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Federal Income Tax Amendments of 1944

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COMMENT

FEDERAL INCOME TAX AMENDMENTS OF 1944

Present 1944 changes of the federal income tax statutes consist of amendments made by the Revenue Act of 1943, and the Individual Income Tax Act of 1944 passed in February and May of this year respectively. Additional changes are unlikely. It is anticipated therefore, that there can now be presented an analysis of statutory changes which must be considered in the preparation of returns for the year 1944.

The Revenue Act of 1943 (hereafter referred to as the 1943 Act) was designed to raise two or three billion dollars in revenue as well as make a number of technical amendments to improve the tax law and remove certain inequities.[1] The Individual Income Tax Act of 1944 (here-

[1] For a discussion of the economic and political background of this Act *see* Blakey, *Federal Revenue Legislation of 1943-44*, (1944) 38 AM. POL. SCI. REV. 325. The objectives of Congress are amply set out in the committee reports. Report of Committee on Ways and Means, *Revenue Bill of 1943*, P-H ed., p. 5.

after referred to as the Individual Act) was passed for the purpose of simplifying the individual income tax.[2]

PERSONAL INCOME TAX CHANGES

Personal income tax changes under these Acts seem to fall in a general way into four classes; (1) simplification measures, (2) relief provisions, (3) revenue measures, and (4) technical changes to aid administration. All of the simplification provisions are in the Individual Act with the exception of § 107 of the 1943 Act repealing the earned income credit. Rates have been completely revised by the simplification provisions, but no substantial change in revenue is anticipated therefrom. These new rates and the provisions necessitating them will therefore be discussed first.

New Rates. The Victory Tax is repealed[3] and a new normal tax rate of 3 per cent is substituted to apply to all net income over $500, less certain interest on United States bonds or interest on certain obligations of instrumentalities of the United States. INTERNAL REVENUE CODE (hereafter cited as I. R. C.) § 11. If a joint return is filed an additional $500 exemption for normal tax purposes will be allowed unless the adjusted gross income of one spouse is less than $500 in which case the exemption shall be $500 plus the adjusted gross income of such spouse.[4] I. R. C. § 25(a)(3).

The new surtax rates combine the former normal and surtax rates, and are slightly higher in the lower brackets.[5] I. R. C. § 12(b). The surtax applies to the net income after allowing the established deductions for expenses, losses, interest, taxes, depreciation, charitable contributions, alimony, and other items in I. R. C. § 23, but the credits allowed against it are quite different. The taxpayer is now allowed one surtax exemption of $500 against his net income for himself, a second $500 exemption for his wife if it is a joint return or she has no gross income, and an additional $500 exemption for each dependent whose gross income is less than $500. I. R. C. § 25(b)(1).

Short Form Returns, Supplement T. Anyone having an "adjusted gross income" of less than $5,000, from any source, may elect to use the short form and pay the tax provided in Supplement T.[6] I. R. C. § 400. "Adjusted gross income" is, in general, all income less business

[2] Report of House Committee on Ways and Means, *Individual Income Tax Bill of 1944*, CCH ed., p. 1.

[3] Individual Act, § 6.

[4] Taxpayers whose spouse has less than $500 income will be able to save up to $15 in a community property state by dividing their income according to a community property law so that the wife will have an income of $500 or more. Poe v. Seaborn, 282 U. S. 101, 75 L. ed. 239, 51 S. Ct. 58 (1930). The elective community property system of Oklahoma has been upheld in Harmon v. Commissioner, 1 T. C. 40, aff'd. 139 F. (2d) 211 (1943); certiorari granted, — U. S. —, 68 S. Ct. —, 88 L. ed. adv. ops. 777 (Apr. 3, 1944). The Oregon system is very similar to that of Oklahoma.

[5] Formerly the combined normal tax and surtax was 19 per cent in the lowest bracket. A few of the new rates are:

If the surtax net income is:	*The surtax shall be:*
Not over $2,000	20% of surtax net income
Over $2,000 but not over $4,000	$400 plus 22% of excess over $2,000
Over $4,000 but not over $6,000	$840 plus 26% of excess over $4,000
Over $10,000 but not over $12,000	$2,640 plus 38% of excess over $10,000

[6] The use of the short form was formerly limited to incomes of not more than $3,000 derived entirely from compensation for personal service, dividends, interest, or annuities.

expenses. More particularly it is gross income as defined and limited by I. R. C. § 22 less certain specific deductions allowed by I. R. C. § 23. These specific deductions include only (1) trade and business deductions incurred in the taxpayer's own business; (2) expenses of travel, meals, and lodging while away from home incurred by the taxpayer as an employee; (3) other expenses of an employee for which he is reimbursed (since he must report such reimbursement as income); (4) deductions or expenses attributable to rents and royalties which though not from business arise from property held for the production of income; (5) deductions of life tenants and income beneficiaries of property held in trust for depreciation and depletion as allowed by I. R. C. § 23(l) and (m);[7] (6) losses from the sale or exchange of property. I. R. C. § 22(n).

