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Certain Technical Recommendations Dealing with H.R. 7378

American Institute of Accountants. Committee on Federal Taxation

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American Institute of Accountants
INCORPORATED UNDER THE LAWS OF THE DISTRICT OF COLUMBIA
THE NATIONAL ORGANIZATION OF CERTIFIED PUBLIC ACCOUNTANTS
13 EAST 41ST STREET, NEW YORK

August 26, 1942

Hon. Walter F. George, Chairman,
Senate Finance Committee,
Senate Office Building,
Washington, D. C.

Sir:

When the Chairman of the Committee on Federal Taxation of the American Institute of Accountants testified at the hearings of your committee (Tuesday, August 11, 1942), it was arranged that certain technical recommendations dealing with H.R. 7378, would be submitted later. Our committee is now pleased to submit them herein.

COLLECTION OF TAX AT SOURCE - SUPPLEMENT "U"

Because of their work for clients, public accountants are necessarily familiar with various accounting records and methods and the office equipment used to record payments of dividends, bond interest and wages. Our suggestions with respect to Supplement "U" deal with the practical problems of carrying out the provisions of the proposed plan for collection of tax at source and for this purpose assume that the plan, generally laid down in H. R. 7378, will be retained.

We are in favor of the principle of the collection of tax at source, but any such plan will increase the burden on industry and on the Treasury Department and Bureau of Internal Revenue. It is therefore essential that such a radical change in income tax practice be developed in a way that is as simple and practical as possible. It

has been estimated that the present proposal will increase the cost of payroll departments by from 10% to 20% (more if it prevents using present mechanical equipment). Hence, anything that can be done to save any part of that labor effort leaves that much more effort for the prosecution of the war.

As a step in attaining that very desirable goal we offer seven suggestions which we summarize briefly as follows:

(1) Section 425 should be amended to exempt employers of less than 8 from withholding.

(2) Section 426(b) should be modified to provide a series of tables providing for income blocks on which specified amounts should be withheld.

(3) Section 427(b) should be modified to base withholding on the status (as to exemption and dependents) at the beginning of the year.

(4) Section 430 should be amended to eliminate the requirement that a statement of tax withheld be furnished with final wage payments.

(5) Section 426(a) should be modified to eliminate withholding on payments to partnerships or fiduciaries.

(6) Section 426 should be modified to exempt payments of interest and dividends of less than $50.00.

(7) Section 430(b) should be modified to eliminate the requirement that a special statement of tax withheld be furnished with every interest or dividend payment.

(1) <u>Employers of less than 8</u>

<u>Section 425(h)</u>, defining "employer" and such other sections as are pertinent, should be amended to eliminate the requirement for withholding in the cases of employers of less than 8 employees.

Based on information obtained from the Treasury Department, we understand that there are approximately 360,000 employers who have 8 or more employees and that there are something like 3,000,000 employers in all. If these numbers are substantially correct it means that the inclusion under the withholding plan of employers of less than 8 employees will require quarterly returns from an additional 2,640,000 employers, and yet it is estimated that these additional employers will account for not more than 15% or 20% of the total employees in the country or of the wages paid. Stated in another way, the 360,000 employers with 8 or more employees account for 80% to 85% of the total number of employees and of the total wages.

Therefore, the purposes of withholding income tax at the source would appear to be substantially secured if employers of less than 8 employees were omitted from the requirement to withhold. We doubt whether the additional coverage will justify the extra millions of returns and the extra labor and expense placed upon the Bureau and small taxpayers. During these war times it would appear more important than ever to balance theoretical perfection against large additional requirements of the Bureau for employees, for space, for equipment, for printing and other necessary expenses. We further suggest that any new plan will, especially in its first year, raise numerous administrative difficulties and, even if at a later date it is decided to include in the withholding plan employers of less than 8 employees, that such should be omitted at this time during what might be called a test or trial period.

(2) Special withholding tables on a block, rather than rate, basis

Section 426 (b) sets forth a tabulation of the amounts which shall be allowed as a deduction against wages paid for each payroll period and specified rates must be withheld on any payment in excess of such amounts. In place thereof we suggest that there be sub-

stituted tables such as the attached samples marked Table 1 and Table 2.

