue act, under the Sixteenth Amendment was adopted October 3, 1913. Each successive act included modifications giving recognition to sound requirements of commerce and industry. For instance, under the 1917 act consolidated returns were first permitted. The 1918 act introduced the net loss carry-over, included a limited tax-free reorganization provision, allowed a credit for foreign taxes, and gave corporations a deduction for dividends received. The 1921 act provided for the segregation of capital gains and for their taxation at a moderate rate, repealed the old excess-profits tax, gave special exemption to employees' pension and profit-sharing trusts, and extended the tax-free exchange provisions to cover transfers to controlled corporations and exchanges of like property for like property. The 1924 act allowed an earned-income credit, permitted a depletion deduction on the basis of discovery values, and further extended the tax-free exchange provisions to cover involuntary conversions and gains by corporations in connection with reorganizations. The 1926 act repealed the old capital-stock tax, permitted the instalment method of accounting, and allowed percentage depletion. The 1928 act was notable for its reduction of individual and corporation income-tax rates.

Although the general trend of revisions, especially those beginning with the 1921 act and up to and including the 1928 act, was to reduce rates and encourage business activity, a marked change in tendency is noted beginning with the 1932 act, including not only the imposition of higher rates and the removal of remedial sections, but also the introduction of unsound tax theories, involving regulation and social reform. The 1932 act not only made substantial increases in the tax rates, but it also reduced the net loss carry-over to one year and disallowed net losses on stocks and bonds held less than two years, although permitting a one year carry-over for such losses. The N.I.R.A. abolished the net loss carry-over completely, eliminated the short-term capital net loss carry-over established by the 1932 act, and introduced new capital-stock and excess-profits taxes. The 1934 act further increased the tax rates; in the case of individuals, it set up a complicated time-scale device for the recognition of capital gains and losses, subjecting net capital gains to normal and surtax rates, while limiting net capital losses to $2,000; in the case of corporations, net capital losses were limited to $2,000, but net capital gains were recognized in full, and the filing of consolidated returns was abolished except for railroad corporations. The 1936 act again increased tax
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rates, introduced a surtax on undistributed profits, subjected dividends received by individuals to the normal tax, and subjected 15% of domestic dividends received by domestic corporations to tax. In 1937, the “loophole” law provided among other things an onerous requirement for information reports by accountants, lawyers, and others in connection with the formation of foreign corporations.

The 1932 act and the N.I.R.A., together with the 1934 and 1936 revenue acts, abandoned the reliable method of taxation which had taken more than twenty years to develop to a reasonably fixed and determinable basis, and left in their wake a havoc of tax uncertainty some of which has now been removed by the 1938 and 1939 acts.

**Action Taken by Institute’s Committee**

The Institute’s committee, along with other responsible professional and business groups, viewed with justifiable alarm this distortion of the tax system and the resultant drag upon economic recovery. As each deterrent step was taken, as each reliable and tested method was supplanted by some new, untried tax scheme, the committee combatted the innovations aggressively. The new tax provisions were analyzed, Institute members were kept informed of the nature and progress of each bill, and where new provisions did not conform to generally recognized accounting principles or were contrary to long-term practical considerations, briefs were prepared, explaining the fallacy of such provisions.

In connection with the 1936 revenue bill, representatives of the committee appeared at the Congressional hearings in Washington and put on record its unalterable opposition to the surtax on undistributed profits. In the following year, when the revenue act of 1937 was enacted, the committee immediately took a positive position in respect of section 340 of that act, dealing with the filing of information reports by accountants and others concerning the formation of foreign corporations, and registered strong objections with the Secretary of the Treasury. The ill-fated “third basket” tax proposed in the 1938 bill was vigorously opposed in a timely brief filed with the Senate finance committee.

In addition to its activities concerning specific proposals in the respective tax bills, the committee several times circulated members of the Institute and of the various state societies soliciting suggestions as to desirable changes in the existing revenue laws. The replies were analyzed and embodied in several reports to the Institute’s council, the Congressional committees, the Treasury Department, and others interested in the manifold problems of taxation. The activities of the committee in this regard culminated in a tax-revision program submitted to the Treasury Department in September, 1938.

Besides voicing its opposition to (a) the surtax on undistributed profits, (b) section 340 of the 1937 act, and (c) the “third basket” tax, the three objectionable developments specifically referred to above, the committee in its various tax reports advocated the following vital proposals for improvement of the national tax picture:

1. Creation of a qualified nonpartisan commission to formulate a permanent policy of federal taxation;
2. Restoration of the net loss carryover;
3. Requirement of consolidated returns and repeal of the taxation of intercorporate dividends;
4. Elimination of the capital-stock and excess-profits taxes;
5. Segregation of capital gains and losses and the taxation of such gains at a flat moderate rate, without distinction between short-term and long-term holdings, and with a carryover of capital net losses;
6. Extension of time for filing federal
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income-tax returns to the 15th day of the fourth month following the close of the taxable year;
7. Allowance of expenses incurred in connection with taxable income, although not in connection with a trade or business;
8. Broadening of provisions governing the last-in, first-out inventory method.

Many other constructive recommendations were made by the committee from time to time. A summary of the more important of these proposals, a tabulation of which was originally included in this committee's tax revision program submitted in September, 1938, is again presented at the end of this report.

Effect Given to the Committee's Proposals

As a result of the concerted action of many responsible groups, the inequities produced by harmful tax legislation since 1932 and the days of the N.I.R.A., have now been alleviated. Even prior to the recent 1939 overhauling, several forward steps were made toward a sound national tax policy. The objectionable "third basket" tax proposed in the 1938 bill by the House was eliminated by the Senate. Under the 1938 act, the surtax on undistributed profits was reduced to a nominal rate of 2 1/2%; there was reversion to the pre-N.I.R.A. principle of taxing the capital gains and losses of individuals; the last-in, first-out method of inventory valuation was permitted (under rather exacting conditions) to producers and processors of certain nonferrous metals and to tanners of hides and skins. Although the capital-stock and excess-profits taxes were retained, the 1938 act provided for a new declared value every three years. Within the Treasury Department itself, several liberal interpretations were made, even recognition of the "blockage" rule.

More sweeping changes have been effected by the 1939 act. The remnant of the undistributed-profits tax has been abolished; the capital gains and losses provisions as they affect corporations have been liberalized; a limited net loss carry-over is permitted; in certain net loss discharge of indebtedness is not taxed; the adverse effect of the Hendler decision has been substantially voided; the last-in, first-out inventory method has been extended to all taxpayers; and the harshness of the capital-stock and excess-profits tax provisions has been further alleviated by permitting an upward declared value for 1939 and 1940. Other objectionable features have also been removed.

Proposals Still to Be Considered

Although the 1939 act has eliminated many objectionable features of the law, much remains to be done before we shall have a sound coherent national tax system. The committee on federal taxation respectfully submits the following program of further basic tax requirements:

1. Creation of a qualified nonpartisan commission:

The committee again stresses particularly that Congress could do no one thing of greater importance to assure future economic stability than to create a qualified nonpartisan commission to formulate a permanent and consistent policy of federal taxation. The annual revision of tax laws on the basis of political expediency and social reform is the major cause of hesitancy on the part of businessmen and taxpayers. Fixed principles of taxation are urgently required to give taxpayers the necessary confidence to face the future.

