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Correspondence

"Who Pays the Income Taxes?"

Editor, The Journal of Accountancy:

SIR: In masses of figures, plain facts often escape attention. The following simple graph and concise tabulation of facts and figures on personal returns of net income for the year 1921, present a clear picture that may be useful in shaping governmental policies respecting a reduction of income taxes.

The data used will be found principally on page 40 in the book issued recently by the treasury department, *Statistics of Income from Returns of Net Income for the Year 1921.*

The entire amount of income taxes on personal returns in the year 1921 ($719,387,106) was paid by less than 3½% (3.38%) of the total population; and 16/100th of 1% of the total population, reporting taxable incomes of $10,000.00 and over, paid over three-fourths (77.53%) of the personal taxes collected.

Attention is also directed to the fact that out of the whole number of returns filed (6,662,176), nearly one-half of such returns (3,072,191) were relieved from payment of taxes because of specific exemptions in excess of income reported. In other words, for every $3.00 of net income reported, $1.00 was exempted from taxation.

Would it be just to make the small number of citizens (3,589,985) who now carry the burden of all the personal income taxes, also carry an added burden of taxation for a soldiers' bonus?

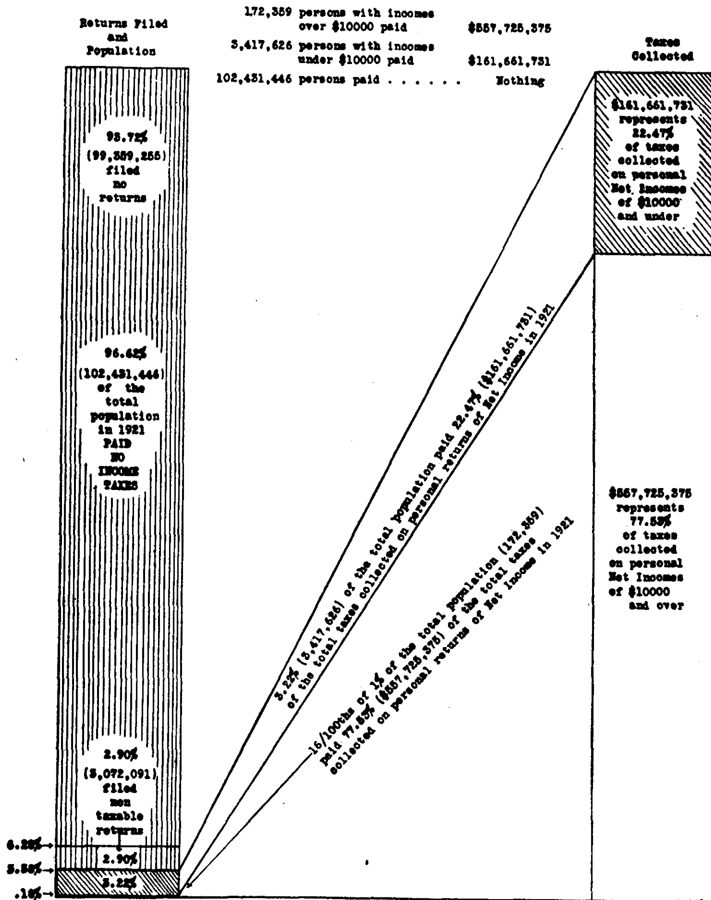
Our soldiers fought presumably for the entire population of the United States and not solely for the 3.38% of the total population that now pays all the taxes collected on personal incomes.

During the war it was "everybody's job" to buy Liberty bonds. If a soldiers' bonus is just, should not it be "everybody's job" to pay for it other than by the present form of income taxation that affects less than 3½% of the population?

Yours truly,

SHEPARD E. BARRY.

Milwaukee, Wisconsin.