The method now provided in H.R. 7378 requires a calculation, for each employee, of the percentage (5% in 1943 and 10% in 1944) of the wages in excess of the minimum amounts stated in the table in order to determine the tax to be withheld. Accounting machinery as used in many payroll departments is not equipped to provide for the necessary multiplication and subtraction computations which would be required. It is suggested, therefore, that tables be included in the bill which will set forth the amount of tax to be withheld, based on the wages per week, etc., falling within each of several income blocks and for the different graduations of personal exemptions and dependents similar in principle to the simplified tax form and table for incomes up to $3,000.00, as illustrated by tables 1 & 2 heretofore referred to. These tables conform approximately to the present provisions in the Act that the amount to be deducted or withheld in 1943 should be 5% after deducting exemptions plus an amount equivalent to 10% of the exemptions (being approximate amount of deductions usually claimed by taxpayers of this income group) based on the mean of the income block. The use of such tables would greatly simplify the withholding by employers as it will eliminate the need for exact computations, to the penny, in every case. Payroll clerks will soon memorize these tables, and will be able to reduce by 75% at least the time needed to determine the tax to be withheld.

Inasmuch as the withholding is not intended to represent the exact tax liability of the employee the amount which will be withheld on such a block basis will be close enough for practical purposes. The suggested spread in the income blocks ranges from $1.00 in the lower brackets to $5.00 in the higher brackets and the

tax to be withheld is computed in even nickels. However, the spread between blocks may be such as the administrative officials may deem most suitable. The higher the income the wider can be the spread. The wider the spread between income blocks and the tax amounts (even dimes is better than even nickels, etc.), the better and simpler it will be for all concerned.

Separate tables can be provided for various numbers of dependents up to whatever number seems workable and necessary. The tables can be carried up to incomes equalling $10,000.00 per annum, with wider spreads between blocks as the income rises. These are details that administrative officials are in a better position to develop than are we. The principle is the important suggestion we urge upon you.

(3) Determination of Exemption Status

Section 427 (b) should be amended so that the personal exemption and credit for dependents will be based upon the status of the recipient at the beginning of the year (or of employment if after January 1st).

The present proposal requiring a change in status to take effect on the first day of each payroll period places an undue if not impossible burden on the payroll department of any business with a large number of employees. We understand that, following the close of each year, an income tax return will be required from most if not all employees, that there will be a difference between the tax for the full year as shown by such return and the tax withheld during the year, and that suitable provision is to be made for refunds and for specially prompt refunds of less than $50.00. Under the circumstances, we do not believe that the difference in amount withheld from any individual employee because of a change during a year in personal

exemption or credit for dependents will justify the extra calculations required. To make it necessary to check back on exemptions at each payroll period will impose a heavy burden not justified by the results it will produce.

Similarly, Section 431 should be amended so that a reasonable time will be given to the employer for preparing the necessary records and making the necessary calculations in the payroll department. We suggest that the status for the year be based upon the situation at the time the certificate is filed by the employee with the employer, which filing to be effective should be at least 7 days prior to the beginning of the year. In the case of employees hired during the year the certificate, to be effective to cover withholding by the employer, should be filed with the employer at least 7 days prior to the day when the first pay is to be received. The purpose of these suggestions is to give reasonable opportunity for the necessary clerical work in the payroll department for the protection of the employer, although each employer would have the option of making up the payroll with a shorter period of advance notice as to status.

(4) Statements of tax withheld when employment is terminated

Section 430 (b) should be amended so that, within thirty days, or some other reasonable period, after the termination of employment a written statement shall be delivered to the employee or mailed by the employer to the employee at his last known address. In making this suggestion we realize that some employees, shifting from job to job, may not be reached by the forwarding of mail, but we believe that the failure of some employees to receive the statement during the year (they can always obtain duplicates by requesting them from the employer) is of less practical importance than the work involved in a requirement that all employers must complete a

statement for the amount withheld up to the time the employment is terminated, and have such statement ready for delivery to the employee with his final pay. This requirement may in some cases extend unreasonably the time the employee is required to wait for such pay.