Determination of fixed principles of taxation should strive to bridge the existing gap between tax accounting and established business practice. The flexible application of accounting principles, as between taxpayers, should be recognized, providing such accounting practices be consistently maintained from year to year.
A permanent tax structure should be established, with fixed principles subject only to changes in rates to meet the varying requirements of the federal budget. Business can adjust itself to changing rates, as long as such rates are nonconfiscatory, but staggers under the impact of successive changes in the general scheme and incidence of taxation, a procedure which calls for new interpretations of tax provisions from year to year.

It is not intended that legislative or administrative powers be delegated to the proposed commission; it is merely expected that the commission function as a study group in examining national tax problems, and on the basis of its deliberations recommend to Congress the adoption of such principles and methods of taxation as would promote uniformity and simplicity and remove as much as is possible of the present complexity and uncertainty.

The second Fortune round table on taxation and recovery, in supporting the appointment of a national tax commission, stated that what they had in mind was something like the committee headed by Lord Colwyn, appointed in 1924 by a Labour Government in Britain. The Colwyn Committee, representing various points of view, studied the British national debt and the incidence of taxation for nearly three years. It held forty-eight sittings and received evidence from sixty-two witnesses, representing among others the Trades Union Congress, the coöperatives, government officials, and economists.

In this connection, as a guide in the formation of a nonpartisan tax commission, we should like to refer to the British tax committee appointed October 31, 1927, and headed by Lord Macmillan. The Macmillan Committee, which included two chartered accountants among its members, was engaged in the study of the British tax system for some eight and one-half years; some hundreds of meetings were held, resulting in the issuance in April, 1936, of a comprehensive report on the British tax situation and a draft of a proposed new income-tax bill. It is expected abroad that the draft bill will become law in substantially its present form.

Official recognition has already been given in this country to the proposal for a qualified nonpartisan tax commission, Representative Treadway having introduced in the last two sessions of Congress joint resolutions providing for the creation of such a commission. Although these resolutions failed of legislative consideration, they should be revived and aggressively championed.

Secretary Morgenthau in his testimony before the House ways and means committee in May, 1939, made certain suggestions representing to some extent a start toward a national commission. He proposed that the House ways and means committee, the Senate finance committee, and the House and Senate appropriations committees sit as one body during and between sessions of Congress to consider the over-all aspects of expenditures and revenues. "This joint committee," he stated, "would in effect be a lens through which all appropriation and revenue measures could be viewed in relationship both to what the nation needs and to what the nation can afford."

The Secretary also suggested that Congress create a small temporary national commission to report to Congress as soon as feasible on the various aspects of intergovernmental (federal-state) fiscal policy and propose a plan for the solution of the problems involved. "Such a commission," he stated, "should be made up of men of ability who command the highest public confidence, who are familiar with fiscal problems, but who will represent the public at large rather than particular government units. . . . The recommendations of such a commission should assist us in achieving more orderly relationship between the federal, state, and
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local fiscal systems." The Secretary's recommendations were not acted upon by Congress, presumably for the reason, as it was stated in some quarters, that members of Congress thought that it would be "just another commission."

Even an attempt to have a joint House and Senate committee conduct a tax study as the basis for action next year has petered out, and the preliminary tax work for next session will be done by a subcommittee of the House ways and means committee, as in the past. Of course, the staff of the joint committee on internal revenue taxation will continue its important work of gathering data on tax problems for the ways and means tax subcommittee, and the Treasury will be bringing its extensive tax studies up to date. This research has considerable merit and should result in tangible benefits to the business community, especially in view of the further appeasement signs on the horizon. The real solution of our national tax dilemma, however, awaits the appointment of an unbiased national tax commission, comprising individuals drawn from business, labor, government, and professional circles, who have a well grounded knowledge of tax matters.

2. Income taxation should contemplate an equitable basis for revenue, not social reform:

Recent tax experiments, such as the surtax on undistributed profits, the "third basket" proposal, the taxation of intercorporate dividends, the elimination of consolidated returns, and the like, indicate the tendency to employ income taxation as an instrument of regulation and social control. This committee realizes that the Federal Government has a number of highly important regulatory functions to perform, but is of the firm conviction that punitive taxation is not the proper machinery for that purpose.

The income tax is a sensitive mecha-
nism, delicately synchronized with the ups and downs of general economic conditions. Experience demonstrates that where emphasis is upon revenue, with fixed principles of taxation closely allied to current business practices, the income-tax system operates smoothly in sympathy with confident business advancement and development. On the other hand, artificial interference with accepted business practices via punitive regulatory provisions, results in the distortion of regular business and economic situations, with a consequent injury to revenue.

The income tax is a satisfactory instrument of the national tax system as long as its primary purpose is the collection of revenue. When punitive provisions aimed at small groups are injected, the whole revenue system suffers through the actual or potential injury to numerous innocent taxpayers caught in the regulatory net. The second Fortune forum, in referring to this question of punitive taxation, said: "The effect of such taxation is unpredictable; it is not a selective agency, for it punishes saint and sinner indiscriminately."

The committee believes that regulation and modification of alleged social abuses should be accomplished by specific legislation outside of the regular income-tax field. There should be no tinkering with the income tax; it should be left alone as a normal instrument of revenue.

3. The law should set forth a satisfactory definition of earnings or profits:

The income-tax status of corporate distributions, from the standpoints of both the corporation and the stockholders, revolves around the existence of corporate "earnings or profits." This term, however, is not defined in the law, with the result that the precise method of computing earnings or profits is unsettled, and the tax status of numerous corporate distributions is very much in doubt.
On the basis of several Board and Court decisions, it has become evident that "earnings or profits" represent neither taxable income nor earnings determined by conventional corporate accounting methods. The Commissioner of Internal Revenue, in his regulations, has attempted to set forth some of the items which enter into the computation of "earnings or profits," but he has been overruled by the Board of Tax Appeals and the courts in several cases. Moreover, even the Board and Court cases conflict with each other in this regard.

As an indication of the hybrid accounting methods applied by the Board and the courts in defining "earnings or profits," we list a number of items which have been held part of "earnings or profits," although for tax purposes not includable in gross income and, in some instances, not properly includable in earned surplus under generally recognized accounting practices:

1. Proceeds from life insurance,
2. Interest on state and local obligations,
3. Gifts,
4. Actual amount of capital gains,
5. Nonrecognized gain on tax-free exchanges,
6. Unrealized appreciation.

The following items have been held deductible in computing earnings or profits, but are not deductible in computing statutory net income:

1. Income and profits taxes on the distributing corporation,
2. Capital losses in full without limitation,
3. Excess of contributions not deductible for purpose of computing net income,
4. Taxes assessed against local benefits,
5. Extraordinary expenses.

In view of this confusion concerning the precise meaning of the term "earnings or profits," Congress should study the possibility of including a clarifying definition in the law. Congress should be able to state whether the generally recognized accounting methods of computing corporate earned surplus are to be observed in determining "earnings or profits," or whether under a hybrid accounting arrangement certain defined items are to be considered as part of "earnings or profits," while other specific items are to be excluded. Although such a definition would necessarily involve additional statutory verbiage, the committee regards this step as true simplification.

4. Consolidated returns should be made mandatory:

It is so well established in the broad field of financial reporting that consolidated statements are essential to the correct presentation of the affairs of affiliated groups, that it is obviously incongruous to prohibit consolidated tax returns when in fact they should be mandatory.

