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Depreciation Under the Revenue Act of 1934

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By Maurice E. Peloubet

Before we begin the discussion of our subject, I should like to read one verse from the Old Testament, the 14th verse of the 12th chapter of the First Book of Kings:

"And (Jeroboam spake to them after the counsel of the young men, saying, My father made your yoke heavy, and I will add to your yoke: my father also chastised you with whips, but I will chastise you with scorpions."

We can hardly take up, in any direct way, treasury decision 4422 or mimeograph 4170 and the letters and other documents issued relative to these without considering the history of the deduction for depreciation as it has been allowed under the various revenue acts.

The revenue act of 1918 lists under allowable deductions from income "a reasonable allowance for exhaustion, wear and tear on property used in trade or business, including a reasonable allowance for obsolescence." This language has been retained in its identical form through all the revenue acts from that time, including the act of 1934.

It appears that the statutory concept of depreciation, which is the only one which concerns us here, is that the deduction is for wear and tear, including obsolescence, and must be reasonable. It would be natural to think that the treasury department would have gradually built up a volume of precedents and information which would progressively and gradually improve administration of this provision of the law.

The testimony of H. B. Fernald before the committee on ways and means at the hearings previous to the passage of the 1934 act gives a good idea of the well-informed accountant's view of what the treasury department has actually been doing in regard to depreciation. Mr. Fernald stated in response to a question:

"When you are taking an average life in that way, trying to get a fair average on the matter, it is very likely there will be cases where you can find there has been some excess; but I can state from my personal knowledge that the treasury department in the last few years has been most carefully canvassing that matter and

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working to eliminate the danger of the very thing you are speaking of."

and in response to another question:

"I also know the very large extent to which they go on these depreciation questions both in the field and in the bureau, and my own experience is that although it may be handled in a somewhat broad way, as I think it must be handled, there has not been the erring on the line of allowing too much for depreciation."

It became quite clear in reading over this testimony that the members of the ways and means committee had been given the impression that great and widespread laxity had existed in the granting of depreciation allowances up to that time, which is borne out by a letter, dated January 26, 1934, from H. Morgenthau, secretary of the treasury, to Robert L. Doughton, chairman of the committee on ways and means, stating among other things:

"The bureau has for several months had under consideration more effective means of administering the depreciation provision. Thus study has shown that through past depreciation deductions many taxpayers have (as shown by facts now known to exist) built up reserves for depreciation which are out of proportion to the prior exhaustion, wear and tear of the depreciable assets. If past methods are continued, the amount representing the basis of the assets will be completely recovered through depreciation deductions before the actual useful life of the assets has been terminated."

Let us look at the situation as it existed before these decisions were promulgated. We all know pretty well what constitutes physical wear and tear on machinery, buildings and equipment, and I think all of us will agree that in general this can be measured with a fair degree of accuracy if we assume that conditions prevailing at the time of the determination of the rate of wear and tear will be uniformly in effect in the future, and we can also make reasonably accurate estimates of the variations in the physical life if we know the changes in volume of production, efficiency of labor and other factors of like determinable nature.

Furthermore, all these factors can be localized to individual machines or units. It may be that records permitting such detailed studies to be made do not exist in many corporations. However, they do exist in some and there is no reason, except cost and inconvenience, that they should not exist in all. In any case

the problem of physical wear and tear is one that can be solved, and the limits of error can be balanced against the cost of obtaining more accurate information.

But we are allowed a further deduction under the statute—that for obsolescence. This is, by its very nature, more difficult to determine and establish as it depends on factors not readily susceptible of accurate measurement and not within the control of the individual company or plant management. It is defined as follows:

Report of special committee on terminology of the American Institute of Accountants:

The basic idea conveyed by this word is that of becoming out-of-date or falling into disuse.

Oxford Dictionary:
The process of becoming obsolete.

Webster's Dictionary:
The state of becoming obsolete.

In all of these definitions it will be seen that the essential meaning of the word is steady, gradual progression towards uselessness or non-existence. We know that this process is going on continuously. It is sort of a negative growth and we know that the factors are operating quietly and steadily, for the most part invisibly, until their work is completed. Improvements are being made daily in machines and processes; fashions and styles are changing; natural resources are becoming exhausted; new materials are taking the place of old—all these things cause changes in the design of the machines which work on the material and the buildings in which they are housed.

Most of these factors are quite outside the control of the individual manufacturer or business man. He must know, if he is to exist and prosper, what the trend in his business is, but, in general, he can not say that a particular machine or a particular type of machine will become obsolete three years from now and another one will be obsolete five years from now. He does know, however, that both of the machines are becoming obsolete; in other words, they are suffering obsolescence, and as a prudent man he must provide for this certain though intangible loss of value.

The revenue acts have quite properly permitted allowances for obsolescence; and we have a long series of cases and decisions

which allow the taxpayer to estimate this factor, to provide for it and to deduct the provision which he has made.

While the cases covering the right of the taxpayer to a reasonable allowance for obsolescence are numerous, two may be cited which illustrate the principle clearly.

In the appeal of *Robert H. McCormick* (2 B.T.A. 430) in calculating an allowance for obsolescence on an office building in Chicago, the fact that most buildings in Chicago could reasonably be expected to be torn down and replaced before the end of their physical life was held to be the determining factor in fixing a rate of obsolescence to be applied to the building. It is interesting to note here that the taxpayer was not required to prove that this particular building would be torn down before the end of its useful life but merely that buildings of this type could generally be expected to be demolished and replaced within a period shorter than their physical life. It will probably be quite difficult to have evidence of this sort accepted in the determination of depreciation which is required under the department's new policy. The taxpayer's legal right to the consideration of such evidence, however, is unchanged.

In the appeal of *Northern Hotel Company* (3 B.T.A. 1099) it was held that obsolescence of a hotel began when better hotels were built and that the allowance of 1/97th of the original cost to cover wear and tear should be increased by a deduction of 2% beginning with the year 1918 when the revenue act permitted an allowance for obsolescence. Here again is a case of a proper and lawful deduction. Perhaps it may be more difficult to obtain under the treasury department's new depreciation policy, but it should not be denied.