(5) Withholding from partnerships and fiduciaries

We question whether the proposed withholding of tax at source from payments to fiduciaries, as covered by Section 173, and partnerships, by Section 173 (g) and Section 191, are of sufficient importance to justify the additional burden placed upon those making payments of interest and dividends and to the fiduciaries and partnerships themselves. Partnerships and fiduciaries are now required to file information returns showing the distribution to individual taxpayers, who in turn include such distributions in their personal returns. If partnerships and fiduciaries were omitted from withholding, as provided in the case of domestic corporations, there would be no loss of income but additional work would be saved those filing returns and the Bureau in handling such returns.

Hence, we suggest that Section 426 (a) be amended to effectuate the above suggestion.

(6) Withholding from small payments of dividends and interest

Dividends and bond interest in many instances involve the payment of relatively small sums. To withhold tax on all such payments will involve the handling of many small items (in many instances less than $1) on the records of the withholding agent and the Bureau of Internal Revenue. The detail work would be reduced if no withholding were required except when the payment to the recipient of bond interest or dividends is $50.00 or more.

(7) Statements with payments of bond interest and dividends

Section 430 (b) provides for a statement to the person to

whom dividends and bond interest are paid showing the amount of tax withheld. It should be made clear that this requirement can be satisfied by showing the proper deduction on the dividend check or interest check or by ownership certificates necessarily filed for bond coupons. To require the issuance of a special statement with each such payment will involve a heavy clerical task that will not be justified by the benefits to be obtained thereby. This will be particularly true if it be provided, and we suggest it be provided, that withholding on dividend and interest payments be on the gross amount without exemptions or deductions. There are not many people receiving investment income of this type who will have no tax to pay and most of these will probably receive their income without deduction if payments under $50.00 are exempted.

<u>Summary</u>

If these suggestions are adopted the cost to, and burden on, business and the Treasury Department will be materially reduced without appreciably reducing the effectiveness of the withholding plan.

Taxation of Income of Decedents
Section 129:

Section 129 of H.R. 7378 will grant relief and reduce the aggregate tax liability in some cases, but in the case of the larger estates, it will increase the tax rather than decrease it, and in some estates will result in levying tax in excess of 100% of the amount involved. This results from the specific provision which defines the deduction allowable for estate tax in the tax returns of the recipients of the accrued income and provides that (1) it be a portion of the total estate tax on an average basis, and (2) the credit for state taxes be first deducted so that in effect there is allowed as a deduction only 20% of the taxes actually paid on the income. The fact is, however, that the addition of the accrued income to the estate increases the tax in the highest bracket and by the full amount thereof as the credit is allowed for state taxes only if actually paid. Under the present law, whatever income tax may be chargeable against the deceased, serves to reduce the estate tax in the highest bracket, and thus, under no circumstances, does the combined income and estate tax equal 100% of the total amount involved.

As an illustration of the effect of the proposed amendment, assume the case of a deceased having an estate of $5,000,000, including $100,000 of accrued income. Adding that to the taxable estate will increase the tax by 63% thereof or $63,000. The recipients of the income ought to deduct that $63,000 in determining the amount subject to income tax.

However, the statute, as proposed in H.R. 7378, will permit a deduction of only the average tax (less credit for state taxes) which will be about $41,000 so that the recipients will be

taxable on a net amount of $59,000. The tax payable by the recipient will depend on the total income including the income derived through the estate, but it is to be noted that on incomes over $26,000 a rate of 61% begins to apply. It will be quite easy, therefore, for a tax of 61% or more to be levied on the $59,000 net income of the deceased, and even at the 60% rate, it will amount to $36,000, making an aggregate estate and income tax of $99,000 on accrued income of $100,000. The total tax may easily exceed 100% of the amount involved and, in many cases, will considerably increase the tax over what is payable under the present law.

We urge, therefore, that this situation be taken care of by providing that the credit or deduction for the estate tax be determined by ascertaining the difference between what the estate tax would have been without the accrued income and what it was after including the income, and the credit for taxes paid to states be not considered in determining such amounts.

Re: SECTION 218 of REVENUE ACT OF 1942
ADDING SECTION 761 to INTERNAL
REVENUE CODE

A careful study of proposed Section 761 indicates that it will not accomplish the purposes set forth in the report of the House Ways and Means Committee. We agree wholly with the principal proposed, namely, to approach as closely as possible the normal accounting procedure in connection with consolidations, as generally outlined in Consolidated Returns Regulations 110, so as to obtain the same net results whether subsidiaries remain in existence and are included in the consolidated return or were previously liquidated. However, it seems quite clear that if the language of the proposed amendment is followed, such result will not obtain for several reasons.

