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Income-Tax Department

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For the first time in over two years we are not walking in the dark in approaching the season for filing income-tax returns. In both the last two years we had to deal with new laws—the revenue acts of 1917 and 1918, respectively—containing elements entirely novel to us and aggravated by lateness in promulgation of the relative regulations and forms. The conditions and rates for taxation of 1919 incomes and those of subsequent years also—until legislation declares otherwise—are fortunately known in advance. Though slightly lower than those for 1918, the rates for 1919 are, like those of 1918, set forth in the revenue act of 1918.

The normal individual rates for 1919 and following years are 4% on the first $4,000 above the exemption and 8% on the balance (as against 6% and 12%, respectively, for 1918) ; but the surtax rates remain the same.

The normal corporation rate is now 10% (instead of 12%) ; the excess profits rates are 20% and 40% in the first and second brackets, respectively (where they were 30% and 65% for 1918) ; and there is no 80% war profits tax except on income from war contracts.

Recommendations by the Treasury Department

If the legislative branch of the government pays heed to the executive branch, it will in future be the policy to fix the terms of taxation not only in advance of the year in which the taxes are to be collected, but in advance of the year in which they accrue. In commending the revenue act of 1918 to congress for reconsideration, the president, in his message of December 2, 1919, urged that the present law should not be disturbed so far as regards taxes for the calendar year 1920, payable in the calendar year 1921. And the secretary of the treasury in his annual report goes on to say:

> "It is of the utmost importance that the congress should follow the wise precedent adopted by the last congress in determining in advance of the year's business the basis upon which taxes are to be imposed. Uncertainty in respect to taxation during any given business period results in each taxpayer's setting aside for taxes an ample margin to cover variations in the tax law which may affect him onerously and calculating his costs and prices on that basis. Even a bad law is better than a retroactive law. It is, therefore, of the utmost importance, in my judgment, that the congress should give consideration in the calendar year 1920 to the question of revision of the tax law, with a view to making such revision effective well in advance in respect to the incomes and profits of the calendar year 1921."

The fundamental reform in the minds of the chief executive and the secretary of the treasury is not reduction but "simplification of the income and profits taxes." Indispensable as war measures, these financial devices are not favored as productive of prosperity in peace times. Congress should reduce the excess-profits tax, or eliminate it altogether; curtail the highest brackets of the surtax; and make up the difference by increasing the normal rates and the lower surtax rates. Secretary Glass has this to say:

> "Though any appreciable reduction in the amount of the revenues from taxation is not to be thought of during a fiscal year when the government's current disbursements will exceed its current receipts, ... it is, I believe, the duty of the congress to give its closest attention to the study of the incidence of taxation with a view to the revision of the revenue act on lines which will produce the necessary revenue with the minimum of inconvenience and injustice. The treasury's objections to the excess-profits tax even as a war expedient (in contra-distinction to a war-profits tax) have been repeatedly voiced before the committees of the congress. Still more objectionable is the operation of the excess-profits tax in peace times. It encourages wasteful expenditure, puts a premium on overcapitalization and penalty on brains, energy and enterprise, discourages new ventures and confirms old ventures in their monopolies. In many instances it acts as a consumption tax, is added to the cost of production upon which profits are figured in determining prices, and has been and will so long as it is maintained upon the statute books continue to be a material factor in the increased cost of living.
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> "The revenue sacrificed by elimination or reduction of this tax must be sought in an increase of the normal income tax (from which the income on Libery bonds is exempt) and of the lower brackets of the surtax. The upmost brackets of the surtax have already passed the point of productivity, and the only consequence of any further increase would be to drive possessors of these great incomes more and more to place their wealth in the billions of dollars of wholly exempt securities heretofore issued and still being issued by states and municipalities, as well as those heretofore issued by the United States. This process not only destroys a source of revenue to the federal government, but tends to withdraw the capital of very rich men from the development of new enterprises and place it at the disposal of state and municipal governments upon terms so easy to them (the cost of exemptions from taxation falling more heavily upon the federal government) as to stimulate wasteful and non-productive expenditure by state and municipal government."