Another factor, not formerly of great importance, now looms large in the depreciation picture. We used to assume that, in the long run, variations in the rate of depreciation merely transferred income from one year to another, on the assumption that we would always get back our original depreciation base whether our rates were high or low. The theory that each year must stand by itself so far as depreciation is concerned may frequently operate to deprive the taxpayer of the right to deduct a portion of the cost of machinery which should be recoverable through depreciation. The position is not unlike that taken when the treasury department applied so-called "sustained depletion" to the values of mining properties as opposed to the actual deduc-

tions taken. Here it was held that failure to exhaust the depletion base did not justify additional deductions in later years.

We may summarize the position before the promulgation of treasury decision 4422 thus:

1. A reasonable allowance for wear and tear, including obsolescence, was assured to the taxpayer by law.
2. The base was cost or value at March 1, 1913, and this generally carried through to a second purchaser.
3. The total amount of the base was recoverable through deductions from income or the remainder was added to the loss in the year in which the loss was sustained.
4. Unless shown by the treasury department to be unreasonable, the taxpayer's computation of the deduction was accepted.
5. The treasury department made elaborate studies of depreciation and recommended uniform rates, which were published and then were applied by the income-tax unit and revenue agents.

In considering the effects of treasury decision 4422, let us first look at the results on the assumption that it is to be applied exactly as the department wishes it to be and that no questions will be raised as to the possible illegality or unconstitutionality of some of the treasury department's proposals. In the first place it must always be remembered that the program of the department in respect to depreciation is primarily determined by the size and character of the task set it by the secretary of the treasury. His letter to R. L. Doughton makes it quite clear that the department did not wish to attempt the task of administering the obviously illegal, not to say fantastic, proposal that a reasonable allowance for depreciation should, after being properly determined, be reduced by 25%. The proposal is, of course, ridiculous and contradictory on its face and would not, in all probability, be upheld by any court.

Recognizing, however, that congress demanded the raising of additional revenue, the treasury department promised, by means of changes in administration, without any change in the law, to bring in the additional $85,000,000 of revenue demanded by the committee on ways and means. This is a sufficiently impressive sum, but when we think that, at a tax rate of 13¾%, this means a reduction in allowances for depreciation and obsolescence to taxpaying corporations of about $618,000,000, we get some idea

of the magnitude of the job which the treasury department chose for itself.

The latest year for which published statistics of income are available is the year 1931 and that year may not be unfair for comparison with 1934. We know that in general the industrial facilities of the country have not been largely increased since that time. The year 1931, while a year of declining profits, was better than 1932 or possibly 1933, and may approximate 1934 better than either of those two later years. A comparison of the treasury proposals with 1931 figures, therefore, should give us a reasonable basis for judging their probable effects.

The proposed or hoped-for reduction in depreciation allowed to tax-paying corporations of $618,000,000 amounts to 36% of the total deduction for depreciation taken by tax-paying corporations in the year 1931 ($1,721,295,000) and amounts to about 13% of the total income of all tax-paying corporations for that year ($4,642,204,000).

Mr. Morgenthau stated that taxpayers have built up excessive reserves in the past. From the published figures which show only net capital assets, lands, buildings and equipment, less depreciation, it does not appear that the average rate is excessive. The net figure for lands, buildings and equipment amounts to $45,687,523,000 and the depreciation to $1,721,295,000. This gives an average composite rate for all taxpaying corporations of some 3.77%. This rate would, of course, be lower if we knew the total depreciation base. It might be raised to a small extent by the exclusion of some non-depreciable assets, such as land. However, it is obvious that, on the whole, this composite rate is higher rather than lower than that actually used on a straight-line basis.

Under the United States revenue acts depreciation is taken on a straight-line basis, but under the British income-tax acts it is taken on a diminishing basis. The published statistics of the treasury department show only net assets so that as gross assets are not known we must calculate rates on a composite diminishing basis. A. S. Fedde, in a paper presented to the international congress on accounting held in London in 1933, gave percentages of reserves for depreciation to total plant in several important industries and these are used to convert the net depreciable asset figures published by the treasury department to gross for the purpose of determining straight-line rates. Where Mr. Fedde's

figures are applicable they are used and where they do not exactly agree in classification a figure of 35%, substantially below the average reserves as shown in his paper, is used.

The table attached shows, for tax-paying corporations for the year 1931:

For tax-paying corporations (statistics of income—1931—U. S. treasury department):
  Net fixed assets per returns
  Depreciation per tax returns
Composite rate of depreciation (diminishing basis)
Rates allowed for British income-tax purposes on diminishing basis
Percentage of reserve:
  A. S. Fedde—paper presented at International Congress on Accounting, 1933
  Assumed at minimum
Straight-line composite rates actually taken
Straight-line composite rates as taken reduced by one-third to produce approximately $85,000,000 additional tax
Recommended by United States treasury department (*Depreciation Studies*, January, 1931)

It would appear that if the department's proposals are put into effect and the $618,000,000 deductions are denied, resulting in straight-line composite rates of from .82% to 5.85%, the deductions can hardly fail to be inadequate. If depreciable assets in the average plant, consisting, say, of ⅕th buildings and ⅘ths equipment, are depreciated at the low rates of 2% for buildings and 5% for equipment, we would have a composite rate of 4.4% as compared with 3.13% for all manufacturing corporations paying taxes on the basis proposed by Mr. Morgenthau.

Public utilities, it will be observed, show a composite rate on diminishing balances of 2.64% and they account for $670,237,000 of the total depreciation taken by all tax-paying corporations—$1,721,295,000.

In pursuing one means to its end the department must reduce this by one-third, with the depreciation of all other corporations, resulting in a straight-line rate of a little over 1% for utilities, even though the difficulties in further reducing the rates on government-supervised utilities and railroads are almost insuperable.

On the other horn of the dilemma dangles the engaging prospect of reducing all rates, other than those for public utilities, by two-thirds.

The department will not, of course, decide to leave utilities alone and to concentrate on industrial corporations, nor can it

be expected to make an equal drive against all classes of corporations. The policy will probably be selective, but in the end there will still remain the three possibilities:

1. $618,000,000 deductions denied to all corporations approximately ratably.
2. $618,000,000 deductions denied principally to industrial corporations.
3. Failure on the part of the department to deny sufficient deductions to produce $85,000,000 increased revenue.

The third possibility would seem to be the one most apt to occur.

The British revenue authorities are generally conceded to do their work fairly well and they do not have the reputation of unduly favoring the taxpayer. Furthermore, their rates do not include any allowance for obsolescence. Yet their rates, on a diminishing basis, are, in the cases of nine industries where comparable rates are quoted, higher than the rates actually taken in 1931 in seven cases, about 1¼% lower in the case of the textile industry and ⅕ of one per cent. lower in the case of the metal trades. If any fair allowance for obsolescence were added to the British rates those of tax-paying corporations in the United States would be far lower. The proposed reduction to bring in the $85,000,000 tax would make our rates, including obsolescence, lower in every case than the British rates without it.