In the first place, Section 761(b)(1) provides that under certain circumstances the result should be to reflect in the invested capital of the transferee or parent company the equity invested capital, etc. of the transferor. However, it is stated that such result should obtain when the stock of the subsidiary was acquired by the parent by the issuance of its stock in transactions "in which gain or loss in whole or in part was not recognized." However, the report of the Committee indicates that such situation will generally occur where the stock of the subsidiary has been acquired "with a substituted basis." The language of the Committee report follows generally the Consolidated Returns Regulations, the particular situation being covered by Section 33.34(b)(2)(IV)F. However, there may be many cases in which stock is acquired without recognition of gain or loss but which would still permit the parent company to include, in invested capital, its cost for the stock of the subsidiary. The obvious illustration is the case of a corporation acquiring all the shares of another corporation in exchange for its own stock where the stockholders of the subsidiary acquired less than a controlling interest in the parent corporation. Under Section 718, the parent corporation, without liquidating the subsidiary, could include in its invested capital an amount equal to its cost for the stock of the subsidiary which would be the value of the shares issued. Though no gain or loss was recognized to the former shareholders of the subsidiary, no substitute basis in the hands of the parent corporation is involved. Under such circumstances, the Consolidated Returns Regulations would require a consolidation of the two companies (if liquidation has not occurred) on the basis of including in the parent's invested capital the amount ordinarilly includible

under Section 718 and add to or deduct from the parent's accumulated earnings the accumulated earnings or deficit, as the case may be, of the subsidiary, accumulated after its acquisition.

While the report intimates that the rule of Section 761(b)(1) applies generally in cases involving a substituted basis and further intimates that the substantial equivalent of the Consolidated Returns Regulations is included, it seems doubtful that the Commissioner of Internal Revenue has authority to issue a regulation that will accomplish the exact opposite of what the law specifically requires. This, of course, can be partly corrected, at least to relieve the situation previously described, by changing Section 761 to apply only with respect to stock of the transferor (liquidator) which was acquired with a substituted basis - but even that will not go far enough. There are circumstances in which a substituted basis is involved, in so far as it relates to the owner of the stock at the date of liquidation under which Section 761 will not result in a true consolidated picture even if amended as just suggested. An example is the case of a corporation that originally acquired all the shares of another corporation for cash or the equivalent but subsequently transferred that stock to another affiliate and, either because the transfer occurred in a consolidated return period or because the transfer to the affiliate in itself constituted a non-taxable reorganization, the holder of the stock at the time of liquidation would have had a substituted basis or would have acquired the shares in a transaction in which gain or loss was recognized. In all cases there would not have been involved the issuance of stock of the transferee but that has happened in many cases in which a parent of an affiliated group organized another corporation and transferred to it certain properties

including stock of another affiliate, previously acquired for cash in exchange for stock of the new corporation.

Both of the difficulties previously mentioned can be substantially overcome only by including in the statute wording similar to that contained in sub-sections F and G of Sections 33.34(b)(2)(IV) of the Consolidated Returns Regulations, including particularly the parenthetical clause. Even that clause will probably not cover every particular situation, including all very unusual situations, but it will lay down a sufficiently broad policy that will probably permit the issuance of Regulations or rulings that will accomplish substantial justice. It seems doubtful that, despite the statement of policy set forth in the report of the House Ways and Means Committee, the restricted and specific wording of Section 761 will accomplish the result ultimately desired. It is suggested, therefore, that the wording be changed to that contained in the aforementioned two sub-sections of the Consolidated Returns Regulations.

A third feature that seems to require clarification relates to the method by which the invested capital of the subsidiary is to be reflected in the invested capital of the taxpayer. Section 761(b)(1) states that there shall be included in invested capital of the taxpayer

> "the amount determined to be necessary to reflect the equity invested capital and the deficit in earnings and profits, if any, of the transferor with respect to such stock."