The taxpayer elects annually whether or not to pay the tax according to Supplement T, and such election is irrevocable. I. R. C. § 402. If the taxpayer shows an adjusted gross income of less than $5,000 on his return and has elected to pay according to Supplement T, he is bound by that election to take the standard deduction of $500 even if, on correction, his adjusted gross income is more than $5,000.[8] And *vice versa,* if he takes the standard deduction on a return which shows the adjusted gross income as more than $5,000, but on correction it proves to be less than $5,000, he is considered to have elected to pay according to Supplement T. I. R. C. § 23(aa)(3)(D).

Certain taxpayers are ineligible to elect to pay the tax according to Supplement T. These include non-resident aliens, citizens entitled to benefits of I. R. C. § 251 (relating to income from possessions of the United States), estates, trusts, or individuals making a return for less than a year due to a change in accounting periods. I. R. C. § 404. In the case of a husband and wife living together neither can elect to use Supplement T, or the standard deduction, unless the other elects to take the standard deduction. I. R. C. § 23(aa)(4). This means that Supplement T must be used by both spouses or neither if the adjusted gross income of each is below $5,000. If the husband's income is $10,000 and wife's $4,000, she cannot elect to pay under Supplement T unless the husband takes the standard deduction of $500.

Tax Computed by Collector. There is an excellent provision in the Individual Act allowing an individual with gross income of less than $5,000 entirely from wages, with the exception of not more than $100 from interest and dividends, to make a simple return without computing his tax. I. R. C. § 51(f).[9] Such a person must be eligible to elect the

[7] It appears that it would have been much better to have combined (4) and (5) of this subsection in a more general paragraph allowing the deduction of non-business expenses incurred in the production of any income rather than merely rents and royalties. The question whether life tenants can deduct other non-business expenses immediately arises under the above provisions. Paragraph (4) seems to allow them and the life tenant referred to in paragraph (5) cannot deduct depreciation as allowed in that provision unless he can also come under paragraph (4) by renting such property. I. R. C. § 23(l) and (m).

[8] "Standard deductions" are discussed *infra* under that heading.

[9] Hereunder the Commissioner with the approval of the Secretary can set up regulations by which persons with other types of income may come under this subsection provided that not more than $200 is from a source other than wages subject to withholding. He may also by his regulations increase the allowable income to $5,200 in such instances.

use of Supplement T and in making this return is considered to have so elected, whereupon the collector will compute the tax on that basis and mail him a statement. The taxpayer will then have thirty days in which to pay any balance due. The statute leaves the details of this procedure to be worked out by the Commissioner with the approval of the Secretary, but congress had in mind that this simple form probably would be the statement of the employer as to earnings of the employee with the necessary information as to dividends, interest, spouse and dependents added by the employee together with his signature.[10] This procedure relieves such a taxpayer from all computations although in many cases he will still compute his tax to make sure he is not losing anything.

Standard Deductions. Another new concept in income tax law is the "standard deduction" which is used in connection with Supplement T as mentioned above, and may be used by those with adjusted gross incomes of more than $5,000. If the adjusted gross income is less than $5,000, the standard deduction is 10 per cent of this income, but is only allowed when the taxpayer elects to use Supplement T. If the adjusted gross income is $5,000, or more, the standard deduction is $500. I. R. C. § 23(aa)(1). The standard deduction is given in lieu of all deductions except those allowed in computing the adjusted gross income as outlined above, and in lieu of practically all credits against net income or against the tax except those for taxes withheld by the employer on wages and credit for a dependent or a spouse. That is, foreign tax credits, credits for taxes withheld at source on certain tax-free covenant bonds, and credits against net income for interest on certain tax-free government bonds and those of government corporations are not allowed if the taxpayer uses the standard deduction; nor is he allowed any deductions for interest, taxes, casualty losses, contributions to charity, medical expenses, alimony, or other deductions not in I. R. C. § 22(n) (the adjusted gross income subsection). I. R. C. § 23(aa)(2).

Credits Against Net Income. The personal exemption credits for both normal and surtaxes have been discussed *supra* under "New Rates," but for certain types of taxpayers there are some other changes which should be noted. Estates are allowed a $500 normal tax exemption and a $500 surtax exemption. Trusts are allowed only an exemption of $100 from each tax. I. R. C. § 163(a)(1). Nonresident aliens, unless residents of Mexico or Canada, are not allowed normal or surtax exemptions for their spouses or dependents. I. R. C. § 214. Taxpayers benefited by § 251, relating to income from possessions of the United States, are treated the same as nonresident aliens. I. R. C. § 251(b). There are two changes in deductions allowed by I. R. C. § 23. The deduction for charitable contributions is increased slightly by making the maximum 15 per cent of adjusted gross income instead of 15 per cent of net income. I. R. C. § 23(o). The allowable deduction for medical expense is that portion of the expense which exceeds 5 per cent of the adjusted gross income rather than of the net income. I. R. C. § 23(x). This reduces the medical expense deduction, since the new 5 per cent of the adjusted gross income will include a larger