Subsidiary companies are organized normally by a parent for the purpose of complying with state requirements, to minimize risk in opening up new territory, to facilitate financing, or to simplify the establishment of new lines of business. They are, for all practical purposes, merely branches or departments of one enterprise. Businessmen, stock exchanges, and the S.E.C. recognize that the financial position and earnings of the parent company and its subsidiaries can be presented satisfactorily only by means of consolidated statements showing the combined position and results of operations. The entire consolidated group is treated as a single unit, intercompany transactions and profits not realized by means of sales outside the group being eliminated.

When the filing of consolidated returns was abolished in 1934, Congress deliberately set aside a long established and generally recognized business practice. By requiring separate statements of income from each unit of the one enterprise, nonexistent "paper" income is often taxed, and the earnings of...
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particular units may be distorted and incorrectly presented. Moreover, elimination of the consolidated return, being contrary to ordinary business practice, has unduly complicated administration of the income-tax law and has placed additional burdens on corporate groups which follow the consistent practice of preparing consolidated financial statements for all other purposes.

Accordingly, to simplify the preparation and auditing of returns, and at the same time to prevent both the taxation of artificial, nonexistent income, and the avoidance of tax by arbitrary intergroup charges, it is again urged that consolidated returns be made mandatory for affiliated groups.

Every argument which can be urged in favor of consolidated returns applies with equal force against the taxation of intercorporate dividends. The principle is unsound from an accounting standpoint, and we repeat our recommendation that, as a corollary to mandatory consolidated returns, the taxation of intercorporate dividends between affiliated corporations be repealed.

5. Treatment of capital gains and losses should be further revised:

Much opposition, supported by sound argument, has long existed in regard to the capital-gains tax, and strong efforts have been made at various times by informed groups to eliminate capital gains from the field of taxable income. Many businessmen oppose this tax on the grounds that it hinders sales, exchanges, and business generally. Others consider the tax inequitable because it not only covers items of a nonrecurring nature, but also applies to profits which have accrued over a long period of time. Still others contend that during a normal business cycle, capital losses tend to offset capital gains and that from a revenue standpoint the long-term results are nil. For reasons such as these, Great Britain does not subject capital gains to income taxation.

The committee realizes that much can be said in favor of the outright repeal of the tax on capital gains, but despite the cogent arguments against the tax, recognizes that capital gains represent ability to pay and as such should probably bear their just proportion of taxation instead of shifting the entire burden to those carrying on commercial and professional pursuits.

The committee is aware that the method of taxing capital gains prescribed in the Internal Revenue Code, as amended, is a vast improvement over the hampering capital gain-and-loss provisions of the 1934 and 1936 acts, but believes that serious defects still remain in the law.

One objection is that capital gains and losses are still taxed according to the length of time the asset is held. This arbitrary statutory arrangement is merely an administrative expedient to assure the taxing of speculative gains at the regular normal and surtax rates; but, in effect, it operates as an artificial barrier to the conduct of normal business enterprise by encouraging the postponement of transactions until such time as is most propitious from a tax standpoint. The timing factor thus tends to hinder sales and exchanges, thereby retards the general flow of capital, upon which depends the reemployment of our national human and material resources.

Another important objection is that capital net losses may be used, in effect, to reduce the tax on ordinary income and thus operate to decrease federal revenue, especially in lean years.

These objections were the two main criticisms levelled at the capital gain-and-loss provisions of the pre-1930 era, during a period (1924–1929) when the capital gains of individuals exceeded capital losses by some 16 billions of dollars. How much more valid are these arguments today in this period of thin markets and sluggish business conditions!

To remove these objections, the fol-
lowing change in the law is recom-
mended: Capital gains and losses should
be segregated from ordinary income and
such gains should be taxed independ­
ently at a flat moderate rate of, say,
12½%, without distinction between
short-term and long-term holdings, and
with a carry-over of capital net losses
for at least a period of five years. It is
believed that such a provision in the
law will greatly improve the income-tax
system and that additional revenue will
result from the increase in normal busi­
ness transactions.

Inasmuch as the treatment pre­
scribed for corporate capital gains and
losses in the Internal Revenue Code, as
amended, corresponds substantially to
that provided for individual capital
gains and losses, we recommend that a
Corresponding change be made in the
corporate provisions.

6. Eliminate capital-stock and excess-
profits taxes:

This committee has repeatedly ad­
vocated the elimination of the capital-
stock tax and the related excess-profits
tax. These scissor-like taxes, as they are
sometimes called, are based on guess
work, certainly an unsound method of
taxation. The one blade, adjusted de­
clared value, is an artificial figure,
representing an official guess of the cor­
porate management and having no rela­
tionship to actual net worth. Where the
guess work is inaccurate, the other blade
of the scissors comes into play and sub­
jects the taxpayer to a high excess-
profits tax.

These taxes were marked for repeal
by Secretary Morgenthau last May
when he appeared before the House
ways and means committee with his
tax-revision program. Mr. Morgenthau
repeated the aforementioned objection
to the taxes and said also: "Their major
defect is that they operate very erratic­
ally. The tax liability they impose
depends upon the taxpayers’ ability to
forecast profit for the next three years,
as well as upon the amount of profit
actually realized during each of the three
years. Forecasts of earnings are particu­
larly difficult to make in the case of
new businesses and those with unstable
incomes such as the capital-goods in­
dustries, with the result that taxes im­
posed on such businesses are at times
inordinately high."

In considering the Secretary’s pro­
posal, Congress thought it unwise to
lose the revenue involved by repealing
the two taxes, but in the 1939 act gave
corporations the privilege of revising
their declared values upward for 1939
and 1940. For 1941 the Internal Reve­
nue Code already allows a new declared
value. In effect, Congress has to a large
extent removed the sting from the
excess-profits tax, except for corporate
taxpayers who make an unlucky guess
as to current profits.

In view of the general recognition of
the inequities inherent in the capital-
stock and excess-profits taxes, the com­
mittee feels that they should be elimi­
nated.

7. All expenses incurred in the produc­
tion of taxable income should be
allowable deductions:

Section 23 (a) (1) of the present law,
like the corresponding section of prior
laws, provides for the deduction of all
ordinary and necessary expenses in­
curred during the taxable year in car­
rying on any trade or business. This
provision should cover the deduction of
expenses paid or incurred in the produc­
tion of taxable income, even though
such income does not arise from the
taxpayers’ trade or business. In some
instances, the Commissioner has dis­
allowed expenses of this character by
placing an unduly narrow interpretation
on this section of the law. The failure
to allow such expenses as deductions is
contrary to sound accounting concepts
and the reasonable intent of the law,
and results, in many cases, in the taxa­
tion of gross, instead of net, income.
Your attention is directed to the fact that this recommendation had the support of the subcommittee on taxation of the House ways and means committee, as set forth under the caption of "Other income tax and administrative changes" of the proposed revisions submitted by that committee under date of January 14, 1938.

Accordingly, it is again recommended that section 23 (a) (1) be amplified to permit the deduction of all ordinary and necessary expenses paid or incurred during the taxable year in the production of taxable income.

8. The time for filing federal income-tax returns should be fixed at the fifteenth day of the fourth month following the close of the taxable year:

Under section 53 of the Internal Revenue Code, income-tax returns are required to be filed, as heretofore, within two and one-half months following the close of the taxable year. The Commissioner is empowered, by the same section, to grant reasonable extensions of time.