The above paragraph would seem to require that if there should be a deficit of the transferor, it must be reflected in the equity invested

capital of the taxpayer which means that the latter's invested capital must be reduced. However, if the taxpayer itself has a deficit, there should be no reduction on account of the deficit of the subsidiary. To the extent that both corporations have earnings no problem arises. If the parent corporation has accumulated earnings in excess of the subsidiary's deficit, the deduction will be correct. Under the Consolidated Returns Regulations, the subsidiary's deficit will not be deducted if the consolidated surplus otherwise is a deficit. It should not be required by Section 761. While Regulations might be issued to produce the correct result, here also it is doubtful that the Regulations will be valid. In this connection, we suggest that the language of Section 761(b)(1) be modified to read, in so far as the last phrase beginning "there shall be included", is concerned, as follows:

> "there shall be included, in lieu of the amounts determined to be otherwise includible in the equity invested capital of the taxpayer with respect to such stock, the amount determined to be necessary to reflect the equity invested capital of the transferor, with respect to such stock and in the event the transferor has an accumulated deficit in earnings and profits, the amount of such deficit shall be deducted from the accumulated earnings and profits of the taxpayer but not in an amount in excess of such accumulated earnings and profits."

A fourth feature which arises with respect to this proposed new section relates to transactions which occurred during the period

when the provisions of Section 718(a)(5) and 718(b)(4) were part of the Revenue Act. Transactions which may have been consummated before the enactment of the Excess Profits Tax Law containing the aforementioned provisions were not consummated in the light of the excess profits tax law. However, those that have been consummated since the law was first enacted have necessarily had to deal with and recognize the effect of the law. There have been cases in which subsidiaries were liquidated because under the terms of the law, then existing, the liquidation would not adversely affect invested capital. In cases where it would adversely affect invested capital, the transactions could not be consummated. A typical situation involves the case of a corporation (which we here call corporation A) owning all the shares of another corporation (which we here call corporation B) the latter having paid in and accumulated capital at the date of A's acquisition thereof, in excess of the tax basis of its shares in the hands of the corporation that owned it. If the two corporations continue their separate existence, corporation A as a holding company only would not be concerned with excess profits taxes or invested capital and corporation B would be entitled to its own invested capital. However, if corporation B were liquidated into corporation A, the latter succeeded to invested capital equal to that of corporation B. If such were the circumstances, corporation B could be liquidated. On the other hand, if the result would have been to reduce the aggregate invested capital, such a subsidiary was not liquidated. Relying on the provisions of Section 718, some such corporations were liquidated, without changing invested capital. The application of the proposed Section 761 however, will result in

reducing such invested capital. It is believed that taxpayers who relied on the existence of Section 718, as it now stands, with respect to these liquidations, and accordingly liquidated subsidiaries, should not now be penalized by being required to reduce their invested capital. To meet this situation, therefore, we suggest that the amendment to eliminate Sections 718(a)(5) and 718(b)(4) and to apply the provisions of Section 761 should not be applicable to transactions consummated between the date of enactment of the first excess profits tax law (October 8, 1940) and the date of enactment of the pending law. If desired, the right to continue under the present provisions could be made elective but this seems hardly worthwhile as taxpayers who found, under the existing law, that the liquidation of the subsidiary would reduce invested capital, did not liquidate their subsidiaries.

REGARDING BAD DEBTS

When Deductible-Sec.23(K):

Sec. 119 of H.R. 7378 proposes to modify the requirements for the deduction of bad debts in two respects. One is to eliminate the write-off requirement, in which proposal we fully concur. The other change is to require that they be deducted in the year they become worthless rather than in the year ascertained worthless as provided by the existing law. We believe that this change is not desirable.

Most of the bad-debt deductions are sustained by business corporations. In the general operation of business, thousands of non-collectible accounts are charged off. In a great many such cases, it will be virtually impossible to prove the particular year in which the debts became worthless, particularly as to small accounts. As a matter of fact, many of them, particularly when individuals are the debtors, are worthless at the time the debt is created, but unfortunately the creditor does not learn that until sometime later.

In many other cases, where it might be possible, ultimately, after a great deal of work, to establish the year in which a particular debt became worthess, it will, nevertheless, be the cause of much dispute between the Treasury Department and taxpayers.

There is no advantage in making this change, nor is there any point in putting the bad-debt deduction on the same basis as worthless stock, because in the final analysis, bad debts are primarily the deductions of business corporations, while worthless stocks are primarily the deductions of individuals.