When the diminishing value rates actually taken by tax-paying corporations in the United States in 1931 are converted, on a basis where the possibilities of error are all on the side of producing higher rates, to straight-line rates they are lower in fourteen industries than those recommended by the department in the pamphlet *Depreciation Studies* published in 1931, and in no case are they higher.

I shall not take any more time to discuss the figures in the table. They are, of course, statistical rather than accounting and are prepared primarily to show trends and tendencies. Every attempt has been made to give the advantage to the contentions of the treasury department, rather than to make out a case against it.

Among other conclusions to be drawn from these facts is this: either the depreciation allowances are substantially correct and are calculated on fair rates or if some taxpayers have been calcu-

lating depreciation at excessive rates, others must be claiming grossly inadequate allowances. Unfortunately, Mr. Morgenthau has not given us much information, confining himself to general statements, backed up by references to studies made in the department but not yet available to the public.

Indications, apart from the treasury statistics, do not show that most corporations have taken excessive depreciation allowances. A survey of published accounts will indicate, in general, that depreciation is seldom more than adequate, and a review of our own clients' affairs will, I think, convince us that the depreciation taken by most of them is not more than is required by the conditions of their businesses.

We do not notice in going through a compilation such as Poor's *Manual* that depreciation taken is very heavy or that there are many plants almost written off the books, but on the other hand, we do notice an epidemic of write-downs that swept over the business community in the past few years which certainly indicated that the management of those corporations did not think their reserves were excessive.

If the secretary of the treasury is correct in his statements, he owes it to the business public to make a full exposition of the data on which he relies.

However, a discussion of the theoretical basis for the treasury department's attitude will not get us very far when we are dealing with a revenue agent. No matter how effective you may be in convincing the agent of the errors of the general practice of the department, you will get no result whatever from his change of heart. He is bound to follow this decision. Your position is to try within this decision if possible to get the reasonable allowance to which the taxpayer is still entitled, but if the department will not now make a reasonable allowance, you should keep your cases open and reserve all rights in anticipation of a time when some of the proposed methods of the department will be tested in the courts.

Meanwhile, we must advise our clients and possibly prepare their tax returns. We must take some position as to whether the accounts are adequate and correct as they now stand or whether they should be amplified or revised. We should do this with two things in view, (1) the securing of as nearly adequate a depreciation allowance as is possible under the present administration of the revenue act and (2) we should endeavor to leave each client in

the best possible position to take advantage of later decisions which may reasonably be expected to modify or reverse the department's present attitude and practice. It will certainly be easier if we can prepare our returns on the assumption that we are forced to do as the department requires and to carry out, as nearly as possible, its instructions, making, of course, appropriate protests at every proper point. This applies only to form. The taxpayer using rates he considers fair should not admit that his rates are excessive or do anything to suggest such an admission if he wishes to retain his status as an "aggrieved taxpayer."

Let us look at the language of treasury decision 4422. This decision is primarily an amendment of article 205 of regulations 77—the article which deals with the methods and rate of computing depreciation. As we read through the decision we find that the first change of any importance is the omission of the words: "While the burden of proof must rest upon the taxpayer to sustain the deduction taken by him, such deductions will not be disallowed unless shown by clear and convincing evidence to be unreasonable." The next change is the omission of these words: "If it develops that the useful life of the property will be longer or shorter than the useful life as originally estimated under all the then known facts, the portion of the cost or other basis of the property not already provided for through depreciation allowable, determined in accordance with the useful life of the property as originally estimated, should be spread over the remaining useful life of the property as reëstimated in the light of the subsequent facts, and depreciation deductions taken accordingly." In place of these deletions there is added the following: "The deduction for depreciation in respect of any depreciable property for any taxable year shall be limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost, or other basis. The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, taxpayers must furnish full and complete information with respect to the cost or other basis of the assets in respect of which depreciation is claimed, their age, condition and remaining useful life, the portion of their cost or other basis which has been recovered through depreciation allowances for prior taxable years, and such other information as the commissioner may require in substantiation of the deduction claimed."

Now let us see what these changes really mean: The first sentence omitted makes it appear that it is the department's intention to challenge practically every depreciation deduction and to force the taxpayer to present evidence of the reasonableness of the allowance claimed. There is nothing particularly new or startling in this. We are all familiar with the flurries in the income-tax unit which result in drives against particular types of deductions or classes of taxpayers. It is obvious, no matter what it theoretically should do, that the income-tax unit can not investigate every type of income or deduction continuously and with a uniform intensity and thoroughness. If it had merely intended to make a drive on depreciation deductions, as has been done in the past, such an amendment to the regulations would be quite unnecessary. However, substitution of the last three sentences of the revised article for the matter which is stricken out indicates a definite change in policy, although the language of the regulation does not indicate clearly the extent to which the income-tax unit is departing from its previous practice.

The first sentence of the new matter in the revised article sets up an entirely new principle. In the past it has generally been considered that, if depreciation allowances had been excessive prior to the current year, the depreciation actually sustained should be charged off until the cost or other basis of the property had been recovered. For instance, a machine costing $1,000 with a correct rate of, say, 10%, has been depreciated for two years at the rate of 15% per annum. At the end of the second year the correct rate is determined and $700 balance remains to be depreciated. Under previous methods 10% per annum for seven years would be taken. Under the amended article 8¾% would be taken for eight years. On the other hand, if in the same case 5% had been taken for two years, leaving a balance of $900 at the end of the second year, the total depreciation which would be allowed under the revised article would be 10% per annum for eight years, and the depreciation which was not taken in the first two years, that is, $100, would be lost to the taxpayer entirely. Previous department practice would have permitted the taxpayer to recover the entire $900.

The statement that the burden of proof rests upon the taxpayer tells us nothing new, as this has always been true of any deduction, and the practice of the department of not challenging depreciation allowances which appeared reasonable was merely

an administrative expedient by the use of which it gave up none of its own rights, nor did it add anything to those of the taxpayer.

The next sentence covering the information which the taxpayer may be required to furnish is also a mere restatement of what has always been true, but has not always been enforced, for the same reasons of administrative convenience. We all know, however, that where there has been a controversy with the department involving depreciation it has always been necessary for the taxpayer to prepare full statements in support of deductions which the income-tax unit had disputed.