[10] Report of House Committee on Ways and Means, *Individual Income Tax Bill of 1944,* CCH ed., p. 3.

amount of non-deductible expense.[11]

Dependents. A surtax exemption of $500 is allowed for each dependent rather than the former $350, but the definition of a dependent is rather radically changed. I. R. C. § 23(b). A dependent cannot have a gross income of $500 or more and must be a relative by blood, marriage, or adoption as specified in the statute. He must be related to the taxpayer as a (1) child or descendant, (2) stepchild, (3) brother, sister, stepbrother or stepsister, (4) parent or ancestor, (5) stepfather or stepmother, (6) son or daughter of a brother or sister, (7) brother or sister of the father or mother, (8) son-in-law, daughter-in-law, father-in-law, mother-in-law, sister-in-law, or brother-in-law, (9) legally adopted child, or (10) half-sister or half-brother.[12] The dependent must live in the United States, Canada or Mexico as formerly. The provisions are more liberal in that no age is specified nor is any particular date important. The taxpayer must supply over half the support of the dependent for the calendar year in which the taxable year begins. The former statute provided that the taxpayer had to contribute the "chief" support which the Bureau of Internal Revenue interpreted as over half.[13] Whether a child who earns $400 or $450 a year can be claimed as a dependent may be a difficult question of fact.

The past practice has been to allow a parent credit for an unemancipated child under eighteen even though the child earned enough to support himself, but the parent had to include the child's earnings in his return.[14] Now the parent does not have to include the child's earnings in his return, so the commissioner will likely require that the parent be able to show that he has actually contributed more than half of the financial support of the child.[15] The parent may still claim the credit even though the child earned $499, which was more than half the cost of his support, if the parent actually contributed over half the support while the child saved some of his earnings or used them for other purposes.[16]

Children's Earnings. Another amendment which will resolve confusion treats a child's earnings as gross income of the child and not of the parent. I. R. C. § 22(m). All expenditures attributable to these earnings are to be deemed incurred by the child. This will limit a few of the parent's deductions, but, on the other hand, the parent will in most cases derive a much more substantial benefit by not having to include these earnings in his income. If the child does have sufficient earnings to be taxable on them, the parent is liable for the tax as well

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[11] These two amendments seem to be rather unnecessary. The result is that taxpayers and the collectors must compute "adjusted gross income" although it cannot be used for any other purpose on these returns.

[12] This definition is restrictive inasmuch as it cuts out aunts and uncles who are not blood relatives and children of sisters-in-law, but it is clear.

[13] Regulation 111, § 29.25-6.

[14] P-H Fed. Tax Serv., 1944, par. 4076-A, C. B. 1942-1, p. 81.

[15] In Harry Sommers, 32 B. T. A. 490 (1935), the court held that the parent must be able to show that he contributed over half the financial support regardless of his legal obligation.

[16] In Warren S. Booth, 43 B. T. A. 846 (1941), the court held that even though a child had income sufficient for his own support, the parent could claim him as a dependent if he actually contributed over half the support.

as the child.[17] Every individual with a gross income of more than $500 must file a return under the Individual Act regardless of age or marital status. I. R. C. § 51(a).

Estimated Tax. A change designed to simplify tax returns in the lower brackets eliminates estimated returns for many more taxpayers. I. R. C. §§ 58, 59, and 60. Starting January 1, 1945, estimated returns will only be required from (1) a taxpayer whose gross income from wages exceeds $5,000 plus $500 for each surtax exemption except his own, or (2) one whose gross income from sources other than wages can reasonably be expected to exceed $100 and whose total gross income will probably exceed $500. A joint declaration of estimated tax may be made regardless of whether a joint return is to be made. The time for filing is the same except that January 15 of the succeeding year is substituted for December 15, and a return by January 15 may be substituted for a declaration not required before that date. The Commissioner is now authorized to grant an extension of time up to six months for filing declarations and paying the estimated tax. Individuals who derive two-thirds of their gross income from farming may file their declaration or return for the entire year on January 15 of the succeeding year. For 1944 the penalty for an estimate less than 80 per cent of the tax may be computed without regard to the amendments made by the Individual Act if the taxpayer prefers.

The above discussion of the amendments to simplify the tax indicates that progress has been made. This is counteracted to some extent by the complication arising from the new concept of adjusted gross income. Any real simplification is bound to conflict with the extension of relief in cases of hardship. This is illustrated by the 1943 Act which is concerned primarily with granting relief to certain taxpayers.