Year 1921 INCOME CLASSES Personal Returns (Taxable)	% of Population	Number of Returns	% in each taxable Class	Tax Collected Normal and surtax	% in each taxable Class	Average Amount of Tax per Return	Average Rate of Tax on Net Income	Net Income Reported
Under $1000	.01	10,897	.30	$ 173,678	.03	$ 15.94	3.09	$ 5,618,429
$1000 to $2000	1.55	1,646,590	45.87	29,160,654	4.05	17.71	1.22	2,392,698,381
$2000 to $3000	.55	580,773	16.18	20,712,375	2.88	35.66	1.43	1,444,533,628
$3000 to $4000	.46	488,058	13.60	19,675,016	2.73	40.31	1.16	1,691,589,345
$4000 to $5000	.32	338,061	9.41	23,068,588	3.21	68.24	1.52	1,513,466,470
$5000 to $10000	.33	353,247	9.84	68,871,422	9.57	194.97	2.89	2,378,759,237
Total under $10000	3.22	3,417,626	95.20	$161,661,731	22.47	$ 47.30	1.71	$ 9,426,665,490
$10000 and over	.16	172,359	4.80	557,725,375	77.53	3235.83	14.00	3,983,019,080
Total taxable income all classes	3.38	3,589,985	100.00	$719,387,106	100.00	$ 200.39	5.36	$13,409,684,570
Non-taxable under specific exemptions	2.90	3,072,191		Nothing				6,167,527,958
Total returns filed	6.28	6,662,176		$719,387,106		$ 107.98	3.67	$19,577,212,528
No returns filed	93.72	99,359,255		Nothing				
Total population	100.00	106,021,431						
Tax exempt	96.62	102,431,446						

"Income Taxation"

The Journal is glad to publish the following letter addressed by a prominent member of the Institute to the acting chairman of the committee on ways and means under date of November 26, 1923:

HON. WILLIAM R. GREEN, *Acting Chairman,*
Committee on Ways and Means,
House of Representatives, Washington, D. C.

MY DEAR MR. GREEN:

Having been a student of taxation for many years and having had the opportunity in various capacities to acquire some familiarity with the actual working of the income-tax laws, I venture to write you in advocacy of the programme recently outlined by Secretary Mellon. Many of the suggestions contained in the secretary's letter will, I imagine, be immediately understood and approved. The reasons underlying the suggested rearrangement of surtaxes on the higher incomes are, however, probably less generally appreciated, and I would like to submit some considerations bearing particularly on that recommendation

The argument that the high surtaxes divert capital from productive industry and encourage municipal extravagance by unduly stimulating the market for tax-exempt securities is unquestionably sound. It is, however, becoming of less relative importance for the reason that tax avoidance is growing more rapidly and is less limited in scope than tax exemption. I believe the time has come when justice to the earners who cannot resort to tax avoidance, and to those possessors of investment income who do not resort to it, requires either that the present extreme surtaxes shall be made generally effective or, if that be impossible, as it has proved to be up to the present, that the rates shall be reduced to a point where substantial enforcement becomes practicable.

It is difficult to arrive at definite conclusions regarding the extent of tax avoidance, especially as its effect is obscured by the increase in taxable income resulting from the rise in price levels and other causes since the high surtaxes were first imposed. Moreover, the latest statistics available are those for 1921, and tax avoidance has extended greatly since that time. In tables attached hereto I submit some comparative figures which throw light on the question, and I would particularly draw your attention to the following facts.

Incomes over $100,000 constituted 29.5 per cent. of the total income reported in 1916, and 5.4 per cent. and 4.5 per cent. in 1920 and 1921 respectively—returns under $3,000 being eliminated in all cases so as to make the figures fairly comparable. If all salaries and wages be omitted the percentages for the three years become 36.0 per cent., 9.1 per cent. and 8.3 per cent. respectively.

The income from business, professions, etc., reported in classes over $100,000 fell from 862 millions, or over 25 per cent. of the whole, in 1916 to 260 millions, or about 5½ per cent. in 1920, and to 136 millions, or 4½ per cent. of the whole, in 1921.

Dividends reported in classes over $100,000 fell from 944 millions, or roughly 44 per cent. of the whole in 1916, to 465 millions, or 18 per cent., in 1920, and 332 millions, or 15 per cent., in 1921.

Rents and royalties remained substantially unchanged in total but the amount reported in classes over $100,000 fell off 60 per cent. in 1920, and 70 per cent. in 1921 as compared with 1916.

Even salaries showed a falling off in the higher groups in 1920 and 1921 as compared with 1916, and though this falling off is not so marked as in the cases of business incomes, dividends, rents and royalties, it is sufficiently striking in view of the fact that the total salaries and wages reported in all classes increased in the same period some four- or five-fold.