Experience has shown that many taxpayers, especially corporations, cannot gather the necessary data for the preparation of returns within the time specified by law. Audits of taxpayers' accounts are not completed generally until one or two months after the end of the year, and until then the work of collecting tax data cannot be started effectively. Moreover, the technical complexities of our present income-tax structure make it imperative for most taxpayers to give extended consideration to tax problems and to secure professional aid in their solution. As a result, it is rarely possible for returns to be prepared by the due date and in many cases it is necessary to obtain extensions of either one or two months. This is a source of expense, inconvenience, and uncertainty to both taxpayers and the Treasury Department.

The annual repetition of extension requests may be removed by amending section 53 (a) (1) to read as follows:

"(1) General Rule—Returns made on the basis of the calendar year shall be made on or before the 15th day of April following the close of the calendar year. Returns made on the basis of a fiscal year shall be made on or before the 15th day of the fourth month following the close of the fiscal year."

In respect of instalment payments, section 56 could at the same time be amended to provide for the payment of one-quarter of the total tax on or before the fifteenth day of the fourth month following the close of the taxable year and one-fourth on the fifteenth day of the sixth, ninth, and twelfth months. This would not lessen the Government's revenue in any fiscal year, and at the same time it would not be inequitable to taxpayers.

It is strongly urged that the changes recommended herein be incorporated in the tax law, in order that one unnecessary source of friction between the Treasury Department, taxpayers, and tax practitioners be removed.

9. In the interest of a sound, equitable national system, we urge (1) taxation of income from future issues of Government securities, (2) reduction in "top" surtax rates, (3) increase in "middle" surtax rates, and (4) lowering of exemptions, accompanied by abolition of hidden taxes:

The committee believes that in the various official tax studies now being conducted, major attention should be given to two related questions: (1) of taxing future issues of otherwise tax-exempt securities and (2) of lowering the "top" surtax rates. These two conditions unite to discourage the taking of normal business risks by "large wealth." Because of high surtaxes, venture capital is lured into tax-exempt securities instead of performing its normal function of financing industrial
development. Thus new issues of industrial equity securities are curtailed, and the regular investment market is distorted by the inordinate demand for government obligations. It is estimated that of more than 19 billion dollars’ worth of state and local tax-exempt securities outstanding, over half, representing in the main sterile risk capital, is held by individuals.

Stimulation of general economic activity depends to a large extent on reversing this process. Not only must the use of Government obligations as a haven for “large wealth” be made less attractive, but incentive must be extended to such wealth to perform its regular economic function of supplying risk capital to industrial enterprise. Proper reduction of the top surtax rates will accomplish this latter purpose.

Late in June, 1939, Mr. John Hanes, as spokesman for the Treasury, proposed to the ways and means committee that tax-exempt bonds be eliminated and that top surtax rates be lowered. Mr. Hanes pointed out the adverse effect of both these conditions on risk capital, stating: “The attractiveness of tax-exempt securities combined with the high surtax rate has greatly diminished the willingness of persons with large incomes to risk their capital.” In regard to the refunding of existing issues, Mr. Hanes suggested that any hardship could be prevented by permitting the new obligations to be tax-exempt up to the maturity date of the obligation being refunded.

This committee endorses these Treasury recommendations.

In conjunction with the elimination of tax-exempt securities and the lowering of the top surtax brackets, consideration should be given to the question of increasing the rates in the middle brackets. This group of taxpayers in the U.S.A. contributes less proportionately to the national revenue than under similar economies abroad.

The committee favors the lowering of personal exemptions, to the end that taxpayers in the low income groups may be made conscious of their contributions to the cost of government. Statistics show that about 96% of Americans of voting age pay no federal income tax. A large portion of these individuals are unaware of the tribute they pay by way of hidden excise taxes. These voters, in considering Government expenditures, should be conscious of the share they pay in taxes. By lowering the personal exemptions, say from $1,000 to $500 for single persons, and from $2,500 to $1,000 for married couples, it is estimated that six million more taxpayers would become subject to the direct, visible income tax.

The broadening of the federal income-tax base should be accompanied by the abolition of hidden excise taxes other than those which clearly relate to luxuries. These taxes, being fixed in rate, bear down most heavily on the low-income groups, who are blind to this imposition. As a class the hidden taxes ignore the principle of ability-to-pay. We recommend the repeal of these taxes.

10. Section 3801, dealing with mitigation of effect of limitations, is defective and should be revised:

Section 3801 of the Internal Revenue Code (section 820 under the 1938 act) is a highly technical provision of law intended to remedy a hardship either on the taxpayer or on the Government which results from the operation of the statute of limitations where inconsistent treatment has been accorded an item in different taxable years. Many accountants favor striking the section from the law until it can be redrafted. The committee viewing the section in a constructive spirit, believes the section should be retained, but that its obvious deficiencies should be remedied.

The section fails of its purpose if it begets new inconsistencies or accentu-
ates old ones. Yet that seems to be the result of the section as now drafted, by reason of the omission to authorize adjustments in one of the most flagrant and disturbing types of inconsistencies, namely, the double disallowance of deductions.

Furthermore, in restricting the general scope of the section to cases covered by closing agreements, refund claims, or judicial determinations, there are excluded automatically a very large portion of all returns filed. In most cases, there is no closing agreement, refund claim, or judicial contest. The tax liability is closed either by the acceptance of the return or the voluntary acknowledgment of additional tax or refund, and ultimately, by the running of the statute of limitations. Yet, if there be double inclusion or exclusion of income or other inconsistency, there is no less occasion for adjustment than in cases falling within the limited scope prescribed by the statute.

The inevitable effect of the present requirements is to force cases to the Board or to the courts, when inconsistencies are involved. This will continue to engender strife unnecessarily. Moreover, it endangers the whole fabric of case settlements, especially in cases where the issues are not clear and a lump sum of tax is agreed upon. Such settlements are unwise and erect dangerous precedents to the extent that they dispose of items in a manner inconsistent with other years.

Finally, section 3801 induces adjustment in the liability of one taxpayer for inconsistencies of a related taxpayer. The occasion for this in certain situations is recognized, but surely the repercussion should expressly be confined (except in the husband-and-wife status) solely to transactions growing out of the relationship, and possible only by reason of the existence of the relationship. The Commissioner's interpretation of this section as promulgated in T.D. 4856 recognizes no such limitation.

11. Section 3604 concerning foreign corporations should be repealed:

Section 3604 of the Internal Revenue Code, in requiring information returns with respect to foreign corporations, imposes an unreasonable and repugnant burden upon professional accountants, undermining the confidential relationship between accountant and client. The interests of all will be served best by fostering a forthright relationship between the accountant and his client in determining sound and ethical procedure.

The provision also injects an insidious and inconsistent form of espionage into the administration of the law, which is particularly repulsive to an honorable profession.

Section 3604 calls for comprehensive returns of information by accountants in connection with the formation, organization, or reorganization of foreign corporations. The language of the law itself is ambiguous, and the regulations thereunder imply an extension of the requirements to include information concerning proposed transactions in addition to consummated incorporations or reorganizations. The hypothetical questions provided in the regulations and in the related form 959 call upon accountants to divine the intent of clients. Furthermore, where does mere conversation end, and advice and counsel begin?