So far the amendments to the article itself do not seem particularly far-reaching and indicate merely an intention to go a little deeper into the question of depreciation allowances. The only thing at all new about the amendment is the possibility of losing some of the cost or basis of the property where insufficient depreciation has been taken in the past. However, we should not be deceived by the apparently innocuous appearance of these amendments. It is quite interesting to note that besides amending article 205 of regulation 77 and 74, article 165 of regulation 69, 65 and 62 is also amended to conform to the amendment of article 205. To get at the true meaning of this amendment we must go a little further and study first the letter of the secretary of the treasury to the chairman of the committee on ways and means. Mr. Morgenthau states that the reasons for these changes are:

"Acting under these provisions and the corresponding provisions of prior acts and regulations, the bureau has attempted to check the amount of depreciation deductions taken in income-tax returns by an investigation through its field officers of the records of taxpayers and by the preparation of detailed and often burdensome depreciation schedules which are ordinarily necessary before judging the reasonableness of the deduction. In proceeding in this matter the bureau has been handicapped in at least two important respects: First, the volume of this work has been such as to preclude the preparation of proper schedules in many cases. Second, the bureau has been placed in the position of having to show by clear and convincing evidence that the taxpayer's claim was unreasonable, a particularly difficult matter since the determination of the useful life of assets and the consequent rates of depreciation is largely within the taxpayer's experience."

I have already taken up the contention of Mr. Morgenthau that depreciation allowances have been grossly excessive in the

past. Mr. Morgenthau states clearly that it is the intention of the department "to reduce substantially the deductions for depreciation with respect to many taxpayers in various industries." He says further that it is the intention that this shall be accomplished by requiring taxpayers to furnish detailed schedules of depreciation, by limiting deductions to amounts which will recover during the remaining useful life the unrecovered basis, and to place the burden of proof upon the taxpayer to sustain these deductions.

Mr. Morgenthau states further that:

"Although the studies of depreciation made in the bureau bear out the conclusion of the ways and means committee that as a whole the deductions taken for depreciation in the past have been excessive when considered in the light of the facts now known to exist, it is the opinion of the present bureau officials that the situation can be more equitably remedied through proper administrative measures than through legislation which would arbitrarily reduce each and every taxpayer's depreciation allowance by a certain percentage, whether or not the allowance may have been excessive for past years. I concur in this opinion, and I therefore urge that the matter be rested on proper administration rather than on legislative action."

It is obvious from this last paragraph that Mr. Morgenthau's legal advisers did not care to go quite so far as to deny a portion of a legal deduction properly computed.

This letter is the second document we have to consider in the department's new policy, and it brings out, much more clearly than the amendment to the regulations, the purpose and attitude of the department. I do not know what other information Mr. Morgenthau may have submitted to Mr. Doughton, but as we have nothing before us we must assume that the letter is all he had. It is, of course, clear that this letter is made up of broad and unsupported general statements and of restatements, purporting to be something quite new, of facts and conditions which have been in existence for a long time. The main points in this letter are that the treasury department is committed to increase the revenue by decreasing depreciation allowances: that the difficulties of doing this by lopping off an arbitrary percentage are so great that the department hesitates to attempt to enforce an increase in the revenue by such a means; and that the department seems inclined to turn every possible assumption or fact against the taxpayer.

This attitude of the department is brought out in more detail by mimeograph 4170, which is given in full in all tax services. It is really the kernel of the whole matter so far as the disclosing of the department's purposes and methods are concerned. While it is obscurely worded, a careful reading and a little meditation will bring out pretty plainly what the department intends to do.

The first paragraph has to do with information required and lists four points to be covered. The first three have to do with cost, basis, age and amount unrecovered. The fourth, however, demands "such other information as may be required"—presumably by the department—"to establish the correctness of the deduction claimed or to determine the amount of the deduction properly allowable." In other words, besides requiring statements of information which will be burdensome and expensive for many taxpayers to prepare, the department is in the position of being able to say that what is submitted is insufficient and may require all sorts of other data to support a taxpayer's claim.

The second sentence of the next paragraph, while implied in the amendment to article 205 of the regulations, comes out plainly for the first time and says: "A taxpayer is not permitted under the law to take advantage in later years of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years." This makes it quite definite and puts the taxpayer in a position of having to prove not only that his present deduction is correct but that all his past deductions have been not less than adequate. This may involve a great deal of difficulty and expense and if the adequacy of previous depreciation can not be shown to the department's satisfaction it may cause the taxpayer a substantial loss.

If certain machinery was for some reason operated at a higher speed, say, for the last three years than for the preceding five years, it would be quite correct to change to a higher rate of depreciation for the last three years. Such a condition is easily possible where machinery is unchanged but power equipment has been improved or where a machine next in line is improved and the machine in the first process is speeded up. However, the possible attitude of the revenue agent would be that judging from present conditions, which is all that he would know, the depreciation for the first five years had been inadequate and he would proceed to apply depreciation for those years on the same basis as for

the last three years and would endeavor to see that the taxpayer lost that portion of his depreciable base. In a case like this the taxpayer should have incontrovertible operating and engineering evidence of the facts. While it is perhaps difficult to anticipate exactly what stand a revenue agent will take, it is nevertheless worth while to try to anticipate what will be done as evidence prepared before the examination and ready for submission to the agent may be much more effective than evidence prepared and brought forward in rebuttal of a conclusion on the part of the agent based on incomplete or misunderstood facts.

Paragraph three refers to the preparation of the data by the taxpayer and the placing upon him of the burden of proof. As we have seen previously the burden of proof has always been on the taxpayer and any temporary shifting to the department has been more apparent than real and has been permitted for convenience only. We see here also the tendency of the department not to limit itself to specific data, as the last sentence states that "all schedules and other data deemed necessary shall be prepared by the taxpayer and not by the examining officer."

The next paragraph deals with exceptions and these exceptions all have the same common basis, which although not specifically stated is quite clear—that is, where no or very little additional tax can be extracted from the taxpayer the full information will not be required. In other words, the department is not interested in the question of depreciation as such. Adequacy of the depreciation allowance in a corporation which is paying no tax or where the amount of depreciation is obviously too low or where there is not enough in it to warrant the expenditure of any time on the part of the revenue agent does not interest the department. If the department had a correct and scientific attitude it would be just as anxious to increase an inadequate allowance as to reduce claims for excessive depreciation. However, this paragraph brings out clearly that what the department seems to want is more tax rather than to determine a correct tax for every taxpayer.