Special Exclusions and Deductions. Several amendments grant exemptions or tax benefits to particular classes or in situations where equity seems to demand them. The most popular of these provisions is the exclusion from gross income of mustering-out payments for military and naval personnel, I. R. C. § 22(b)(14), and a special deduction of $500 for a blind person.[18] I. R. C. § 23(y). A similar amendment excludes from gross income cost-of-living allowances paid to government employees while stationed outside the United States. I. R. C. § 116(j). This applies to 1943 as well as subsequent years.

Trusts. There are two new relief provisions in connection with trusts. Under the Revenue Act of 1942 certain deductions are allowed to trusts but the amount of the deductions under I. R. C. § 162(b) and (c) are then considered taxable income to the beneficiary. This has resulted in a form of double taxation in some cases, since under the former law by the application of I. R. C. § 162(d)(2) and (3)(A) a beneficiary might receive trust income after the 65-day period which would therefore be considered income of the trust deductible only to the

[17] It is suggested that this amendment is unconstitutional under the holding in Hoeper v. Tax Commission, 284 U. S. 206, 76 L. ed. 248, 52 S. Ct. 120 (1931). That one person could not be taxed on the income of another even though he may have derived some benefit from it. Paragraph (4) of this section seems to prevent such a controversy by placing the liability on the parent anyway. It is believed that practical considerations will probably prevent this question from arising.

[18] A blind person is defined as one whose central visual acuity does not exceed 20/200 in the best eye, with correcting lenses, or whose visual field is limited to 20 degrees in width. I. R. C. § 23(y).

extent of the actual trust income for that year. If the actual income of the trust was less than the amount distributed during that year, or within 65 days of the last day thereof, the trust had no deduction for the income of a prior period which was actually distributed to the beneficiary and therefore taxable to him as well. The amendment excludes the excess which is subject to double taxation under former law from the income of the beneficiary.[19] I. R. C. § 162(d)(4).

The other trust amendment has arisen as a result of *Helvering v. Stuart.*[20] Previously *Douglas v. Willcutts*[21] held the income of a trust set up by a grantor for the support of a person whom he was legally obligated to support was taxable to the grantor. The *Stuart* case extended this rule to situations where the income could be applied to support such dependents of the grantor in the discretion of a person who did not have a substantial adverse interest, whether it was so used or not. This overruled G. C. M. 18972 which declared the grantor taxable only to the extent the income of the trust was actually used for the support or maintenance of persons he was legally obligated to support. Congress by the new amendment restored the rule of G. C. M. 18972. I. R. C. § 167(c). This rule is made applicable to 1943 or fiscal years ending therein and subsequent years. It is retroactive to prior years if the taxpayer consents to its complete application for those years and in such cases the Statute of Limitations, I. R. C. §§ 275, 276, is lifted for one year from the filing of the consent and any adjustments are not subject to interest either on deficiencies or overpayments. 1943 Act, § 134.

Tax Benefits, Back Pay. The remaining relief provisions seem to be in the nature of tax benefits rather than deductions, exclusions, or exemptions. For instance an amendment to I. R. C. § 107 provides by subsection (d) that if more than 15 per cent of the gross income is back pay the tax rate for the year in which it should have been received will apply to it. This subsection is limited by the definition of back pay which requires that it fall within one of three alternatives: (1) be paid later due to bankruptcy, dispute, or lack of funds by a government, or similar situations as determined by the Commissioner with the approval of the Secretary, (2) be retroactive pay increase(s) authorized by a federal or state agency such as the War Labor Board, or (3) be due to violation of a labor law by the employer.

Aliens. Aliens brought into the United States by the War Manpower Commission are given a substantial tax benefit in the nature of a flat 10 per cent withholding. I. R. C. § 143(b). This does not affect the ultimate tax but properly reduces withholding at the source to the approximate tax liability.

Penalties. Another relief provision allows the taxpayer to avoid penalties for failure to file an estimated return or pay the tax by show-

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[19] Revenue Act of 1943, § 133, amending I. R. C. § 162. The 1942 amendment, establishing the 65-day rule and making other changes which led to the difficulty corrected by the present amendment, was passed to get around the court decision in Dean v. Commissioner, 102 F. (2d) 699 (1939). This case established the rule that where income was accumulated in one year, but was not distributable until the succeeding year even though payable on January first of the following year, it was income taxable to the trust for the year in which accumulated. The Senate Finance Committee has indicated that it is not satisfied with this complicated situation and has referred the matter to its research staff for revision.

[20] 317 U. S. 154, 87 L. ed. 154, 63 S. Ct. 140 (1942).