This last topic, the treatment accorded income from state and municipal bonds, draws an emphatic protest from the head of the treasury. It is not the exemption of this income, as such, from taxation that is attacked. That exemption has always been thought to be inevitable. The courts have held that "the United States has no power under the constitution to tax either the instrumentalities or the property of a state," and that the tax on interest from their obligations "is a tax on the power of the states and their instrumentalities to borrow money, and consequently repugnant to the constitution." It was out of deference to this theory that the interest in question was specifically freed from income tax by the terms of the income-tax laws.

What the secretary criticises is the exclusion of the exempt state and municipal interest from the calculation by which the taxpayer's total income is determined and his surtax fixed. Thus, the apparent amount of a taxpayer's total income may be reduced, his other income may be brought within a much lower zone than that wherein it rightfully belongs, an avenue for evasion of his just share of taxes is legalized, and, into the bargain, the states are given a premium over the féderal government in the disposition of their securities. All these defects, the secretary holds, should be remedied, and he makes his recommendations plain in these words:

> "I call attention to the urgent necessity of revision of the revenue law so as to require that, for the purpose of ascertaining the amount of surtax payable by a taxpayer, his income from state and municipal bonds shall be reported and included in his total income, and the portion of his income which is subject to taxation taxed at the rates specified in the act in respect to a total income of such amount. The treasury's recommendations in this respect have been transmitted to the appropriate committees of congress in connection with the revenue act of 1918, and again in the present calendar year. Under the present law a person having an income of, say, $1,000,000 from taxable securities would, upon the sale of half his property and the investment of the proceeds of that half in state or municipal bonds, not only obtain exemption for the income derived from such investment in state and municipal bonds, but greatly reduce the surtaxes payable in respect to his other income. It is intolerable that taxpayers should be allowed by purchase of exempt securities, not only to obtain exemption with respect to the income derived therefrom, but to reduce the super-taxes upon their other income, and to have the super-taxes upon their other income determined upon the assumption, contrary to fact, that they are not in possession of income derived from state and municipal bonds.
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> "It is impossible to determine the actual gain in revenue to the government which would result from such an amendment of the law. That it would be very material I have no doubt. A still more important result of the amendment of the law in this respect, however, would be the reflex benefit to Liberty bonds which carry exemption from normal income tax, but (as to the great bulk) not from surtaxes. The very great advantage the states and municipalities now have in conferring upon holders of their bonds larger exemptions from federal taxation than the federal government itself confers upon holders of Liberty bonds should be reduced, so far as it may be reduced, by the adoption of appropriate administrative provisions in the federal revenue law."

That the amendment asked for will not be found unconstitutional the secretary is confident. He distinguishes the income tax on the income from state and municipal bonds from the surtax on the individual's income. The interest on obligations of states and their subdivisions now exempt would, it appears, continue to be exempt from normal tax, to satisfy the constitutional difficulty, and would be brought in for surtax only. The income tax may recognize sources of income, but the surtax regards only dimensions. It is a tax on income in bulk, without regard to identity of components; it bears on income for reaching the magnitude it does in the hands of any one individual. This seems to be the underlying theory on which reliance is placed. To quote again from Secretary Glass:

> "A question has been raised concerning the right of the federal government under the constitution to tax the income from state and

municipal bonds, but there can be no doubt of the constitutionality of such an administrative provision. The proposal is not to tax the income derived from state and municipal securities, but to prevent evasion of the tax in respect to other income. The principles involved are abundantly established in the decisions of the supreme court sustaining taxes upon corporations, bank stock, etc., computed after taking into account income derived from government, state and municipal bonds."