The obvious and simple manner in which the desired information should be obtained is by means of questions on the regular tax-return forms, with reference to such matters as would be disclosed by the information returns now required to be filed by accountants pursuant to the provisions of section 3604, augmented, if need be, by special information returns by the officers, directors, and stockholders directly concerned in such matters. The Government should not resort to reports of indirect informants.
Immediately upon the proposal of this provision in the revenue bill of 1937, the Committee registered its objections. We again strongly urge the repeal of section 3604.

12. Cancellation of indebtedness should not result in taxable income when debtor is insolvent:

Article 22(a)-14 of Regulations 101 provides in part that income is realized by a taxpayer by virtue of the discharge of his indebtedness as a result of an adjudication in bankruptcy, or by virtue of an agreement among his creditors, if immediately thereafter the value of his assets exceeds the amount of the taxpayer's remaining liabilities. This rule has long operated to discourage the rehabilitation of financially embarrassed and insolvent taxpayers, especially where restoration of solvency involved substantial income-tax liability.

As it relates to bankrupt taxpayers, this inequitable condition was corrected by section 268 of the national bankruptcy act, as amended June 22, 1938. Section 268 provides that no taxable income is realized by a taxpayer in the case of cancellation or reduction of his indebtedness under a plan of corporate reorganization, a composition agreement, a real-property arrangement, or a wage-earner's plan confirmed by a court as provided under the act.

There is no logical reason why this provision should not be embodied in the revenue law and applied to all insolvent taxpayers, whether going under formal bankruptcy proceedings or reorganizing with the help of creditors independently of the bankruptcy act.

Accordingly, it is recommended that a provision be inserted in the revenue act to the effect that there shall not be included in gross income indebtedness cancelled, in whole or in part, as a result of an adjudication in bankruptcy, or by virtue of an agreement with one or all of the creditors, if immediately before cancellation the debtor's liabilities exceed the value of his assets.

In connection with the national bankruptcy act, as amended, it should be pointed out that a disconcerting inequity has appeared in section 270 thereof, relating to the "basis" of the debtor's property after cancellation of indebtedness under the act. Section 270 provides in general that the basis of the debtor's property (other than money) shall be reduced by the amount of the indebtedness which has been cancelled or reduced in the proceeding. This provision is unduly broad and will serve to vitiate the mitigating effect of section 268 of the same act.

Prior to the 1938 amendments to the national bankruptcy act, several forms of cancellation of indebtedness arising out of adjudication in bankruptcy would not have been taxable under the revenue act in any event. For instance, the conversion of indebtedness into stock or the cancellation of indebtedness by a stockholder would not have resulted in taxable income to the debtor. Moreover, the Board of Tax Appeals has held in several decisions covering the purchase by corporations of their own bonds that if actual asset values (rather than book values) are less than liabilities (both before and after repurchase transaction), gain realized on the repurchase transaction is not taxable. According to the Board decision, taxable income is realized only to the extent that assets are freed from the claims of creditors; to the extent that no assets are freed, no income is realized. To require reduction in basis in those cases where no income is realized in any event, is to sabotage the spirit of the 1938 national bankruptcy act amendments which were designed not to penalize, but to relieve debt-ridden corporations. By reducing the base, all of the intended benefit is vitiated.

As section 270 of the act now reads, debt-ridden corporations, because of reduced bases for depreciation, or for
gain or loss, will in a great many in­
stances suffer greater hardships than
under the prior law. In order that the
relief purposes of the national bank­
ruptcy act amendments may be effec­
tively carried out, it is recommended
that the following qualifying clause be
added to the first sentence of section
270: “which cancellation or reduction
but for the provisions of section 268
would have resulted in taxable income.”
Thus, the first sentence of section 270
might read as follows:

“ . . . , the basis of debtor’s property
(other than money), or of property
(other than money) transferred to any
person required to use the debtor’s
basis in whole or in part, shall, for the
purposes of any federal or state law
imposing a tax upon income, be de­
creased by an amount equal to the
amount by which the debtor’s indebted­
ness, not including accrued interest
unpaid and not resulting in a tax bene­
fit on any income-tax return, has been
cancelled or reduced in a proceeding
under this chapter, which cancellation or
reduction but for the provisions of section
268 would have resulted in taxable in­
come.”

A requirement similar to section 270
of the national bankruptcy act has been
included in section 215 of the revenue
act of 1939. Section 215 provides that
where a corporation is in an “unsound
financial condition,” it may under cer­
tain limited conditions discharge at a
gain its outstanding indebtedness, in­
cluding indebtedness which it may have
assumed, without incurring taxable in­
come. The section also provides that the
discount which is excluded from taxable income “be applied in reduction of the
basis of any property held (whether be­
fore or after the time of discharge) by
the taxpayer during any portion of the
taxable year in which such discharge
occurred.”

As pointed out above in regard to
section 270 of the national bankruptcy
act, there are many instances where
cancellation of indebtedness would not
have resulted in taxable income in any
event. To require adjustment of basis in
these cases may, in effect, tax what is
not income, through reduced deprecia­
tion allowances or through increased
gain or decreased loss in the case of sub­
sequent sale or exchange. We recom­
mend, therefore, that the requirements
of section 215 be amended so that re­
duction of basis will be required only to
the extent that the discount realized on
the discharge of indebtedness would
have represented taxable income prior
to the enactment of section 215.

It should be noted, furthermore, that
section 268 of the bankruptcy act com­
prehends “indebtedness on open ac­
count,” and properly so. Section 215 of
the revenue act of 1939 should be
brought into conformity in this respect.

13. Land used in trade or business
should be excluded from definition
of capital assets:

Section 117 (a) (1) of the Internal
Revenue Code excludes from the defini­
tion of capital assets: “Property, used
in the trade or business, of a character
which is subject to the allowance for
depreciation provided in section 23 (1).”
It is strongly urged that the land upon
which such depreciable property stands
likewise be excluded from the statutory
definition. Land and the building at­
tached thereto generally are considered
to be one asset, and almost any transac­
tion which could result in capital gain or
loss would involve the sale or exchange
of the land and building together. There
is no logical ground for holding
that buildings used in trade or busi­
ness, and the land upon which the
buildings stand, belong in different
categories.

To remedy this objection, it is sug­
gested that section 117 (a) (1) be amended
to exclude from the definition of capital
assets “property (including land) held
for productive use in the trade or
business.”
14. **Excess depreciation not “beneficially allowed” should be ignored in determining basis of depreciable property:**

In recent years the Treasury Department has subjected depreciation deductions to close scrutiny, and in many cases has required the use of lower annual rates. Throughout the depression, a large number of companies operated at a loss; but in accordance with correct accounting principles, consistently maintained, continued during those years of loss to compute depreciation at established rates. Upon the return of profitable years, the Treasury Department has often required such taxpayers to use lower rates, without permitting retroactive application, with the result that the taxpayer is required to reduce the depreciable basis of his property by the excess depreciation taken in the years of net loss. Such excess depreciation clearly has not been “beneficially allowed” and the taxpayer should be permitted to add it back to the basis of the depreciable property.

We repeat our recommendation, therefore, that section 113 (b) (1) (B) of the Internal Revenue Code be amended to provide that in determining the basis of depreciable assets, adjustment should be made for depreciation “allowed or allowable,” except that where depreciation rates are revised downward by the Department, excess depreciation taken in years of net loss and not “beneficially allowed” for tax purposes, should be ignored.