[21] 296 U. S. 1, 80 L. ed. 3, 56 S. Ct. 59 (1935).

ing a reasonable cause for delay to the satisfaction of the Commissioner. I. R. C. § 294(d). Otherwise the penalty is 5 per cent of the installment due plus 1 per cent per month, or fraction thereof, until the penalty reaches 10 per cent. This new subsection also provides that if the taxpayer pays according to his current personal exemption and credit for dependents status, but on the basis of the previous year's income, no penalty will be assessed.[22] I. R. C. § 294(d)(2). This affords relief to many taxpayers by eliminating the uncertainties of estimated returns, since they can simply file an estimate on the basis of the previous year and pay on that basis. It should be kept in mind that this procedure is limited to cases where the income, exemptions, and credits reasonably appear to be about the same as for the previous year. A farmer's estimate need only be 66⅔ per cent of the actual tax to escape penalty. If the estimate is less than that for farmers or less than 80 per cent of the tax for others, the penalty is the difference or 6 per cent of the excess of the actual tax over the estimated tax, whichever is less.[23]

Gain in Certain Corporate Liquidations. An election as to recognition of gain in certain corporate liquidations also results in a tax benefit affording relief in certain instances. I. R. C. § 112(b)(7). Under this paragraph an election allowed under the Revenue Act of 1938 is revived. The application of the new paragraph is rather restricted but will aid some corporations, especially personal holding companies, to liquidate where desirable because of high duplicate taxes. If a plan of liquidation is adopted after February 25, 1944, under which the entire stock is redeemed or cancelled by a transfer of all the assets in one month in 1944, then the stockholders possessing 80 per cent of the voting power of individually held stock, or in the case of corporations 80 per cent of corporation held voting stock, can upon agreement elect to take the benefits of sub-paragraphs (E) and (F) which allow the "qualified electing shareholders" to receive assets (other than money or stock acquired by the corporation after December 10, 1943), without any recognition of gain or loss.

Gain or Loss Upon the Cutting of Timber. Probably the most important relief provision for the Pacific Coast is the addition of I. R. C. § 117(k) allowing timber owners to elect to treat as capital gain the excess of the fair market value of their timber, as of the first day of the taxable year in which it is cut, over its adjusted basis for depletion.

Formerly, timber owners who cut their own timber were required to treat it as their stock-in-trade which meant that the entire profit

[22] This paragraph of the Code still refers to the status of the taxpayer as to personal exemption and credit for dependents on July first. The Individual Act, § 10, changed the determination of such credits to December 31 or the last day of the taxable year for marriage and requires that the taxayer contribute over half the support of a dependent, as defined therein, for the calendar year in which his taxable year begins. Therefore it would seem that the taxpayer must reasonably foresee that he will contribute such support. If the declaration is made after July first and this section is applied literally it would seem that what appears reasonable as of July first would control.

[23] To illustrate this: T filed an estimate of $79 tax. His actual tax turned out to be $100. He can elect between (1) the actual tax less the estimated tax multiplied by 6 per cent: $\$100 - \$79 = \$21 \times .06 = \$1.26$, penalty, or (2) the difference between 80 per cent of the actual tax and his estimate: $.8 \times \$100 = \$80 - \$79 = \$1.00$, penalty.

was ordinary income subject to the regular income tax rates. This amendment allows the capital gain to be taxed at 25 per cent in the case of a corporation, rather than the higher rates which frequently reach the 95 per cent excess profits tax. Individual or non-corporate owners do not benefit as much as corporations but will benefit where their tax rates are higher than 50 per cent, the rate for them on long-term capital gains. In both cases capital losses from other transactions may preclude the benefits of this subsection. I. R. C. § 117(c). The taxpayer must have owned the timber, or the contract rights to cut it, for a period of more than six months before the beginning of the taxable year in order to be eligible to make this election, and once made the election is binding as to subsequent years unless the Commissioner permits a revocation. The major justification for this provision seems to be that it encourages timber owners to continue mill operation during the present critical need for lumber.[24]

Revenue Additions. The relief and simplification provisions far outweigh the meager attempts at raising additional revenue. There are, however, a couple of amendments which not only simplify but also raise a fair amount of new revenue. The most substantial is the repeal of the earned income credit.[25] The addition to I. R. C. § 23(c)(1) of subparagraph (F) increases the revenue by disallowing the deduction of federal import duties, excises and stamp taxes unless they are incurred as a business expense or as a necessary and ordinary expense of the production of income under I. R. C. § 23(a)(2).

Limitation on Deductions, Business Losses. Another limitation on deductions which will probably contribute some additional revenue is the partial disallowance of deductions attributable to the operation of a business at a loss for five consecutive years. A new section, I. R. C. § 130, added to supplement B, provides that if the loss from a business operated by an individual results in deductions for five consecutive years of more than $50,000 the net income of that individual is to be recomputed for each of the years and not more than $50,000 allowed for each year. The statute of limitations[26] is amended to allow this, but although the five-year period can extend back to January 1, 1940, so that December 31, 1944, will be the end of a five-year period, the tax liability for any year beginning before January 1, 1944, will not be affected.[27]

Technical Amendments. There are a number of technical amend-

[24] The amendment might have the effect of causing these taxpayers having several stands of timber to shift operations to that stand upon which they would make the greatest capital gain in lieu of working the most productive stands.

[25] 1943 Act, § 107. Formerly, for the 6 per cent normal tax, individuals were allowed a credit of 10 per cent of their earned net income not exceeding $14,000 and all net income up to $3,000 was declared to be earned income.