We suggest, therefore, that the present statute permitting the deduction in the year ascertained worthless be retained, but that the requirement regarding write-off be eliminated, as proposed in

H.R. 7378.

Statute of Limitations-Sec.322:

Section 150 of H.R. 7378 proposes to amend the Statute of Limitations with respect to worthless securities and bad debts to extend the same to a seven-year period. This is a very desirable change.

It is noted, however, that the application of this amendment is to be limited to taxable years beginning on or after December 31, 1938. We believe that this limitation is unsound and should be removed. The amendment should be made retroactive to all open cases.

To begin with, it may very well be that for the years 1941, 1942, 1943 or even 1944, there will be disallowances of either debts or securities alleged to have become worthless in prior years, including years prior to December 31, 1938. There is no reason why future disallowances should be outside the pale of the proposed amendment.

In the second place, there were many uncertainties in the years prior to 1938. In fact, there was more uncertainty about the particular year in which securities or debts became worthless during that period than there is likely to occur in many future years. Taxpayers who have been whip-sawed by actions on this most difficult problem should not be denied appropriate and proper relief merely because the alleged worthlessness occurred prior to December 31, 1938. Furthermore, this limitation will not completely relieve the situation because if disallowances should occur now, the proposed amendment merely extends the existing statutes by one year and possibly not even that in some cases. There will still be much dispute on the question of whether or not a particular debt or security became worthless before or after December 31, 1938.

We urge, therefore, that this limitation on the application of proposed Section 322(d)(5) be eliminated.

Taxpayers on the Reserve Basis:

There is no provision proposed to make the changes with respect to bad debts, particularly the extension of the Statute of Limitations, applicable to taxpayers on the reserve basis. If our experience with the interpretations of the Bureau of Internal Revenue, with respect to Section 711(a)(2)(H), is any criterion, it will not be applicable to taxpayers on the reserve basis, although the net effect, whether the reserve or charge-off method be used, is always the same.

To develop this point it is first necessary to explain the operation of the reserve for bad debts. In determining what is a reasonable amount, the normal method is to estimate the probable future loss in the accounts receivable uncollected at the end of the year and add to the existing reserve for bad debts such amount as is necessary to increase the reserve to the required total. Such an ultimate check on the adequacy or inadequacy of the reserve is provided for in the applicable regulations. It is also required that any recovery be credited against the reserve, making it perfectly clear that any recovery of a bad debt serves to increase the balance before ascertaining the amount of the addition which may be deducted from income, and, in turn, serves to reduce the deduction allowable for the bad-debt reserve. The net effect, therefore, whether the bad-debt recovery be credited to the reserve or credited directly to gross income, is exactly the same, as will be observed from the following illustrative tabulation:

Balance of Reserve at beginning of year	$ 50,000
Less - charged off during year	30,000
Balance	20,000
Plus - Recoveries during year	5,000
Total	25,000
Reserve required at year end	45,000
Allowance for addition to reserve	$ 20,000

If the recovery above had not been made or if it had been credited directly to taxable gross income, the allowable deduction would have been $25,000. The recovery has, therefore, effectively served to increase taxable income.

In applying Section 711(a)(2)H, the Bureau of Internal Revenue has taken the position, by Regulation, that taxpayers on the reserve basis are not entitled to any adjustment with respect to bad-debt recovery after January 1, 1940, which were written off prior to January 1, 1940, despite the fact that the recovery served to increase the net taxable income for the years after January 1, 1940.

If recoveries of bad debts, which affected the deduction for the reserve in a loss year, thus serving to increase the deduction without tax benefit, are to be similarly treated under this proposed amendment, the taxpayers using the reserve basis suffer discrimination.

The only difference between the application of the reserve method and the write-off method is in the effect it has on the year of the deduction. In the aggregate the total deductions must always be the same. There is no reason why a taxpayer using the reserve method should not obtain the benefit of the extended Statute of Limitations with respect to such items. Similarly, there is no reason why such taxpayer should not have the benefit of the provisions of Section 711(a)(2)(H). We, therefore, urge that the aforementioned section relating to excess profits tax and the proposed provision relating to the Statute of Limitations be modified to make taxpayers, using the reserve method of treating bad debts, entitled to the benefits

thereof.