"NOTES" BY THE TREASURY DEPARTMENT

In a document, entitled *Notes on the Revenue Act of 1918,* the secretary of the treasury draws attention to numerous suggestions that have been made, both from outside and within the department, for amendment of the law. These are distinctly not recommendations, but merely a collection of ideas gathered from all sources and submitted to the committee on ways and means of the house of representatives for consideration.

The most important of these "suggestions" are indicated below, to show the trend of thought in the development of our experience with income taxation. If read with care not to confuse them with existing requirements, they are informative.

(a) To extend the scope of the "personal service corporation" provision (section 200) to cover all "personal corporations," whether employing capital or not, if the number of inactive stockholders is small, and the active ones own a stipulated majority of the capital stock.

This suggestion has considerable merit, moving as it does towards the elimination of an artificial distinction between actual partnerships and what are virtually partnerships in corporate form.

(b) To enlarge the class of property exchanges from which (under section 202) no loss or gain is held to accrue, so as to include cases (1) where the market value of the property received cannot be determined; (2) where the property received is substantially all of the stock of a corporation; (3) when the exchange is between "affiliated" corporations; and (4) all cases of corporate reorganization or partnership-corporation organization, whether the new securities have a greater par value than the old or not.

Why the line between a profitable and a no-profit exchange should ever have been drawn at such an ambiguous standard as the difference between par value is incomprehensible to the innocent bystander; and there are innumerable conversions of rights and properties that are changes in form only and should not be deemed closed and profit-or-loss fixing transactions.

The general intent of this suggestion is so commendable that it is to be hoped it will appeal to congress and take definite form.

(c) To permit the deduction of operating or capital losses incurred in any year from the profits of the preceding year, or if in excess of that, then from the profits of the succeeding year.

If this idea were adopted, what has been felt to be a grievance ever since the enactment of the 1909 act would be removed. The alternative conceptions in the law are of annual income as against no-income, but (except for the opening wedge introduced into the 1918 act, in section 204, for fiscal years falling between October 31, 1919, and January 1, 1920) not of positive income as against negative income or loss. Why should each year thus be made to stand by itself in tax accounting, contrary to the principles maintained in sound financing? No such arbitrary divisions by years can be recognized in the accumulation of a corporate surplus or deficit and the payment of dividends.

> (d) To make the depreciation and depletion allowances on property received by gift and the profit or loss to a beneficiary from its sale dependent on its cost to the donor and not its value at the date received by the beneficiary.

The irony of this proposal is at once evident. The beneficiary who parted with his gift would have to pay a tax on any increase in the value of the property while in the hands of the donor. This appreciation does indeed escape the income tax under the present law, but when the property passes by bequest, devise or descent it bears the estate tax, which, being based on market values, gives the federal government its due under another portion of the revenue act. And perhaps this is the key to a correct solution of the present inequity in allowing appreciation in value of property bestowed by the gift of a living donor to escape the tax: tax the donor and not the beneficiary.

> (e) To create a distinction between current income and "extraordinary" income, so that compensation paid in a lump sum in one year for services of a period and gains realized in one year from the sale of investments and capital assets may be taxed at special rates, with due regard to the years in which the income accrued.

This thought is as much in line with that expressed in (c) above as it is opposed to that in (d).

It has justice in it if tax rates continue to vary greatly between years; but it presents practical difficulties in the way of adequate definition and prevention against abuse.

> (f) To permit obligor corporations to deduct as interest taxes paid by them on tax-free covenant bonds.

It is on the theory that the amount of tax paid by the corporation is an addition to its interest payments that the recipient is obliged to return this amount as income, if he follows article 31 of regulations 45. This income thus bears double taxation. Either the corporation should be allowed the deduction or, preferably, the individual should be permitted to treat it as a payment on account of his tax, in accordance with the purpose of the tax-free covenant.

> (g) To remove the possibility of reducing taxable income by the deduction of interest paid on indebtedness incurred for 3¾% Victory notes.