Thus a striking reduction is seen under every head and I believe the conclusion is fully warranted that the taxable income reported today in the highest surtax groups is not more than between 10 and 20 per cent. of what it would be but for tax exemption and deliberate tax avoidance. If earned income could be excluded from the computation the percentage on the remainder would fall to still lower figures.

The second table attached clearly shows a similar tendency for incomes between $50,000 and $100,000 in spite of an increase in salaries subject to tax in those groups, amounting to about 150 per cent. in 1920 and 90 per cent. in 1921.

Unless this condition can be remedied, surely the continuance of the present high surtaxes is indefensible. And study of the subject leads to the conclusion that the present situation is not due mainly to defects in the form of the present law, although some defects exist which could be remedied with benefit to the revenue. The difficulty lies far deeper. The distinction between capital and income is at best difficult to draw, and the complexities of modern business have greatly enhanced this difficulty. Tax laws must be specific and according to well-settled rules of construction must be interpreted strictly—any ambiguities being resolved in favor of the taxpayer. The form of every business transaction, and indeed whether the transaction shall or shall not take place, is determined by the taxpayer and his decision is reached with a knowledge of the tax law and is usually framed so as to produce the greatest possible profit after taking taxes into consideration.

The difference in taxation between corporations and individuals alone creates an almost insoluble difficulty. The ease with which incorporation and disincorporation are effected; the difficulty of making laws and regulations governing corporations which will apply with equal justice to the large public corporation and the small private corporation, which practically represents an individual fortune, and the further fact that between these two extremes there are innumerable gradations, so that it is impossible to draw hard-and-fast lines and to treat corporations on one side of the line in one way and corporations on the other side of the line in another—these and other such conditions make it impossible for legislation ever to do more than temporarily check the increase of tax avoidance, so long as the inducements to tax avoidance are so compelling as they are today in the case of all those possessing more than a very moderate income.

If it were possible to lay down a few broad principles and leave the administration of the surtax to the discretion of a highly competent taxing authority which could be governed by the substance rather than the form of the transaction, it might conceivably be possible to administer the surtaxes on the present scale with some measure of efficiency. This is, however, impossible and under any other conditions the form rather than the substance inevitably determines the tax and the form is selected by the taxpayer so as to defeat the tax.

The continuance of the high surtaxes therefore means an unedifying contest of wits between the tax avoider and his advisers on the one side and Congress and the Treasury on the other—with all the advantages on the side of the tax avoider and with those who are unwilling or, like most earners, unable to avoid taxes, caught between the two and bearing the brunt of the conflict. Congress must legislate in advance and on broad lines to meet all conditions. The tax avoider acts after Congress has taken its position and deals with specific proposed transactions, capable of infinite variation in form and time to meet the rules laid down by the legislature. Naturally the result of the conflict is as disappointing to the Treasury as it is demoralizing to the taxpayer.

Whatever may be possible in time of war, all experience shows that it is impossible in times of peace to levy surtaxes on any such scale as is now in force with any degree of efficiency or with any approach to

equity. I am convinced that readjustment of the surtaxes will ultimately benefit the revenue as well as the business of the country and will make taxation far more equitable. I hope, therefore, that your Committee will favorably regard the secretary's proposals on this as well as on other points.

I am sending copies of this letter to Senator Smoot and to the secretary.

Respectfully,

———

Comparison of total incomes and of incomes over $100,000 by sources for the years 1916, 1920 and 1921, based on "Statistics of Income," published by treasury department.

* * * * *

(Note: Incomes under $3,000 are omitted in all cases in order to make comparison on the same basis possible.)

(Millions of dollars)	Total			Over $100,000 Amount			Over $100,000 % of total		
	1916	1920	1921	1916	1920	1921	1916	1920	1921
Business, etc.*	3,390	4,709	2,952	863	260	136	25.4	5.4	4.6
Dividends	2,136	2,584	2,145	944	465	332	44.2	18.0	15.5
Rents and royalties	644	699	669	80	32	24	12.5	4.6	3.6
Interest and miscellaneous	702	1,235	1,094	181	104	65	26.3	8.4	5.9
Gross income (except sal. and wages)	6,872	9,227	6,860	2,068	861	557	30.1	9.3	8.1
General deductions	2,051	2,382	2,134	333	239	163	16.2	10.0	7.7
Net income (except sal. and wages)	4,821	6,845	4,726	1,735	622	394	36.0	9.1	8.3
Salaries and wages	1,478	6,656	5,691	121	105	69	8.1	1.6	1.2
Net income—total	6,299	13,501	10,417	1,856	727	463	29.5	5.4	4.5

Comparative numbers of personal income-tax returns 1916, 1920, 1921.