DEDUCTIONS FOR TAXES

Some rather peculiar and anomalous situations are developing as a result of a strict application of the ordinary provisions of the Internal Revenue Code relating to the deduction for taxes. Some of these apply to taxpayers reporting on the accrual basis and some apply to taxpayers reporting on the cash receipt and disbursement basis. Three types of taxes create these situations, to wit:

(1) Capital stock taxes

(2) State income and franchise taxes

(3) Federal income and excess-profits taxes.

Capital Stock Taxes

Rulings of the Treasury Department, fully supported by Court decisions, now hold and maintain that capital stock taxes being payable for the year beginning July 1 and ending the following June 30 accrue and become deductible as of July 1 or the later date when the corporation began business and first became subject to the tax if it did not begin business on or before July 1.

It is proposed to amend the Law to permit an annual redeclaration of value for the purpose of capital stock tax which redeclaration will not be made until at least 14 months after the liability technically accrued and became deductible under established procedure. No calendar year corporation and many fiscal-year corporations can possibly file their returns correctly when they are required to deduct a tax liability, the amount of which will not be determined until they declare a value some months after the return is due to be filed. When it is realized that the amount which will be declared will be predicated on the estimate of the succeeding calendar year's taxable income, the propriety of permitting the deduction to fall in

the year in which was earned the income for which the value was declared, becomes apparent. Of course, taxpayers who report on the cash basis do not face that problem. Therefore, we suggest that this situation be corrected or at least relieved by permitting taxpayers to deduct the capital stock tax as of the date when accrued, as under the present procedure, or when paid according to whatever the taxpayer elects, such election to be binding as for future years' procedure. The amendment, of course, should obtain appropriate safeguards to prevent a double deduction and to assure a complete deduction for all such taxes.

State income and franchise tax:

These tax deductions may cause trouble whether the taxpayer reports on the accrual basis or on the cash basis.

To consider the cash-basis taxpayer first, many of them are earning and receiving, before tax deductions, substantially increased incomes. They are permitted to use the cash basis for reporting only when that method clearly reflects income, and most items entering into the determination of income ordinarily overlap from year to year so that the use of the cash method does not materially distort the annual results. That is not so, however, with a State income tax deduction, which is based on such income. If a taxpayer reports on a cash basis and his income increases materially for the year 1942, the tax payable thereon to the State will not become due until the following year, and will be paid in the following year. Following the cash accounting method, that tax would not be deductible in determining the amount owing to the Federal Government on the enlarged income which is the basis for the State tax. It will be all right if the same taxpayer happens to have a large income for 1943, but then the same problem will arise with respect to 1944. Inasmuch

as such State taxes are predicated on the income of the previous year and fluctuations in income will seriously distort the ultimate result if the State tax deduction falls a year behind, we suggest that the Law be amended to permit taxpayers on the cash basis to deduct income taxes or other taxes measured by income, whether called income taxes or not, in the year in which the liability accrued regardless of the method of accounting generally employed otherwise. Here, also, safeguards should prevent either a double deduction of the same tax or a loss of any deduction for taxes that will actually be paid.

On the other hand, in the case of the accrual-method taxpayers, certain State taxes, particularly New York State franchise tax, technically accrue in the year following the year in which the income is actually earned. Thus, if a corporation operating in New York earned a large income in 1942, the tax thereon which is payable to New York State as a franchise tax, but is nevertheless measured by the 1942 income, will accrue technically and become deductible as of November 1, following the end of the year 1942. Nevertheless, if the income is large in 1942, the tax will be proportionately increased, and the tax therefor relates directly to the 1942 income rather than 1943 income.

It is true, of course, that in such a case if the taxpayer corporation ceased to do business and liquidated, without passing its assets over to any successor, the tax would never be payable, but that seldom happens. If a particular taxpayer actually ceases to do business, it usually is the result of a transfer of a major portion of its assets to another corporation and the liability is technically passed over to the other corporation if the first corporation fails to pay the tax. In most cases, the first corporation is required to pay the tax as part of the transaction. However, the result is seriously

distorted if the tax under such circumstances is not permitted to be deducted from the income which gives rise to it, as a matter of fact, if not as a matter of technical accrual. We urge, therefore, that the Law be amended to permit taxpayers to deduct taxes which are measured by income from the income of the taxable period which serves as the yardstick regardless of the technicalties of accrual. The possibility of the tax not being paid by reason of liquidation or some unusual situation can be met by also providing that if in the subsequent period the tax is not paid, the reduction shall be disallowed.