As a matter of sound economic policy, there should be a deliberate tendency to liberalize the tax allowance for depreciation. A study of the Swedish system of “free depreciation” under which rates set by the taxpayers, and consistently maintained, are accepted by the taxing authorities without question, will pointedly demonstrate the long-range soundness of such a policy. One of the strong deterrents to the replacement of obsolete equipment is the fact that there must be a reasonable recovery of the cost of investment through depreciation before the abandonment of equipment may be justified from an operating standpoint. Business should be encouraged to accelerate the amortization of capital facilities beyond the ordinary “useful life” theory, commensurate with the trend of technological development and financial ability.

15. **Where loss results in transaction between persons to whom losses are disallowed, basis of property should be transferor’s basis:**

Section 24 (b) of the Internal Revenue Code provides for the disallowance of losses from sales or exchanges of property between closely allied individuals, corporations, and fiduciaries. It appears, however, that the basis of the property to the purchaser is the price paid in the non-recognized transaction. This offends the general theory of the effect of transactions resulting in no recognized loss. Provision should be made in the law that in such cases the basis and time period of the capital assets in the hands of the vendor shall be continued in the hands of the vendee.

16. **Use of average method, particularly where identification is impossible:**

The general rule, as stated in article 22 (a)–8 of Regulations 101, is that when shares of stock are sold from lots purchased at different dates or at different prices, and the identity of the lots cannot be determined, the stock sold shall be charged against the earliest purchases of such stock. In the case of split-ups, stock dividends, reorganizations, and other capital changes, especially where securities were acquired in many separate transactions over a period of time, the “first-in, first-out” rule has required complex record keeping and accounting.

There seems to be no reason why
matters cannot be simplified by requiring the use of the "average" method where identification is not possible. The "average" rule is practicable, is preferred from an accounting standpoint, and in the case of reorganizations has been approved by the Board of Tax Appeals and the courts.

Accordingly, it is again recommended that the "average" method be approved under any circumstances, instead of the "first-in, first-out" method, and be required where the identity of lots cannot be determined.

17. Where redemption of stock is held in effect a taxable dividend, basis of stock to stockholders should be applied against (1) dividend or (2) other holdings in the corporation:

Where stock is redeemed, and it is held under Section 115 (g) of the Internal Revenue Code that the redemption is in effect the distribution of a taxable dividend, it should follow that the basis, if any, of the stock in the hands of the stockholders should either be deducted from the dividend, or, more logically, be applied to the other holdings of stock in the corporation. For example, if stock is bought for $1,000 and a 100% stock dividend is declared and subsequently the dividend stock is redeemed, the $1,000 base should continue in the original stock. Apportionment made at the time of the declaration of the stock dividend is obviously undone when a redemption is held to be a dividend. This restoration of original basis is not covered in the law at present, and there is considerable doubt as to just what the situation would be. The problem is altogether complicated when the stock issued as a dividend is acquired by a third party for cash and this purchase constitutes the sole holdings of the third party. When the redemption of such stock is held to be a dividend, the third party's stock basis evaporates. He should be permitted either to offset it against the dividend or to consider it as a loss.

18. Basis of property devised, where estate tax is computed on values one year after death, should be value upon which estate tax is computed:

Prior to the revenue act of 1935, an executor could value an estate only as of the date of death. An amendment of section 302 of the revenue act of 1926 by the 1935 act, however, gives the executor an election with respect to the time as of which the property included in the gross estate may be valued. Under the amendment, the executor may now value the estate as of the date of death or as of the date one year after the decedent's death.

For income-tax purposes, the Code (section 113 (a) (5)) says that the basis of property transmitted at death is the value at time of acquisition. In interpreting section 113 (a) (5), the regulations hold that the time of acquisition of such property is the death of the decedent, and its basis is the fair market value at the time of the decedent's death. The regulations also state that the value of property as of the date of death as appraised for the purpose of the federal estate tax shall be deemed to be its fair market value at the time of the death of the decedent. However, the regulations continue, if the property is not appraised as of the date of death for federal estate tax purposes, the basis of the property for income-tax purposes shall be the value as appraised as of the date of death for the purpose of state inheritance or transmission taxes.

Under the interpretation, if the executor chooses to value the estate, for estate-tax purposes, as of one year after the decedent's death, that value cannot be used as the basis for gain or loss on subsequent disposition of the property. In such a case, the value at the date of death as appraised for state death taxes shall be deemed to be the fair market
value at the time of the death of the decedent.

From the standpoint of equitable treatment, it is not sound that one value should be used for estate-tax purposes and an entirely different value for income-tax purposes. Consistency of treatment should be the paramount consideration and, accordingly, it is recommended that the condition be rectified in the law, by prescribing that the basis of property devised shall be the value upon which the estate tax is computed.

19. **Worthless corporate obligations and stocks should be excluded from capital losses:**

Sections 23 (g) and 23 (k) of the revenue act of 1938 established a revised treatment for uncollectible corporate obligations and worthless stocks, which the committee deems unsound. This treatment has been continued in the Internal Revenue Code.

Inherently, capital losses arise from sales and exchanges which differ widely from losses occurring through worthlessness. The one lies within the control of the taxpayer; he may or may not sell or exchange, as he pleases. In the other case the result is involuntary and clearly beyond the control of the taxpayer. This difference justifies a distinction in the effect upon taxable income.

The result of the committee's questionnaire last summer disclosed a preponderance of opinion among accountants in favor of maintaining the distinction between the two types of losses. Accordingly, we again urge the restoration of the sound treatment previously accorded such losses.

20. **Omit the requirement that debts ascertained to be worthless must be charged off within the taxable year, and expand section 3801 to cover outlawed bad-debt deductions:**

Under Section 23 (k) of the Internal Revenue Code, bad debts to be deductible must not only be ascertained to be worthless during the taxable year, but must also be written off during the year. Worthlessness is a question of fact. It may be clear in some instances exactly when a debt becomes worthless, but in a majority of cases the exact point of time when worthlessness occurs is far from certain.

Conservative accounting practice very often requires the charge-off of doubtful accounts before they may actually become worthless for tax purposes, and under such circumstances it is questionable whether under the law the debt so charged off is ever deductible, as the required conditions—charge-off and ascertainment of worthlessness—have not both occurred in the same year. Moreover, it is alleged repeatedly that the Department regards bad-debt deductions from a prejudiced standpoint, and invariably determines that the debt became worthless in some year other than the taxable year—usually a year barred by the Statute of Limitations, a year in which the taxpayer had no income, a year in which the taxpayer was in a lower tax bracket, or a year in which the taxpayer could not comply with the write-off requirement. Under such circumstances, the taxpayer never will get the benefit of the deduction.

To remedy this situation, section 23 (k) should be revised to omit the rigid requirement that debts must have been charged off in the year ultimately determined to be the year of loss in order to constitute an allowable deduction. In addition, section 3801 of the Code, providing for mitigation of the effect of the statute of limitations, should be expanded to cover situations arising out of the denial of bad-debt deductions on the ground that worthlessness occurred in an outlawed year.

21. **Administration of worthless stock provision should be liberalized:**

The administration of section 23 (g) of the Internal Revenue Code, re-
Federal Tax Revision Program

garding losses from worthless stocks, has been very unsatisfactory. As in the case of uncollectible debts, discussed immediately above, it is alleged that the Department invariably determines that the stock becomes worthless in some year other than the taxable year. If the year of final determination is outlawed by the Statute of Limitations, the taxpayer loses the deduction entirely, as this situation is not covered by section 3801, providing for mitigation of the effect of the Statute of Limitations. From the standpoint of equity, relief should be granted taxpayers who make their determinations of worthlessness in a reasonable manner.