While the interest deduction is proper when the income is subject to surtaxes or excess-profits taxes, obviously there is no ground for permitting it when the securities carried are wholly exempt from tax.

(h) To free from tax interest received by non-resident foreign individuals and corporations not doing business here on funds on deposit here.

This proposal is made as a measure of reciprocity with other countries that will cost us little and will encourage foreign business enterprises to use our banking institutions.

(i) To define the income of foreign individuals and corporations from American sources so as to exclude their profits from manufacture and disposition of goods outside our boundaries, and to determine the American income by a rational method of apportionment.

It appears that foreign producers are equally liable to taxation here on their entire income if, first, their factory is located here but they make sales abroad, and, second, the factory is located abroad and their sales are made through an established office in the United States. This comes about because, in the first case, "sources within the United States" is held to cover manufacture or production, while in the second instance it covers sale.

The case needs only to be stated to justify the amendment. But, while dealing with this subject, we may express the hope that it will be made clearer than it is now how to distinguish between sources within and sources without the United States. How far may the non-resident go and what are the extreme measures he may employ to secure trade here without becoming subject to our income tax? What classes of the voluminous sales made here through salesmen, brokers, commission merchants and similar agencies are legitimately escaping tax? And what are not?

(j) To provide that in case of a return by an individual for a fractional part of a year, "the surtax shall be such part of a surtax computed upon an amount twelve times the average monthly income for the fractional part of the year included in the return as the number of months in such period is of twelve months."

Without some such rule as this, "an individual making a return for a fractional part of a year secures a lower rate of surtax than would be applied to him if he made return for an entire year."

(k) To embody in the law the present regulation that a taxpayer's status at the close of the year determines his personal credits, except that in case of death during the year the individual's status at his decease shall govern.

(l) To make statutory the present rulings, in connection with the excess-profits tax and war-profits tax, to the effect that (1) for a return covering less than twelve months, the limits of $3,000.00 and $20,000.00, respectively, in section 302 (the limited tax section), should be proportionate to the fraction of a year covered, and (2) taxes for the preceding year "may be included in the computation of invested capital only until such taxes become due and payable."

(m) To extend to prior acts the benefits of the 1918 act in respect of (1) the five-year limitation upon amendment of returns and assessment by the commissioner, and (2) the remission of the 5% penalty and lowering of the interest rate to one-half of 1% on all bona fide claims for abatement.

Schedule of Average Percentages of Pre-War Income

Section 311 of the revenue act of 1918 provides that a corporation which was not in existence during the whole of at least one calendar year during the pre-war period, and therefore received no income during the pre-war period, shall be allowed a specific exemption of $3,000 and—

> "An amount equal to the same percentage of the invested capital of the taxpayer for the taxable pear as the average percentage of net income to invested capital, for the pre-war period, of corporations engaged in trade or business of the same general class as that conducted by the taxpayer, but such amount shall in no case be less than 10 per centum of the invested capital of the taxpayer for the taxable year. Such average percentage shall be determined by the commissioner on the basis of data contained in returns made under title II of the revenue act of 1917, and the average known as the median shall be used."

In pursuance of this requirement of the law, there have been compiled by the treasury department and issued as *Bulletin D. Income Tax,* tables showing the average percentages of pre-war income to pre-war invested capital of general classes of corporations, grouped as to trades or businesses. The bulletin cannot be repeated in full, but can be obtained from the bureau of internal revenue. Corporations entitled to more than the minimum 10% exemption are the exception, as is indicated by the following summary:

CHART

Showing the average percentages of net income to invested capital for the pre-war period and the number of industrial groups of the same class of business under each median.