Federal Income Tax:

Finally with respect to Federal income taxes, the problem arises with respect to taxes on undistributed income whether they be under the provisions of Section 102 or personal holding company taxes. Where the accrual basis is used, no problem arises, but where the cash basis is used, the result may be so seriously distorted as to, in effect, require a corporation to pay out a dividend that it is legally unable to pay because, whether it uses the cash-basis accounting or otherwise, it cannot overlook a substantial Federal tax liability which must be paid out of the income of the year before anything is available for dividends. If such a corporation paid out all of its income without reserving enough to pay the tax liability, the Treasury Department would be the first to contend that the recipients are liable for tax as transferee in having received distributions that did not provide for the payment of Federal tax liabilities. We urge, therefore, that with respect to such taxes, as Federal income taxes, the taxpayer should be permitted to deduct the tax accrued during the year regardless of the method of accounting employed for tax purposes.

Respectfully submitted,

Walter A. M. Cooper, Chairman
John A. Conlin
Scott H. Dunham
John D. Filson
William R. McNamara
Leslie Mills
George M. Thompson
Troy G. Thurston
Clarence L. Turner.

For the Committee,

Walter A. M. Cooper

Chairman

TABLE - I

(Referred to in page 4 of accompanying letter)

TAX AMOUNTS TO BE WITHHELD AT EACH PAY PERIOD
FOR
SINGLE PERSONS WITH NO DEPENDENTS

Line No.	If earnings are between			Withhold following amounts if payroll period is		
				Weekly	Semi-Monthly	Monthly
1	-	and	$ 11.00	-	-	-
2	$ 11.00	"	11.99	$ .05	-	-
3	12.00	"	12.99	.10	-	-
4	13.00	"	13.99	.15	-	-
5	14.00	"	14.99	.20	-	-
6	15.00	"	15.99	.25	-	-
7	16.00	"	19.99	.35	-	-
8	20.00	"	24.99	.60	-	-
9	23.00	"	24.99		.05	-
10	25.00	"	29.99	.85	.25	-
11	30.00	"	34.99	1.10	.50	-
12	35.00	"	39.99	1.35	.75	-
13	40.00	"	44.99	1.60	1 00	-
14	45.00	"	49.99	1.85	1.25	-
15	46.00	"	49.99			.10
16	50.00	"	54.99	2.10	1.50	.35
17	55.00	"	59.99	2.35	1.75	.60

etc.

etc.

(Complete tables will be furnished upon request)

TABLE - 2

(Referred to in page 4 of accompanying letter)

TAX AMOUNTS TO BE WITHHELD AT EACH PAY PERIOD
FOR
MARRIED PERSONS OR HEADS OF FAMILY WITH NO DEPENDENTS

Line No.	If earnings are between			Withhold following amounts if payroll period is		
				Weekly	Semi-Monthly	Monthly
1	-	and	$ 26.00	-	-	-
2	$ 26.00	"	26.99	$ .05	-	-
3	27.00	"	27.99	.10	-	-
4	28.00	"	28.99	.15	-	-
5	29.00	"	29.99	.20	-	-
6	30.00	"	30.99	.25	-	-
7	31.00	"	34.99	.35	-	-
8	35.00	"	39.99	.60	-	-
9	40.00	"	44.99	.85	-	-
10	45.00	"	49.99	1.10	-	-
11	50.00	"	54.99	1.35	-	-
12	55.00	"	59.99	1.60	.15	-
13	60.00	"	64.99	1.85	.40	-
14	65.00	"	69.99	2.10	.65	-
15	70.00	"	74.99	2.35	.90	-
16	75.00	"	79.99	2.60	1.15	-
17	80.00	"	84.99	2.85	1.40	-
18	85.00	"	89.99	3.10	1.65	-
19	90.00	"	94.99	3.35	1.90	-
20	95.00	"	99.99	3.60	2.15	-
21	100.00	"	104.99	3.85	2.40	-
22	105.00	"	109.99	4.10	2.65	-
23	110.00	"	114.99	4.35	2.90	-
24	115.00	"	119.99	4.60	3.15	-

etc.

etc.

(Complete tables will be furnished upon request)