One method to accomplish this would be to expand the time, within which a worthless stock loss may be claimed, to a spread of five years which would include the two years before, the two years after, and the year of occurrence of the event which clearly establishes worthlessness.

Another solution is to broaden the scope of section 3801 of the Internal Revenue Code to permit a "corrective adjustment" in the case of worthless stock deductions disallowed in the current year and "determined" as belonging in a year now outlawed.

22. Mortgagee's loss should be considered bad debt:

Where a mortgage is foreclosed and the creditor bids in the property at a price below the face amount of the mortgage, the difference, if uncollectible, may be written off as a bad debt. However, in connection with the voluntary surrender of property in lieu of foreclosure, the Commissioner has ruled (in I.T. 3121, (1937) XVI-40-8952):

"Where a debt secured by a mortgage is compromised by the debtor transferring title to the mortgaged property to the creditor in exchange for a release of the debt from his obligation to the creditor, the loss, if any, sustained by the creditor is to be treated as arising from a sale or exchange of a capital asset. . . ."

In this ruling the Commissioner has seized upon a mere difference in form between foreclosure proceedings and the voluntary surrender of property in payment of a debt. Both transactions are the same in substance and, viewed from a practical angle, it is immaterial whether the property is forcibly taken in payment of a debt or voluntarily given. No "sale or exchange" occurs in either instance. In both cases the relationship between mortgagor and mortgagee is that of debtor and creditor, not of vendor and vendee, and since in the one case the creditor is permitted a bad debt loss, there is no reason why the same privilege should be denied in the other. To exalt form above substance in this instance is to penalize severely creditors who seek to avoid the expense of foreclosure action by arranging with cooperative debtors the voluntary surrender of the mortgaged property. This injustice should be remedied.

23. Treasury Department should publish the year in which securities are held worthless:

To facilitate matters for taxpayers, and to reduce controversy to a minimum, as soon as a conclusion regarding any security is reached by the securities-valuation section of the Department, a statement of the year in which it is deductible should be published in the Internal Revenue bulletin service. Also, it would be helpful if a special bulletin were published by the Treasury Department indicating the year in which securities previously ruled to be worthless, were held deductible.

24. Corporate deduction for contributions should be broadened:

Section 23 (a) (2) of the revenue act of 1938 introduced a new limitation on the deduction of contributions by corporations. This limitation has been continued in the Internal Revenue
American Institute of Accountants

Code. Section 23 (a) (2) provides that no contributions in excess of the five per cent allowable under section 23 (q), shall be deductible by a corporation as "ordinary and necessary business expenses."

The report of the House ways and means committee on the 1938 bill makes it clear that it was not the intent of Congress to limit the deduction of corporate payments to charitable organizations, where the payments made are not purely contributions or gifts. An example is given therein of a mining company making payment to a local hospital in consideration of the hospital assuming an obligation to provide services for employees of the company. Such payments would be deductible, the report indicates, as they are not contributions.

Generally speaking, however, the distinction between payments made to an exempt organization for a valuable consideration and those made without such consideration, cannot be sharply drawn in the case of a corporation. Payments made to charitable organizations by business corporations generally involve a *quid pro quo*, even though the transaction is more complex than the simple example cited by the House committee. Viewed realistically, contributions made by corporations, with very few exceptions, have a promotional motive, and are, therefore, ordinary and necessary expenses of the business, which should be allowed in full.

Section 23 (a) (2) of the Internal Revenue Code is unfair to business corporations and to charitable organizations; it is also contrary to public interest and benefit. Increasing litigations and conflicts between the Treasury Department and taxpayers will probably result from this subsection, as the question of whether a payment has a "valuable consideration" is extremely difficult to determine.

For these reasons it is again recommended that section 23 (a) (2) be repealed.

25. *Credit for foreign income taxes should be revised:*

The Supreme Court decision of January 10, 1938, in the *Biddle* case, to the effect that the British tax on dividends of British companies is not paid by the stockholder, although deducted from the dividend, is likely to discourage investment in foreign securities affected by the decision. As a certain amount of foreign investment is desirable, we recommend that the Internal Revenue Code be amended to include a declaration that such income taxes as the British, withheld from dividends at the source, should be deemed to be paid by the stockholder and should be allowable as a credit under section 131 (a).

26. *Corporations should be permitted to prepare returns for periods of 52 or 53 weeks:*

Under a literal interpretation of the income-tax law, corporations maintaining their books on a weekly basis and preparing their annual financial statements as at the close of the week nearest the end of some month other than December, would not be permitted to file returns on the basis of a fiscal year, but would be required to file calendar-year returns. In practice, however, such corporations are often permitted to use a fiscal-year basis but are required to adjust their income for the difference in days between their fiscal year and the month-end.

In order to obviate the possibility that these corporations might some day be required to file calendar-year returns, and to simplify the preparation of their returns, *permission should be granted* to file returns for the same fiscal periods as in the case of annual statements, viz.: fiscal periods of 52 or 53 weeks.

The foregoing recommendations are designed to call to the attention of Congress and the Treasury Department certain desirable changes in the tax law. They are intended neither to represent
exhaustive analyses of the various topics involved nor to cover all points requiring remedial legislative action. All of them have been stressed before by this committee in substantially the same form and have been endorsed by the tax committees of many of the state societies of certified public accountants throughout the United States, as well as by others competent to speak on the subject.

In conclusion, we should like to mention without explanatory comment several other suggestions for congressional consideration: (1) adoption of moderate tax rates to encourage enterprise; (2) retroactive exemption of deficit corporations from the surtax on undistributed profits; (3) exclusion from gross income of credit adjustments relating to deductions taken in years of net loss; (4) taxation of all corporations at the same rate on the first $25,000 of net income; (5) allowance of deficiency dividends to offset deficiencies in the undistributed-profits tax under the 1936 and 1938 acts; and (6) provision that consent extending period of limitations should also extend time for filing claims for refund.

Respectfully submitted,

AMERICAN INSTITUTE OF ACCOUNTANTS
COMMITTEE ON FEDERAL TAXATION
Jas. A. Councilor
Victor H. Stempf, Chairman
Clarence L. Turner
Edw. B. Wilcox
Leon E. Williams
Richard S. Wyler
### BASIC PRINCIPLES

<table>
<thead>
<tr>
<th>Statement</th>
<th>Yes</th>
<th>No</th>
<th>Doubtful</th>
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<tbody>
<tr>
<td>1. Taxation should be based upon fixed principles closely related to sound accounting procedure</td>
<td>63</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Adopt moderate tax rates to encourage enterprise</td>
<td>58</td>
<td>1</td>
<td>4</td>
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<tr>
<td>3. Congress should create a qualified nonpartisan commission to establish fixed tax principles</td>
<td>56</td>
<td>3</td>
<td>4</td>
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<tr>
<td>4. The tax base should be broadened</td>
<td>54</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>5. Corporate tax burden should be equalized as between normally steady incomes and violently fluctuating earnings</td>
<td>42</td>
<td>17</td>
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<tr>
<td>6. The law should set forth a satisfactory definition of “earnings or profits”</td>
<td>54</td>
<td>8</td>
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<tr>
<td>7. Net loss carry-over should be restored</td>
<td>56</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>8. Consolidated returns should be made mandatory</td>
<td>46</td>
<td>11</td>
<td>6</td>
</tr>
<tr>
<td>9. Corporations may elect to file returns for 52 or 53 week period</td>
<td>52</td>
<td>8</td>
<td>3</td>
</tr>
<tr>
<td>10. All corporations should be taxed at the same rates on the first $25,000 of net income</td>
<td>52</td>
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### UNDISTRIBUTED-PROFITS TAX