* * * * *

Income classes	No. of returns 1916	No. of returns 1920	% of 1916	No. of returns 1921	% of 1916
10 to 20M..........	67,927	148,101	218	114,244	168
Over 20M..........	53,772	78,019	145	58,115	108
" 50M..........	17,085	15,742	92	11,069	65
" 70M..........	10,916	7,951	73	5,398	49
" 100M..........	6,633	3,649	55	2,352	35
" 200M..........	2,449	868	35	535	22
" 300M..........	1,296	395	30	246	19

(Note) Total income reported for all classes was
in 1916 $ 6,299,000,000
1920 13,501,000,000, or 214% of 1916
1921 10,417,000,000, or 165% of 1916

*This heading includes income from businesses, professions and vocations, fiduciaries, and profits on sales of property. Subdivision of the total is impracticable on account of changes in classification in the statistics.

"Deductible Losses under the Revenue Act of 1918"

Editor, The Journal of Accountancy:

SIR: Taxpayers are watching with considerable interest the decisions of our courts on the question of the right of the treasury to disallow "paper" losses under the revenue act of 1918 in cases where such losses were not actually sustained as compared with cost. In conformity with the instructions upon the returns and the regulations then in force, as well as in accordance with the plain intent and language of the law as universally understood and interpreted at the time, thousands of persons claimed deductions when property was sold below its March 1, 1913, value irrespective of original cost. The treasury, however, at a later date (June, 1921), in reliance upon a brief filed by the solicitor general in the cases of *Goodrich v. Edwards* and *Walsh v. Brewster,* reversed its former construction of the law and amended its regulations so that deductible losses were restricted to the difference between selling price and cost, using the March 1, 1913, value as a basis only if lower than cost. Numerous additional assessments have been levied and collected upon these grounds, covering the years 1918, 1919, and 1920.

In the aforementioned brief, the solicitor conceded that no tax could lawfully be assessed upon an apparent gain arising from the use of the March 1, 1913, value as a base unless a profit to that extent had actually been realized, using original cost as a base. He further contended, however, that as the same language was employed by congress in specifying what should constitute the basis of deductible losses, the same rule should apply to both. While the supreme court did not then and has not yet passed upon this point, the solicitor's opinion has been upheld by one of the lower courts—the district court of the United States, eastern district of Pennsylvania, in the case of *Ludington v. McCaughn, collector,* published in T. D. 3496 and quoted in full on page 290 of THE JOURNAL OF ACCOUNTANCY for October, 1923. This court was able to find that "congress did not intend to impose a tax on a mere fictitious or paper profit, or to permit the deduction of a mere fictitious or paper loss."

In spite of the high authority thus supporting the position of the treasury department, the writer believes the plausible contention made to be unsound because of failure to give due weight to the force of original executive construction of the 1918 act and its predecessor act and to the legislative confirmation thereof. It is common knowledge that the treasury construed the section of the 1916 law relating to both gains and losses to mean that the March 1, 1913, value should be used as a basis without considering cost. This construction and the administration of the law thereunder, were well known to congress when the revenue act of 1918 was enacted. Yet that law, in substance, repeated the provisions of the former act on this point. The intent of the legislature could not be more clearly shown. The treasury department, in the Internal Revenue *Bulletin* of December 25, 1922, refers to the "well-known rule of statutory construction that the reënactment by congress, without change, of a statute which has previously received executive construction, is an adoption by congress of such construction." This principle was also recognized in

Edwards v. Wabash Railway Co. (264 Fed. 610) in the following language: "Where a statute that has been construed by the courts has been reënacted in the same or substantially the same terms, the legislature is presumed to have been familiar with its construction, and to have adopted it as a part of the law, unless a different intention is indicated; and the same principle is applied to statutes and parts of statutes which have been reënacted after they have been construed by the legislative or executive departments of the government."