The next paragraph deals with cases where complete and proper schedules have already been filed, either with previous returns or as a result of controversy with the department. While it is not so stated, it may be assumed that if these statements are not in the form required the corporation will have to revise them, and any corporation which has already submitted fairly elaborate schedules should examine its copies of these to make certain that they

do comply with the requirements, so far as any one can tell what they are, of mimeograph 4170. Here again it is better to prepare your defence before being attacked.

We next come to the heading "Depreciation schedule." The first paragraph calls for nothing which has not already been required, as it has always been necessary to state the basis where assets are acquired otherwise than for cash.

The next paragraph states that the original cost or other basis and gross additions by years must be set forth separately. It also requires that adjustments of the accounts be shown. The principal departure from previous practice in this paragraph is the requirement that adjustments which should have been made are required to be shown, as well as adjustments which have actually been made.

I read the following paragraph:

"If the segregation of accounts in the past has not been sufficiently detailed to afford a reasonable basis for the determination of the depreciation deduction, the cost or other basis should be segregated into groups of accounts containing similar assets having approximately the same average lives, to serve as a basis for depreciation deductions for current and future years. If, however, a taxpayer for its own purpose keeps a record of each individual item or classifies its accounts into a large number of different groups, the data required by this mimeograph should be summarized in such form as will present an accurate statement of each distinctly different class of depreciable assets and of the reserve that has been accrued against each class to date for income-tax purposes. The examining officer should verify the correctness of these summarized schedules from the taxpayer's records, but the inclusion in the schedule of a voluminous mass of detail is not ordinarily necessary."

This paragraph explains exactly how the department would like the schedules to be made up. It does not indicate the method which will be most advantageous to the taxpayer. The best position for the taxpayer to be in regarding depreciation under the present administration is to have a detailed record of each item included in his accounts for buildings, machinery and equipment or other depreciable assets showing cost or basis, date acquired, expected life, depreciation written off and all other pertinent data. A good form for such a record is that given on page 97 of Saliers on *Depreciation*—Principles and Applications—1922 edition. The further the taxpayer departs from these con-

ditions the more difficulty he may have in establishing his position. It is much easier to show the probable life of an individual machine than that of a group and it is practically impossible to prove a loss on dismantlement, except where individual records are kept. The disadvantages of accounting for depreciable assets in groups will be brought out later. It may not be a fair statement but it would almost seem, on reading this paragraph, that the effect of the use of group classifications advised by the department is to cause the taxpayer to prepare data in a form which will be easier for the department to attack than it is for the taxpayer to defend, and I think the taxpayer should consider very carefully the damage which may be caused him by any deviation from the presentation of his data in the most detailed possible form.

The next paragraph deals with the analysis of the depreciation reserve and the instructions should not cause much difficulty if the accounts have been properly kept.

The next paragraph reads as follows:

"DEPRECIATION DETERMINATION FOR YEAR UNDER CONSIDERATION

"If, upon examination and verification of the schedule, it is found that the cost or other basis of any depreciable property has been fully recovered though the property is still in use or where the reserve as provided is higher than is justified by the actual physical condition of the property, it will be presumed that the depreciation rates allowed in the past have been excessive. After careful consideration of the information filed in accordance with the requirements of this mimeograph the examining officer should follow the provisions of this mimeograph and of treasury decision 4422 in determining rates of depreciation for the years under consideration."

Here we have some statements which sound reasonable enough but on examination prove to be highly arbitrary, possibly in conflict with the law and may frequently be in conflict with the facts. I think all of us who have had any experience in manufacturing accounting must realize that a machine is not always broken up or even taken out of line at the exact time that its real usefulness ceases. It is easy to think of cases where an old machine is allowed to stay in its position on the floor of a factory long after it has actually become obsolete. I can think of a case where a machine purchased about fifteen years ago was depreciated at the rate of 10% per annum but is still on the floor of the

factory. There is one small order which has to be made up annually for reasons of friendship and policy but is unprofitable and would ordinarily be undesirable, which can be done on this machine. Its operation is expensive and inefficient. If there were ten or twenty times as much work for it to do the machine would be thrown out and a modern one installed. However, it is allowed to stay on the floor for the special purpose of doing this one particular little piece of work which is undesirable in itself, but must be done for the purpose of policy. To my mind there is no doubt that the machine is obsolete and valueless. The 10% rate was none too high, as perhaps 99% of the work done on that machine is now done on others of a more modern type. However, under the paragraph just read, the agent would probably consider this condition as good evidence that excessive rates were being charged. This, perhaps, is an extreme example, but it serves to show that the fact that a machine has not been junked and has been completely written off is not necessarily prima-facie evidence of excessive rates. The mimeograph also states that where the reserve as provided is higher than is justified by the actual physical condition of the property, it will be presumed that the depreciation rates have been excessive. Here we come to one of the principal weaknesses of the department's position. The income-tax laws of the United States since the year 1918 have definitely included obsolescence as a deduction. The assumption that any reserve higher than the physical condition of the property warrants is excessive is equivalent to a denial to the taxpayer for any deduction for obsolescence. A shrewd operator of a knitting mill which uses highly specialized machinery knows that changes in style are frequent and sweeping. He knows that expensive and complicated machinery is necessary to produce certain types of knitted goods, and it is unreasonable to presume that styles will remain the same for more than a few years together. It would be the worst kind of improvidence for such a manufacturer to depreciate his machinery solely on conditions of physical wear and tear. Certain machines, such as carding and spinning machinery, suffer little obsolescence, and a rate substantially equivalent to physical wear and tear would probably be fair for these. However, when we come to knitting machines, which produce varied and intricate stitches and weaves, it is clear that there must be provision for obsolescence. In the case of factories which purchase machinery for the work of particular cus-

tomers or under special contracts, the machinery, although in good physical shape at the end of such contracts, will have little more than a scrap value. An attempt to determine from the physical condition of such machinery the adequacy of the reserves, say in the middle of the period of the contract, would be certain to produce a rate far lower than the facts or prudent judgment would warrant. When cases resulting from the attempted application of treasury decision 4422 are brought before the board of tax appeals and the courts, the most frequent point of attack in all probability will be the virtual denial of obsolescence as permitted under the law.