<table>
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<tbody>
<tr>
<td>11. Remnant of undistributed-profits tax retained in 1938 act should be removed</td>
<td>54</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>12. Doubt as to dividends-paid credit where optional distribution is made should be resolved</td>
<td>52</td>
<td>2</td>
<td>9</td>
</tr>
<tr>
<td>13. Simple scheme should be devised whereby stockholders may pick up pro-rata shares of corporate income without complicated procedure</td>
<td>54</td>
<td>6</td>
<td>3</td>
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<tr>
<td>14. Conflict between subsections 27(g) and 27(i) should be reconciled</td>
<td>57</td>
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### CAPITAL-STOCK AND EXCESS-PROFITS TAXES

<table>
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<tbody>
<tr>
<td>15. Capital-stock tax and related excess-profits tax should be repealed</td>
<td>44</td>
<td>16</td>
<td>3</td>
</tr>
<tr>
<td>16. Excess-profits tax, if retained, should be based upon ordinary business net income and exclude capital gains and losses</td>
<td>50</td>
<td>11</td>
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<tr>
<td>17. Annual redeclarations of value should be permitted</td>
<td>57</td>
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### CAPITAL GAINS AND LOSSES

<table>
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<tr>
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<tr>
<td>18. Capital gains and losses should be removed entirely from taxable net income</td>
<td>24</td>
<td>37</td>
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<tr>
<td>19. All capital gains and losses should be treated as long-term capital gains and losses are treated under the 1938 act</td>
<td>45</td>
<td>13</td>
<td>5</td>
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<tr>
<td>20. As capital gains are taxable in full to corporations, capital net losses should also be allowed in full</td>
<td>62</td>
<td></td>
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</tbody>
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### INVENTORIES

<table>
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<th>Statement</th>
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<tbody>
<tr>
<td>21. Dealer in securities or commodities should be permitted to inventory short position</td>
<td>51</td>
<td>6</td>
<td>6</td>
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<tr>
<td>22. Provisions of 1938 act, covering the “last-in, first-out inventory method,” are too narrow</td>
<td>53</td>
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### BASIS OF PROPERTY

<table>
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<th>Statement</th>
<th>Yes</th>
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<tbody>
<tr>
<td>23. Basis of depreciable property should be reduced only by depreciation allowed</td>
<td>56</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>24. Basis of property received as gift in contemplation of death should be probate value</td>
<td>54</td>
<td>7</td>
<td>2</td>
</tr>
<tr>
<td>25. Basis of property devised, where estate tax is computed on one year after death, should be value upon which estate tax is computed</td>
<td>58</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>26. Where loss results in transaction between persons to whom losses would be disallowed, basis of property should be transferor’s basis</td>
<td>56</td>
<td>5</td>
<td>2</td>
</tr>
<tr>
<td>27. Law should contain provision that basic cost of stock sold by any taxpayer is average cost</td>
<td>31</td>
<td>26</td>
<td>6</td>
</tr>
<tr>
<td>28. Where held that redemption of stock is in effect a taxable dividend, basis of stock to stockholders should be applied against (1) dividend or (2) other holdings in the corporation</td>
<td>53</td>
<td>4</td>
<td>6</td>
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RECOGNITION OF GAIN OR LOSS

29. Irremovable improvements by lessees should not be considered as income to lessor until disposed of. .............................................................. 54 6 3
30. To avoid constant annoyance, loss or gain on trade-in of business property should be recognized. ................................................................. 59 3 1
31. In view of Hendler case, section 112(d) should be amended to permit assumption by a transferee of liabilities of transferor without impairing

tax-free status of transaction ....................................................................................................................................................................................... 56 2 5
32. Gross income should not include indebtedness cancelled as result of adjudication in bankruptcy, or agreement with creditors, if immediately

before cancellation, debtor's liabilities exceed assets. ................................................................................................................................................. 60 2 1

BAD DEBTS AND WORTHLESS SECURITIES

33. Losses from uncollectible corporate obligations and worthless stocks should not be subject to capital gain and loss limitations .................... 55 7 1
34. When mortgage debt is compromised by debtor transferring title to mortgagee for release of uncollectible obligation, mortgagee should be

allowed to deduct loss as bad debt. ............................................................................................................................................................................. 59 2 2
35. Bad debts should be deductible in year ofascertainment by taxpayer, although charged off in different year ................................................. 43 17 3
36. Stock loss should be deductible in year taken by taxpayer if such year is within five-year period in which event occurs which clearly estab­

ishes worthlessness. ....................................................................................................................................................................................................... 38 19 6
37. Treasury Department should publish in Internal Revenue Bulletin service year in which securities are held worthless. ................................. 59 4 2

ESTATE AND GIFT TAXES

38. The law with respect to the valuation of large blocks of stock should be clarified. .................................................................................................. 58 3 2
39. Decedent's charitable pledges are usually valid claims against estate and should be allowed as deductions for estate-tax purposes .............. 62 1 4
40. Where gift tax is paid on property subjected to estate tax, credit should be allowed for gift taxes at highest gift-tax rates paid, instead of

average rate paid in year of gift. ............................................................................................................................................................................. 52 8 3
41. The provisions of the estate-tax law should be consolidated into one act. . ............................................................................................................................................. 63 3 1

BOARD OF TAX APPEALS AND COURTS

42. Eliminate distinction between court actions against the collector and against the United States. ................................................................. 53 1 9
43. Give the board jurisdiction over claims for refund...................................................................................................................................................... 55 2 6
44. Make it mandatory for commissioner to take cases through courts where he does not acquiesce in board ruling ............................................ 51 8 4

MISCELLANEOUS SUGGESTIONS

45. Section 803 concerning foreign corporations should be repealed................................................................................................................................ 55 6 2
46. Section 820 should be stricken from the law until it can be redrafted ...................................................................................................................... 55 5 3
47. Filing of federal income-tax returns should be extended to 15th day of fourth month after close of taxable year ................................................. 58 5 —
48. Taxes should be deductible when accrued in accordance with regular accounting procedure. ................................................................. 57 6 —
49. Expenses incurred in the production of taxable income should be allowed although such income does not arise from trade or business. . . . 63 — —
50. Intent of Congress to allow corporations full deduction for contributions for benefit of employees, should be clearly stated in law .............. 63 — —
51. Personal holding companies on cash basis should use income tax accrued instead of paid for title IA tax. ................................. 51 5 7
52. Section 311 should provide for allowance of refunds to transferee of overpayments by transferor ................................................................. 57 1 5
53. Permit individuals not in trade or business to file returns in district in which employed ..................................................................................... 56 4 3
54. Waiver of statute of limitations should also extend time for filing claims for refund .................................................................................. 61 2 —
55. Interest is collected on deficiencies from date first installment was due. Such interest should be charged from due date of instalments. . . . 56 6 1
56. Such income taxes as the British, withheld from dividends at source, should be allowable as credit under section 131(a) ......................... 51 4 8