[26] I. R. C. §§ 275, 276, 506, 507, 508.

[27] To illustrate this: T has shown a loss from a certain business as follows, 1940, $50,001; 1941, $50,001; 1942, $60,000; 1943, $65,000; 1944, $70,000. On his 1944 return T can only claim a deduction of $50,000 but need not pay any deficiency for 1942 and 1943. However, if he shows a loss of only $50,000 for 1945 he can then again claim deductions in excess of $50,000 for the next four years. If he shows a loss of over $50,000 for five years after January 1, 1944, he will have to pay deficiency for each year in 1949. It appears that the purpose of this section may largely be defeated by careful manipulation.

ments to aid the administration of the tax which apply to individual taxpayers. Formerly, personal exemptions and credits for dependents were prorated in the case of a short taxable year according to the number of months unless it was due to a change in the accounting period. Under the new law full credits are allowed in short years, except when the Commissioner believes the collection of the tax will be jeopardized by the removal of the taxpayer or his property from the United States before the end of the taxable year. I. R. C. § 146(a)(1).

Other technical amendments provide that a husband and wife must use the same taxable year in order to make a joint return. I. R. C. § 51(b). Also fiscal year provisions for years beginning in 1941 and ending in 1942 are clarified by providing that the tax be computed on the basis of the tax rates for 1941 and also on the basis of the tax rates for 1942 and the proportionate parts of each tax used according to the number of months in each year. I. R. C. § 108. Similar provision is made for fiscal years including parts of 1943 and 1944. Foreign tax credit is to be limited in the case of taxpayers other than corporations to the per cent of their tax which is equal to the per cent of their net income from that country, and in the case of corporations the per cent of their tax which is equal to the per cent of their normal tax net income from such country.[28] I. R. C. § 131(b). The definition of deficiency is corrected to allow for withholding and rebates. Individual Act, § 14.

Bad Debts. A technical change relating to both corporate and individual returns is made by amending I. R. C. § 23(k)(1). This change supersedes the court ruling in *Estate of Fahnestock*[29] which allowed a deduction for partially worthless bad debts of only the part determined to be worthless during the tax year. The amendment allows the deduction for an amount not in excess of the part "charged off" regardless of the amount which became worthless during the year.

Withholding for 1945. An amendment of the withholding provisions so that collections will more nearly approximate the tax under the new statute goes into effect on January 1, 1945. The withholding may be on a percentage basis, or according to the table, at the option of the employer. Percentage withholding briefly amounts to this:

(1) Three per cent (normal tax rate) multiplied by 90 per cent of the excess of the wages over one withholding exemption ($11 per week, $46 per month);

(2) Twenty per cent (surtax rate) multiplied by 90 per cent of the excess of the wages over the total amount of withholding exemptions claimed. (That is, if 2 exemptions are claimed, the excess over 2 times $11 or $22 per week, etc.[30] I. R. C. § 1622.

Effective Dates. In general the new amendments apply to taxable years beginning after December 31, 1943.[31] Part of the amendments to

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[28] This eliminates from the computation the adjusted excess profits credit, the use of which produced an inequitable result in some cases.

[29] 2 T. C. 96 (1942).

[30] To illustrate: A earns $50 per week and has a wife and one child. Percentage withholding for him is computed as follows:
(1) .03 × (.9 × $39) = .03 × $35.10 = $1.05, plus
(2) .2 × (.9 × $50 − $33) = .2 × $15.30 = $3.06. (1) $1.05 + (2) $3.06 = $4.11, to be withheld.

[31] Individual Act, § 2; 1943 Act, § 101.

the estimated tax are not applicable until 1945. There are several of the amendments to the 1943 Act which are retroactive to 1943 and a few to 1938 or even prior years.

CORPORATION TAX CHANGES

While many of the changes discussed above obviously refer to corporations as well as individuals, certain of the new provisions relate primarily or solely to corporations. These fall into categories of tax benefit measures, technical changes to resolve uncertainties and improve administration, and revenue protection provisions. The most obvious tax benefit measure is that allowing corporations a deduction for contributions to, or to trusts for, veterans' organizations. I. R. C. § 23(q)(3).

Gain from Sale to Effective Policy of F. C. C. A sound benefit measure allows sales, certified by the Federal Communications Commission to be necessary or appropriate to effectuate its policies, to be considered involuntary conversions under I. R. C. § 112(b). The amendment provides that any gain which is not re-invested in similar property, as is necessary under subsection (b), may be used to reduce the basis of other depreciable property owned by the taxpayer, if he so elects.[32] I. R. C. § 112(m).