It is interesting to note that article 206, directly following the amended article 205, is not formally amended. This article reads:

"Art. 206. OBSOLESCENCE.—With respect to physical property the whole or any portion of which is clearly shown by the taxpayer as being affected by economic conditions that will result in its being abandoned at a future date prior to the end of its normal useful life, so that depreciation deductions alone are insufficient to return the cost or other basis at the end of its economic term of usefulness, a reasonable deduction for obsolescence, in addition to depreciation, may be allowed in accordance with the facts obtaining with respect to each item of property concerning which a claim for obsolescence is made. No deduction for obsolescence will be permitted merely because, in the opinion of a taxpayer, the property may become obsolete at some later date. This allowance will be confined to such portion of the property on which obsolescence is definitely shown to be sustained and can not be held applicable to an entire property unless all portions thereof are affected by the conditions to which obsolescence is found to be due."

No one wishes to claim mere general deductions for obsolescence. However, where machinery is bought to carry out specific contracts or for a specific purpose and where there is little likelihood that it will be used for any other purpose, the taxpayer, on his own books and in the exercise of his own judgment, will recognize this obsolescence and he is entitled, where he can show that economic conditions will result in abandonment of the machinery at a future date, prior to the end of its useful life, to have such deductions recognized from year to year. Cases in point have been cited earlier in this paper.

In a discussion on Mr. Fedde's paper on *Depreciation and*

Obsolescence delivered at the international congress on accounting held in London in 1933, R. N. Carter stated:

"It is interesting to observe that in America obsolescence is allowed without renewal. We can scarcely have that here, under our existing legislation, as it would amount to an allowance for lost capital. Equally we can not have an allowance for improvement in the process of renewal of obsolete items. That would give the old concern an advantage over a new one."

This is a very interesting statement of principle and sums up the difference between our law and the British law in this respect. The taxpayer is certainly burdened and harassed sufficiently through the right of congress to tax gains on capital transactions. Mr. Carter points out that it is probably because of that right to tax capital gains that the allowance for obsolescence is constitutional and has been contained in all the revenue acts for the last sixteen years. The treasury department does not state affirmatively that deductions for obsolescence will not be allowed. It does, however, issue regulations and instructions which amount to a virtual denial of this lawful deduction.

The insistence of the department on physical condition and physical life as the most important, if not the sole factor, in determining depreciation rates, make the engineering features of depreciation more important than ever before and it would seem wise for every accountant who is faced with the problem of revision of plant accounts in accordance with the department's new depreciation policy to consider whether the employment of engineers or appraisers is required. Where a company has records which permit the purchase, sale or disposal of individual machines to be traced it would seem that all the work could be handled by the accountant or the client's staff, as it is unlikely that the department will pay much attention to valuations made by appraisers or engineers where these differ in total from book figures, but where the company records do not permit the establishment of values for individual machines it would appear that a plant inventory taken by competent engineers or appraisers would have to be accepted by the department. The values would need to be ascertained from the books so far as possible and in any case would need to be reconciled in total with the book figures. It is also possible that in large organizations the company's own engineering and technical force could coöperate with the accountant. Engineering advice will undoubtedly be of value

in determining the remaining life of the fixed assets. It is a difficult practical problem to decide the extent to which we wish to burden our clients with the cost of additional technical services, and it is not impossible that in some cases the cost of preparing the information in a way which would be convincing to the department would be greater than the saving in tax by the maintenance of present rates. This is a practical question to be decided in every case, but it is one that should not be overlooked.

The next paragraph, on retirement of assets, reads as follows:

"Where an account contains more than one item it will be presumed that the rate of depreciation is based upon the average lives of such assets. Losses claimed on the normal retirement of assets in such an account are not allowable, inasmuch as the use of an average rate contemplates the normal retirement of assets both before and after the average life has been reached and there is, therefore, no possibility of ascertaining any actual loss in such circumstances until all assets contained in the account have been retired. In order to account properly for such retirements the entire cost of assets retired, adjusted for salvage, will be charged to the depreciation reserve account, which will enable the full cost or other basis of the property to be recovered. Where the taxpayer by clear and convincing evidence shows that assets are disposed of before the expiration of the normal expected life thereof, as for example, because of casualty, obsolescence other than normal, or sale, losses on the retirement of such assets may be allowed, but only where it is clearly evident that such disposition was not contemplated in the rate of depreciation. In single-item accounts or in classified accounts where it is the consistent practice of the taxpayer to base the rate of depreciation on the expected life of the longest lived asset contained in the account, the loss upon the retirement of an asset is allowable."

This shows clearly the disadvantageous position in which the taxpayer is put if each individual item of plant and equipment is not treated separately. Treasury department employees have stated that no loss will be recognized on the sale or disposal of any assets which form part of a group for depreciation purposes, even though the group may be composed of a number of identical machines. For instance, a bank of 50 braiders in a cable mill, which are identical, will be treated as a composite unit for this purpose and if one braider fails and is scrapped no loss will be recognized. If, however, a separate record for each individual braider is kept the department will be forced to recognize the loss when the individual machine fails or is scrapped. The depart-

ment may say that it already recognizes obsolescence when it happens. I do not, however, think this is true and what is really meant is that the department will recognize it when the loss is realized. We know from our definition of obsolescence that it is a gradual process and it appears to be the intention of congress that it should be recognized as it takes place, as nearly as can be determined.

Joseph J. Klein in his book *Federal Income Taxation* emphasizes this gradual character and the influence of economic and social factors arising from without the business and beyond the control of the management. He states, "In other words, the period of economic usefulness of property may be shortened even though its physical life may not be otherwise than normally affected."

I can not help thinking that the over-emphasis on physical life in treasury decision 4422 and mimeograph 4170 may result in taking away from the taxpayer by regulation what has been given him by law. As article 206 of regulation 77 has not been amended it is clear that the department does not wish formally to deny or limit the taxpayer's legal allowance for obsolescence. But I think here, as in so many other cases where the taxpayer has any evidence for his deduction, he should gather and marshal this evidence in the best possible form before an attack is made on his calculations.

The last paragraph of mimeograph 4170 is a statement to the effect that cases now open are affected by this decision. This is something which should be given the most serious attention. If for any reason your clients have cases open on any other points, the department will in all probability question the deductions for depreciation and force the taxpayer to provide detailed information for as far back as any year which is open before the department.