That the 1918 act, insofar as it related to the point at issue, was a reënactment of the 1916 act, is admitted by the Pennsylvania court in the above-mentioned case, as the following extracts from the decision will show: "The questions decided in these cases (*Walsh v. Brewster* and *Goodrich v. Edwards*) had to do with gains, not losses, and the cases arose under the income-tax law of 1916. But the provisions of that act on this question differed only in arrangement and not in substance with the act of 1918. . . . Thus, under the act of 1916, losses were to be computed in the same way as gains, and these provisions were substantially reënacted in section 202 of the act of 1918."

The purpose of congress in the 1918 act to tax gains and allow losses in the manner its plain language "standing alone" indicated, is thus absolutely established by its adoption of the executive construction given to the former act. The treasury continued for more than two years to construe the 1918 law as it had construed the 1916 law, and no one suggested that the will of the legislative branch of the government was not being carried out. Certain taxpayers, however, questioned the power of congress to impose a tax upon gains based solely upon March 1, 1913, values; it was contended that the same did not constitute "income" as defined by the supreme court and therefore were not within the scope of the sixteenth amendment. This contention was upheld in the Goodrich and Brewster cases, although manifestly contrary to the legislative will adopted "as a part of the law."

But the rule that the constitutionality of statutes must be presumed whenever possible is paramount even over legislative construction; and hence the supreme court was impelled, in regard to gains, to overrule congress and interpret the words of the act in a way to avoid the constitutional inhibition. It was therefore held that as other portions of the law expressed the intent to tax income only, and as gains based on the March 1, 1913, value were not income except to the extent that profits had been realized over cost, such other provisions must be read in connection with the section in regard to the use of the March 1, 1913, value as a base. It was upon this ground only that the narrow construction was given to the plain language of the act as it related to gains.

There is, however, no constitutional limitation upon the allowance of losses and no reason to overrule the interpretation of the law adopted by congress as expressing its will with reference thereto. The power to permit deductions is, in effect, practically unrestricted, and congress "could allow taxpayers to deduct 150 per cent. of losses if it cared to, but could not increase taxable income one per cent." (Montgomery, *Income-tax*

Procedure, 1923, page 927). In view of the diametrically opposed rules of construction thus necessarily applicable, the argument that the language used in the two cases, though similar, implies a purpose on the part of the legislature to treat gains and losses alike is untenable. In other words, it is illogical to maintain that words referring to gains, limited by the presumed intent to tax income only, have precisely the same meaning as identical words referring to losses, not limited by any presumed intent. The true doctrine involved is that in both instances the declared will of congress must be carried out as far as is constitutionally permissible.

It is vain to reason that congress would not have permitted apparent losses to be deducted if it had known that the supreme court would not permit it to tax apparent gains, or to say what would have been done under any other varying circumstances. The same Pennsylvania court in a previous decision (*Fidelity Trust Co. v. Lederer, collector,* quoted on page 16, of Internal Revenue *Bulletin* No. 52, volume I, December 25, 1922), said in part: "If congress had taxed one thing the tax cannot be extended to another thing by the executive nor by the courts merely because it is thought that the other thing ought to be taxed or that the purpose or intention of congress was to tax it. The question is not what the courts think should have been taxed or what congress, by its indicated general purpose, intended to tax, but what has been taxed"; also "that a lawful tax must have its rise in the will of congress and not in the inferences drawn from such expressed will by the executive or the judiciary." It is obvious that the assertion that gains and losses were to be treated in the same manner is mere inference and such intention is nowhere indicated in the act. In fact, the law distinctly specifies that the holding of any part of the act as unconstitutional "shall not affect, impair, or invalidate the remainder of the act, but shall be confined in its operation to the clause, sentence, paragraph, or part thereof directly involved in the controversy in which such judgment has been rendered" (sec. 1402). The wishes of the lawmakers could hardly be more clearly apparent than in the present case.

In view of the plain language of the statute, the original interpretation of it by the treasury and the general public, the adoption of such construction by congress in reënacting the law in substantially the same terms knowing how the law was being administered, the constitutional limitation which forces the narrow interpretation of the clause referring to the use of the March 1, 1913, value as a basis for computing gains and the absence of such limitation when applied to losses, and the fact that congress itself in the statute indicated its desire that the declaration of the unconstitutionality of any part of the act should apply solely to that part and not to any other part, it would seem that taxpayers were fully within their rights in claiming a deduction for losses based upon March 1, 1913, values. A decision of the supreme court on this point will be awaited with great interest.

Yours truly,
GORDON C. CARSON.

Savannah, Georgia.