Percentage Depletion. By the extension of percentage depletion to a number of new minerals certain mine owners will apparently derive substantial tax benefits. I. R. C. § 114(b)(4). Those minerals added are flake graphite, vermiculite, potash, beryl, feldspar, mica, talc, barite, lepidolite, and spodumene. Each of these is to be depleted at the rate of 15 per cent of the gross income of the mine, but not to an amount which is more than 50 per cent of the net income. Gross income is now defined in some particularity with reference to these and other minerals. I. R. C. § 114(b)(4)(B). Percentage depletion for these minerals will not apply to any taxable year beginning after the present war is over. 1943 Act, § 124(e).

Consolidated Returns. A tax benefit amendment extends to personal service, personal holding and foreign trade companies the privilege of not being included in a consolidated return made by affiliated companies. I. R. C. § 141(e)(7). These companies are not subject to the excess profits tax ordinarily, but if they are included in a consolidated return the excess profits tax is applied to all. Under the new law these three types of firms must file a consent or they are not includible in such returns.

Mutual Fire Insurance Companies. There is a tax benefit amendment for mutual fire insurance companies issuing perpetual policies. I. R. C. §§ 204 and 207. Formerly these firms were taxable under I. R. C. § 207 on their investment income at the regular corporate rate, or 1 per cent of their gross income, but this was unfair to this type of com-

[32] This was allowed since Congress recognized that at present it might be very difficult for a corporation or person to acquire new property of a similar nature. Report of Senate Finance Committee, *Revenue Bill of 1943*, P-H ed., p. 22. To illustrate: T, a flour company, owns radio stations A and B but desires to sell B. If these are competing stations and the FCC certifies that the sale of B will effectuate its policies, T can sell it at a gain over its adjusted basis for it and adjust the basis of some of its flour mill equipment or buildings for this gain rather than showing a gain on its income tax return.

pany which must derive its operating expenses from its investment income whereas other insurance companies might offset expenses against income from policy renewals. This situation is corrected by taxing these companies under I. R. C. § 204 which relates to insurance companies other than life or mutual. Single deposit premiums are kept out of gross income, and dividends to policyholders are not deductible as they are to other insurance companies in that section.

Technical Changes. There are a number of other corporate provisions which seem to be primarily technical amendments to aid the administration of the tax rather than to allow tax benefits or produce revenue. A few technical changes to I. R. C. § 22(d)(6) are made in respect to last-in first-out inventories. It is provided that the taxpayer may substitute replacement cost in his inventory for the year of involutary liquidation but his new goods must then be valued at the cost of the goods replaced.

Loss on Securities in Affiliated Companies. In allowing a deduction for loss on securities in affiliated operating companies a technical amendment to I. R. C. § 23(g)(4)(B) excludes rentals to employees in the ordinary course of business from "rents" as defined therein and interest on deferred purchase price of operating assets sold from "interest" as defined therein. This reduces the total income for these firms from rent and interest.[33]

Reorganization of Insolvent Corporations. A considerable amount of confusion existed as to certain corporate reorganizations under the prior law. In *Helvering v. Alabama Asphaltic Limestone Co.*[34] the court held in applying the revenue statutes prior to 1934 that a reorganization had occurred where bondholders foreclosed and reorganized even though the former stockholders were cut out. But under the Revenue Act of 1934 it was held that the requirement of that Act by which an acquiring corporation had to exchange solely voting stock must be complied with regardless of the continuity of interest.[35] This limitated reorganizations greatly. Later in *Helvering v. Cement Investors*[36] the court held that there was no gain or loss to foreclosing creditors who transferred property to the new corporation even though there was no reorganization. This left the basis of the property in the hands of the new corporation in an uncertain state. It is to clarify this situation as well as make the law more equitable in similar cases that a new technical amendment has been made as to reorganizations.[37] Under the new law, 1943 Act, § 121, no gain or loss is to be recognized on reorganizations in a receivership, foreclosure, bankruptcy, or similar court proceeding. I. R. C. §§ 112(b)(10) and 113(a)(22).

Limitations on Credits or Deductions. There are two provisions which, although of a technical nature, seem to limit credits or deductions and to that extent protect the revenue to some degree. In 1942

[33] These must be operating rather than holding companies, and since they cannot have more than 10 per cent of their income from rent and interest in order to take advantage of the deduction, the amendment appears equitable.

[34] 315 U. S. 179, 86 L. ed. 775, 62 S. Ct. 540 (1942).

[35] Helvering v. Southwest Consolidated Corp., 315 U. S. 194, 86 L. ed. 789, 62 S. Ct. 546 (1942).

[36] 316 U. S. 527, 86 L. ed. 1649, 62 S. Ct. 1125 (1942).

[37] Report of Senate Finance Committee, *Revenue Bill of 1943*, P-H ed., p. 41.

Congress allowed public utilities a credit against net income for preferred stock dividends under I. R. C. § 26(h)(1). Preferred stock dividends accumulated prior to October 1, 1942, are excluded by this amendment to that paragraph. Stock issued in exchange for stock issued prior to October 1, 1942, is deemed stock issued prior to that date as required by the 1942 provision. I. R. C. § 26(h)(2)(B). The other revenue protection amendment disallows any credit gained by the acquisition of 50 per cent of the stock or voting power of a corporation after October 8, 1940, for the purpose of avoiding income or excess profits taxes. I. R. C. § 129.