While in general the odds are against the taxpayer in the treasury department's new depreciation policy and in the interpretation of it, there are a few features which can work to the advantage, as well as to the disadvantage of the taxpayer, largely because the new depreciation policy applies to all years not closed. Therefore, if any advantages to the taxpayer are developed the taxpayer can amend his returns in his own favor in any year which is open. Another rule which works both ways is that all previous agreements with the department and all previous decisions are assumed to be abrogated by the new policy. If, therefore, for

convenience a corporation in the past, to avoid a laborious compilation of plant statistics, has agreed on some compromise base and compromise composite rates with the department, it would seem quite possible to revise the base and rates to more nearly correct figures and to disregard the previous agreement. This would entail an extensive accounting investigation and probably would require the services of an engineer or appraisal company. However, such a taxpayer would be in so weak a position without this information that he would probably wish to obtain it in any case, and here it is barely possible that the new depreciation policy might be of advantage to the taxpayer, particularly if several years were open. If current indications are trustworthy the department is apt to make concessions if it feels the difficulties of opposing the taxpayer are sufficiently great. This possible revision of base as well as a possible increase in rate for a corporation, previously not taxpaying which is entering the tax-paying class and had taken inadequate rates while a non-taxpayer, would seem to be about the only ways in which the new depreciation policy could benefit the taxpayer.

The safe course to pursue would seem to be to assume that the treasury department means not only what it says but what it implies; that the department is thoroughly in earnest in making an attempt to raise $85,000,000 of revenue by the disallowance of depreciation to tax-paying corporations; and that the department and its agents are not going to be particularly anxious to protect the taxpayer in the application of its procedure. The situation would seem to be more serious for the small and moderate-sized corporation than for the large and well organized one. It seems likely that the department will make the greatest drive against corporations which have an income, but do not have adequate records. The taxpayer with a complete record of each item of depreciable assets and the depreciation applicable thereto will have nothing to fear unless the rates he has used are, in fact, excessive. The agent may attempt to reduce rates, but it will be quite difficult for him to do so in the face of complete records backed up by engineering data and records of similar items either in the same company or in other concerns in the same business. The small concern, however, which has kept no detailed plant record and has only one or two classifications of depreciable assets on its books, will be in a very difficult position. No matter what rates have been used the agent can always say, "The rates

are excessive; I will reduce them by 50%," or "by one-third," or whatever proportion he prefers and this will stand until the unfortunate taxpayer is able to prove that he has used a reasonable rate on an actually existing undepreciated balance of depreciable assets. It will be very hard to persuade the agent to recede from his position by mere general arguments or by statements not supported by financial and engineering data. It is quite probable that the greatest sufferer from these attempts to deny the taxpayer's legal deduction for depreciation and obsolescence will be the small corporation which either has no records or can not afford to keep them in the detail required to controvert the assertion by the revenue agent of excessive rates. The department may say that it does not require detailed records to be kept, and in mimeograph 4170 it states specifically that it does not want a voluminous mass of detail. However, the department makes it perfectly clear that without complete detail every presumption is against the taxpayer and that the object is to bring in the largest possible revenue with the least expenditure of effort.

In many cases there is no business reason why elaborate plant records should be kept, and it seems unfair and oppressive to require such records as the price of a fair depreciation allowance. Among the larger companies the requirement for such large amounts of additional detailed information is generally not impossible to fulfil, although here again the expenditure involved is sometimes a very serious consideration. It is rumored that it will cost one of our large corporations over a million dollars to supply the data required, and I know of other corporations where the expenditure may run into the hundreds of thousands of dollars. Even in comparatively small manufacturing companies it is difficult to rearrange the accounts as required without the expenditure of several thousand dollars, which may be an item of some importance. It should be borne in mind that these companies are not making these expenditures on any speculation or hope that they will get additional depreciation allowances. They are merely fighting to hold what they already have and what has formerly been recognized as correct and lawful and the department apparently has the legal right to place this heavy, troublesome and useless burden on business and industry in general.

The failure of the attempt to raise the entire $85,000,000 is almost inevitable, but it will probably cost the taxpayers a substantial part of this amount to prepare and prosecute their cases.

We have a great many decisions sustaining the rates and practice used by corporations and there will probably be many others which will grow out of the present situation.

To sum up:

1. We must take the treasury department at its word—both as to information required and the arbitrary and possibly illegal action contemplated.
2. We must realize that most small corporations can not afford to carry their cases to the supreme court and generally do not wish to litigate tax cases at all.
3. The most satisfactory way to handle a tax case is to have the agent accept a basis satisfactory to the taxpayer.
4. In this particular situation the best way to have the agent accept the taxpayer's rates and basis for depreciation is to present him with every possible detail. This will have two results. First, it should convince him of the difficulty of fighting the case, and, second, it will provide him with good material for his own report. This detail should be presented as nearly as practicable in the form shown as schedules to mimeograph 4170. Close adherence to this form will make acceptance of the figures more probable both by the agent and the income-tax unit.
5. Where satisfactory allowance can not be obtained in the first place, everything should be done to hold the cases open until the board of tax appeals and the courts have had an opportunity to review the various phases of the new depreciation regulations. This may be done either by appeal to the board of tax appeals against proposed assessments or by claims for refund and/or in court if the additional assessments are paid without appeal to the board.

In this way the case can be kept open for several years, and within that time the situation may possibly be clarified. Above all, the taxpayer should realize that the treasury department can not amend the law by making regulations and that regulations have the force of law only when they are consistent with the law. Every regulation or order which appears to be at variance with the law should be contested on that ground.

One method of resisting arbitrary reductions in depreciation allowances might be through trade associations. Information from a trade association as to the general condition in the trade, particularly in respect to obsolescence and generally expected life of the machinery used in that trade, would be quite valuable.

The present time seems a particularly inappropriate one for the government to attempt to reduce depreciation deductions. The

law permits the cost of the asset to be recovered without regard to changes in replacement value or any other factor. There is much weight in the contention that all depreciation allowances taken in the year 1933 and subsequently are inadequate unless the rates have been increased proportionately to the devaluation of the dollar. All plant acquisitions previous to devaluation had a cost in gold and all plant acquisitions after devaluation, while the cost is expressed in current irredeemable dollars, also have a price in gold, the gold price being a little less than sixty cents gold per irredeemable dollar. There is certainly good economic ground for saying that rates expressed in irredeemable dollars should be increased to cover the cost of plants paid for in gold or, conversely, that plants paid for in gold should be increased to their equivalent in irredeemable dollars and rates should be applied to that base. What the legal status of this claim would be I can not pretend to say, but it certainly seems to be a collateral argument of some validity against wholesale reduction of depreciation rates. While we have not yet had a rise in price level proportionate to the devaluation of the dollar this is inevitable and, when it arrives, the inadequacy of depreciation allowances calculated in irredeemable dollars on a gold base at rates previously in force will be increasingly evident.