Industry	Total number of industrial sub-divisions.	Medians or average percentages of net income to invested capital.										
		10% and under.	Over 10% and under 11%.	11% and under 12%.	12% and under 13%.	13% and under 14%.	14% and under 15%.	15% and under 16%.	16% and under 17%.	17% and under 18%.	18% and under 19%.	19% and under 20%.
Agriculture and dependent pursuits..	10	8	....	1	....	1	....	....	....	....	....	....
Mining..........................	17	15	....	1	....	....	....	....	....	1	....	....
Financial: Banks, insurance companies, brokerage institutions....	22	22	....	....	....	....	....	....	....	....	....	....
Common carriers and public utilities	17	16	....	....	....	1	....	....	....	....	....	....
Iron and steel....................	37	35	2	....	....	....	....	....	....	....	....	....
Chemical manufacturing and allied industries	9	4	2	2	....	....	1	....	....	....	....	....
Manufacturing foods and food products.........................	16	10	4	1	1	....	....	....	....	....	....	....
Leather and leather goods industries	4	1	2	1	....	....	....	....	....	....	....	....
Liquors and beverages...........	5	5	....	....	....	....	....	....	....	....	....	....
Metal and metallurgical extractions	15	13	1	....	....	....	....	1	....	....	....	....
Paper manufacturing, printing, bookbinding, publishing.........	13	10	2	....	....	1	....	....	....	....	....	....
Special manufacturing industries...	37	27	2	3	2	....	1	1	1	....	....	....
Stone, clay, and glass industries....	9	8	....	....	1	....	....	....	....	....	....	....
Textile industries................	33	25	1	4	1	....	....	....	....	1	....	1
Lumbering and woodworking industries.........................	12	12	....	....	....	....	....	....	....	....	....	....
Trading and miscellaneous.........	21	18	1	....	....	....	....	....	....	1	....	1
Total......................	277	229	17	13	5	3	2	2	1	3	....	2

TREASURY RULINGS

The only new treasury decision (T. D. 2956) prescribes regulations for the execution of that provision of the revenue act of 1918 (sections 214-A-10 and 234-A-9), by which a taxpayer discovering oil or gas wells after March 1, 1913, may, if the fair market value is materially disproportionate to the cost, value his property at the date of discovery, or within thirty days thereafter, to establish the basis for his depletion calculations (but not for his profit or loss on sale). The relative articles (220 and 221) of regulations 45 are rewritten. "Discovery" signifies demonstration, natural or artificial, of the presence of sufficient oil or gas to warrant expectation of at least returning the capital invested and thus to justify "commercial exploitation." To make certain knowledge possible as to whether the taxpayer's property is a "discovery" or part of a "proven tract or lease," a unit of "proven area" is created. This unit is defined as "a square surface area of 160 acres, having as its center the mouth of a well producing oil or gas." Thus a new well or exposure falling within the boundaries of a square of 160 acres centering on an existing well is not a discovery, but part of a proven tract or lease, and not susceptible to valuation at fair market value. But if it does not overlap other like "areas," the "property" to be valued covers the well, its equipment and contents, out to the limits of the taxpayer's bounding lines, or of the 160-acre unit, whichever is interior. (What might otherwise be deemed a "discovery," however, is inadmissible as such if situated at the center of a compact area of proven land and if surrounding geological evidences indicate in advance that it is bearing land.)

(T. D. 2956, December 2, 1919)

Deductions allowed. Depletion after discovery of oil and gas wells, proven tract or lease. Disproportionate value, article 220 and 221 of regulations 45, amended.

Regulations 45 are hereby amended by substituting for articles 220 and 221 as they now stand the following three articles:

Article 220. Oil and gas wells.

Section 214 (a) (10) and section 234 (a) (9) provide that taxpayers who discover oil and gas wells on or after March 1, 1913, may, under the circumstances therein prescribed, determine the fair market value of such property at the date of discovery or within 30 days thereafter for the purpose of ascertaining allowable deductions for depletion. Before such valuation may be made the statute requires that two conditions precedent be satisfied: (1) That the fair market value of such property (oil and gas wells) on the date of discovery or within 30 days thereafter became materially disproportionate to the cost, by virtue of the discovery, and (2) that such oil and gas wells were not acquired as the result of purchase of a proven tract or lease.