Returns by Tax Exempt Organizations, Treaties. There are two provisions of the 1943 Act which do not fit into the above classifications. First, certain tax exempt organizations must file returns.[38] I. R. C. § 54(f). This provision is important since labor unions, mutual savings banks, loan associations, cemetery companies, chambers of commerce, clubs, farmers' associations, as well as many similar organizations, must now file returns showing gross income, disbursements, and such other information as the Commissioner, with the approval of the Secretary, may require.[39] The other amendment provides that treaty obligations of the United States are in no way revoked by any amendment in the 1943 Act. 1943 Act, § 136.

CONCLUSION

These acts as amending the income tax provision of the Internal Revenue Code do not seem to have produced any change which will have very great economic effects. The acts are largely relief acts, relieving special cases of undue tax burden and granting tax benefits in a number of instances where the exigencies of war seemed to demand them. Two policies which appear to be undesirable stand out in the amendments. First, in several places elections are allowed the taxpayer and they are binding and irrevocable in each case. This not only complicates the law but often produces hardship where the taxpayer chances to guess wrong.[40] Second, there are a considerable number of provisions which are made retroactive all the way from one to thirty-one years. In many instances they are beneficial to the taxpayer, but on the other hand, several of them will require adjustments and considerable additional computations which cause confusion and complication. For instance the amendments on bad debts, reorganization, gain or loss on timber, business losses, foreign tax credit, and others will require accounting and tax adjustments. Another trend is the increasing amount of regulation allowed the Commissioner with the approval of the Secretary of the Treasury. This is probably desirable in such a complicated and technical field. The complicating factors

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[38] For a good discussion of labor unions under this provisions *see* *Labor Unions and the Revenue Act of 1943*, 77 JOURNAL OF ACCOUNTANCY 296.

[39] This amendment is probably desirable in order to give the Commissioner information to determine taxability of the organization or its employees. One advantage to these organizations is that the statute of limitations will run, whereas it did not when they filed no return. Thurston, *Summary of the Important Features of the Revenue Act of 1943*, 77 JOUURNAL OF ACCOUNTANCY 273.

[40] An excellent criticism of these elections is made in Boch, *Elections Versus Simplification*, 22 TAXES 304, July, 1944.

in these acts seem to far outweigh the meager attempts at simplification.

Simplification is desirable from an economic standpoint. Much time, money and energy is wasted on the complicated and excessive returns which produce no appreciable benefit. Simplification is also desirable from a political standpoint. Complications and confusion as to income taxes have become a major source of antagonism on the part of taxpayers toward their government. Such a situation is highly undesirable under any form of government and a real menace to successful democratic government. As Randolph E. Paul has said:

> "Paying taxes gives citizens a very real sense of participation in government. But they must participate with the feeling of partners, not arithmetical slaves. They cannot derive satisfaction from contact with their government when they are befuddled by a maze of complexities."[41]

It is believed that there will be considerable confusion this year because of new concepts such as "adjusted gross income" and "standard deductions" and other changes in the individual income tax law, but these changes are a step in the right direction and will ultimately mean simplification for a substantial portion of the taxpayers. The Individual Act should be recognized not as any final accomplishment but as a good start toward the goal of simplification. A congressional committee has been established to continue this work and attempt to work out a new income tax law that will be much simpler and of a more permanent nature for the post-war period.[42] This is not an easy problem. Too much simplicity may destroy the clarity of the law or result in unjust distribution of taxes. If we are to have proper taxation, there must be a balancing of these three factors; simplicity, clarity and equity.

Finally, although these acts seem to afford only sporadic and piecemeal relief to corporations, and little more should be expected under existing wartime conditions, the recent writings of such men as Groves,[43] Magill[44] and Paul[45] advocating integration of the personal and corporate taxes after the war probably indicate future trends. The brief reference to a general retail sales tax in the Senate Finance Committee report perhaps indicates that it is leaning that way.[46]

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[41] *Simplification of Federal Tax Law*, 29 CORN. L. Q. 287, 293.

[42] For a discussion of this committee and its proposed work see Lutz, *Tax Simplification*, 5 TAX REV. 11, March, 1944.

[43] GROVES, PRODUCTION, JOBS AND TAXES (1st ed. 1944).

[44] MAGILL, THE IMPACT OF FEDERAL TAXES (1st ed. 1943).

[45] *Supra*, n. 41.

[46] Report of Senate Finance Committee, *Revenue Bill of 1943*, P-H ed., p. 2. The committee reported that the Treasury Department preferred a bill raising only two or three billion dollars to one which would include more by resort to a general retail sales tax. And the report continues, "Aside from its merits, about which there was some difference of opinion, the Treasury's position in this matter weighed heavily in the minds of committee members."