Another anomaly in the 1934 act which must be considered in the case of retirement of assets is the effect of the provisions covering gains and losses on sale of capital assets. Under section 117 of the 1934 act a corporation selling buildings or machinery used in the manufacture of its product can apply only $2,000 of any loss sustained against current income, the remainder of the loss being applicable to gains from sale of capital assets only.

Fantastic and ridiculous as it may sound it is quite possible for a corporation to save money by destroying obsolete buildings and machinery instead of selling them.

Assume that a corporation owned buildings, in, say, a lumber camp, worth $30,000. They have been depreciated to a book value of $20,000 when the destruction by fire of the timber in the neighborhood makes the camp buildings worthless to the company. The company can not move them and it has no gains from sale of capital assets in the year.

Trappers and ranchers in the neighborhood of the camp can use the lumber and some of the fittings in the camp buildings and they offer the company $1,000 for the buildings as they stand. The

company at first is inclined to accept the offer but their accountant points out that if they do it will cost the company $1,485 in cash rather than result in a realization of $1,000 salvage. This is the proof he offers:

Cost	$30,000
Depreciated value	20,000
Deductible loss on total destruction	20,000
Tax saving at 13¾%	2,750
Compared with:	
Depreciated value	$20,000
Sale price	1,000
Loss on sale	$19,000
Portion deductible	$ 2,000
Tax saving	$ 275
Price realized	1,000
Net gain on sale in cash	1,275
Tax saving on destruction	2,750
Loss in cash to company if sold, or gain on destruction	$ 1,485

The president of the company, after a few laudatory remarks on the wisdom of the framers of the tax laws, duly orders the destruction of the buildings.

It is not clear that in such a case the obsolescence might not be recognized as having occurred before the buildings were destroyed or sold. If buildings and equipment as they stand are obsolete and worth only their salvage value, the loss due to obsolescence should then be allowable, regardless of whether or not they are sold for their salvage value. It may, however, be cheaper to forego such a sale than to try to prove the claim if the sale is made.

No one really likes to pay taxes, but it is much pleasanter to pay a tax if it is imposed in a clear, definite way and applies equally to all taxpayers who live or work under substantially the same conditions. It is, however, intolerable to be told that your tax rates have not increased, or have only increased a small percentage, and to be told in the same breath that you will pay more tax because deductions are going to be denied or reduced. There is neither scientific basis nor common sense in this method of taxation. The only fair thing to do is to define income and ex-

ASSETS AND DEPRECIATION RATES—TAX-PAYING CORPORATIONS—1931

	For tax-paying corporations (Statistics of income, 1931—U. S. treasury department)		Composite rate of depreciation (diminishing basis)	Percentage of Reserve			Straight-lines composite rate actually taken	Straight-line composite rates as taken, reduced by one-third to produce approximately $85,000,000 additional tax	Recommended by U. S. treasury department (*Depreciation Studies*, January, 1931)
	Net fixed assets, per returns	Depreciation per tax returns		Rates allowed for British income-tax purposes on diminishing basis	A. S. Fedde—Paper presented at International Congress on Accounting, 1933	Assumed at minimum			
Agriculture	$ 352,338,000	$ 14,822,000	4.20%	5 to 15 %		35%	2.73	1.82%	2 to 20 %
Mining	1,285,018,000	40,170,000	3.12	6¼ to 10		35	2.03	1.35	2½ to 10
Food Products	1,736,642,000	126,290,000	7.27	5 to 15		35	4.73	3.15	5 to 10
Tobacco	85,265,000	5,743,000	6.73			35	4.37	2.91	5 to 10
Textiles	626,989,000	55,419,000	8.83	5 to 7½	45.8%		4.79	3.19	3½ to 5
Leather	84,129,000	6,783,000	8.06			35	5.24	3.49	3½ to 6⅔
Rubber	160,789,000	15,737,000	9.78		39.2		5.94	3.96	5 to 6½
Forest products	171,412,000	9,667,000	5.63			35	3.66	2.44	
Paper and pulp	457,589,000	29,503,000	6.44	7½		35	4.19	2.79	4 to 6
Printing and publishing	505,123,000	34,391,000	6.81	7½ to 10		35	4.43	2.95	5 to 33⅓
Chemical and allied products	2,161,831,000	139,439,000	6.45	7½	41.8		3.75	2.50	5 to 20
Stone, clay and glass	416,903,000	27,269,000	6.54			35	4.25	2.83	2 to 16
Metal	2,112,607,000	162,661,000	7.69	7½		35	5.00	3.33	4 to 20
Construction	252,450,000	34,065,000	13.49			35	8.77	5.85	5 to 33⅓
Trading	2,066,489,000	141,307,000	6.83			35	4.44	2.96	
Service, professions, etc.	1,029,078,000	61,756,000	6.00			35	3.90	2.60	
Finance, banking and insurance	6,582,611,000	126,677,000	1.92			35	1.25	.82	
Unclassified	249,417,000	19,359,000	7.76			35	5.04	3.36	
Total except utilities	$20,336,680,000	$1,051,058,000	5.17			35	3.36	2.24	
Transportation and public utilities	25,350,843,000	670,237,000	2.64	3 to 7½		35	1.72	1.15	3 to 10
Total	$45,687,523,000	$1,721,295,000	3.77			35	2.45	1.63	
Total manufacturing	$ 8,759,363,000	$ 632,097,000	7.22			35	4.69	3.13	

penses in a simple, understandable, accurate manner and raise more revenue by increasing rates. One of the principal causes for the unspeakable complexity of our tax laws is the endeavor to tax everything rather than to tax what is definitely recurrent or ordinary income and limit the tax to that. It is not difficult for congress to raise or lower rates and it is not, in the long run, very disturbing to business or to peoples. The constant doubt which we are now in as to what will next be held to be income, or what deduction will next be disallowed in part or in whole is a factor that makes for disturbance and uncertainty through our whole business life.

It is bad enough to have a law which is full of unnecessary complexities, but since it is the law we can do nothing but follow it. We should at least be protected from any change or extension of the law by administrative methods.