Article 220 (a). Discovery—Proven tract or lease—Property disproportionate value. (1) For the purpose of these sections of the revenue act of 1918, an oil or gas well may be said to be discovered when there is either a natural exposure of oil or gas or a drilling that discloses the actual and physical presence of oil or gas in quantities sufficient to justify commercial exploitation. Quantities sufficient to justify commercial exploitation are deemed to exist when the quantity and quality of the oil or gas so recovered from the well are such as to afford a reasonable expectation of at least returning the capital invested in such well through the sale of the oil or gas, or both, to be derived therefrom.

(2) A proven tract or lease may be a part of the whole of a proven area. A proven area for the purposes of this statute shall be presumed to be that portion of the productive sand or zone or reservoir included in a square surface area of 160 acres having as its center the mouth of a well producing oil or gas in commercial quantities. In other words, a producing well shall be presumed to prove that portion of a given sand, zone or reservoir which is included in an area of 160 acres of land, regardless of private boundaries. The center of such square area shall be the mouth of the well, and its sides shall be parallel to the section lines established by the United States system of public land surveys in the district in which it is located. Where a district is not covered by the United States land surveys, the sides of said area shall run north and south, east and west.

So much of a taxpayer's tract or lease which lies within an area proven, either by himself or by another, is "a proven tract or lease" as contemplated by the statute, and the discovery of a well thereon will not entitle such taxpayer to revalue such well for the purpose of depletion allowances, unless the tract or lease has been acquired before it became proven. And even though a well is brought in on a tract or lease not included in a proven area, as heretofore defined, nevertheless it may not entitle the owner of the tract or lease in which such well is located to revaluation for depletion purposes, if such tract or lease lies within a compact area which is immediately surrounded by proven land, and the geologic structural conditions on or under the land so inclosed may reasonably warrant the belief that the oil or gas of the proven areas extends thereunder. Under such circumstances the entire area is to be regarded as proven land.

(3) The "property" which may be valued after discovery is the "well." For the purposes of these sections the "well" is the drill hole, the surface necessary for the drilling and operation of the well, the oil or gas content of the particular sand, zone or reservoir (limestone, breccia, crevice, etc.) in which the discovery was made by the drilling and from which the production is drawn, to the limit of the taxpayer's private bounding lines, but not beyond the limits of the proven area as heretofore provided.

(4) A taxpayer to be entitled to revalue his property after March 1, 1913, for the purpose of depletion allowances must make a discovery after said date, and such discovery must result in the fair market value of the property becoming disproportionate to the cost. The fair market value of the property will be deemed to have become disproportionate to the cost, when the output of such well of oil or gas affords a reasonable expectation of returning to the taxpayer an amount materially in excess of the cost of the land or lease if acquired since March 1, 1913, or its fair market value on March 1, 1913, if acquired prior thereto, plus the cost of exploration and development work to the time the well was brought in.

Article 221. Proof of discovery of oil and gas wells. In order to meet the requirements of the preceding article to the satisfaction of the commissioner, the taxpayer will be required, among other things, to submit the following with his return: (a) A map of convenient scale, showing the location of the tract and discovery well in question and of the nearest producing well, and the development for a radius of at least three miles from the tract in question, both on the date of discovery and on the date when the fair market value was set; (b) a certified copy of the log of the discovery well, showing the location, the date drilling began, the date of completion and beginning of production, the formations penetrated, the oil, gas and water sands penetrtated, the casing record, including the record of perforations, and any other information tending to show the condition of the well and the location of the sand or zone from which the oil or gas was produced on the date the discovery was claimed; (c) a sworn record of production, clearly proving the commercial productivity of the discovery well; (d) a sworn copy of the records, showing the cost of the property; and (e) a full explanation of the method of determining the value on the date of discovery or within 30 days thereafter, supported by satisfactory evidence of the fairness of this value.