A BRIEF INTRODUCTION TO THE FEDERAL INCOME TAX

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EVEN IN THE halcyon days of the 1939 Code, Judge Learned Hand offered this comment about the federal income tax:[1]

> In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion; yet at times I cannot help but recall a saying of William James about certain passages of Hegel: that they were no doubt written with a passion of rationality; but one cannot help wondering whether to the reader they have any significance save that the words are strung together with syntactical correctness.

The purpose of this paper is not to probe the profound mysteries of the Internal Revenue Code which perplexed Judge Hand. It is designed merely to serve as a prelude to those mysteries, by outlining as briefly and simply as possible the general plan and basic mechanics of the federal income tax.

Specifically, the object of this discussion, which is pointed principally at law students commencing their study of the federal income tax, is threefold: (1) It offers the student a glimpse of the forest before he plunges among the trees, which may serve as an outline about which to

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[1] Hand, *Thomas Walter Swan*, 57 YALE L. J. 167, 169 (1947).

organize his later detailed study. (2) It sets forth a minimum vocabulary of elementary income tax concepts, which are necessary to an enlightened discussion of the tax. (3) Finally, it offers some information about the basic mechanics of computing the tax, which it is difficult to work into the presentation of the tax through the orthodox medium of the case system.[2]

The federal income tax divides taxpayers into: (1) individuals, (2) corporations, (3) exempt organizations, (4) trusts and estates, and (5) partnerships. Perhaps the easiest way to approach the tax is to consider its application to individuals and then to contrast the taxation of other classes of taxpayers with that of individuals.

I

Individual Taxpayers

A. Who Must File a Return

The federal income tax is collected by means of a system of self-assessment, by which each taxpayer files a statement, called a return, setting forth his income for the taxable year and the tax due thereon.[3] Every individual whose gross income during the year amounts to $600 or more must file a return unless he has attained sixty-five years of age before the end of the year. If he has reached sixty-five years of age before the end of the year, he is not required to file a return unless his gross income amounts to $1,200 or more.

B. Exclusions from Gross Income

The amount of a taxpayer's gross income, rather than his net or taxable income, determines his liability to file a return. Thus, a taxpayer may be required to file a return even though he has no taxable income. For example, if *A*, who is forty years old, had a gross income from his business of $10,000 and deductible expenses of $12,000, he would be required to file a return, even though he had no taxable income, because his gross income equaled or exceeded $600. In this connection, it is important to distinguish between what is called an "exclusion" from gross income and a "deduction." An exclusion from

[2] This accounts for the fact that while most of this paper is phrased in very general terms, some topics, such as exemptions, head of a household, the credit for retirement income, and forms of returns for individuals, have been developed in some detail.

[3] If the taxpayer uses Form 1040A, he may elect to have the District Director compute the tax for him.

gross income is an item which is not treated as income at all, but is excluded entirely from gross income. Although both the exclusion and the deduction have the same effect of reducing the taxpayer's net or taxable income, there is a technical difference between the two which is illustrated by the taxpayer's duty to file a return. Since exclusions from gross income do not enter into gross income at all, a taxpayer is not required to file a return unless his gross income, over and above any exclusions, amounts to $600, or $1,200 if he is sixty-five years of age or older. The taxpayer's deductions, on the other hand, have no bearing upon his obligation to file a return, because they do not affect the amount of his gross income. For example, if the taxpayer during the taxable year received taxable interest of $400, interest on state bonds of $1,000, and an inheritance of $1,000, he would not be required to file a return, since the interest on the state bonds and the inheritance are excluded from his gross income, and he has, therefore, gross income of only $400.

Although a taxpayer is not required to file a return unless his gross income equals $600 or $1,200, he may do so—and, indeed, should do so—where this will enable him to recover a tax which has been withheld at the source. This happens, for example, where a person has worked part of the year and earned wages upon which a tax has been withheld, but his total income is below the amount he must earn before the duty to file a return or pay a tax arises.

An individual taxpayer may file one of several different types of return. Since the choice of a form of return depends upon things to be discussed later, such as the amount and source of the taxpayer's gross income or his election to use the standard deduction, consideration of the choice of a form of return will be deferred until these topics have been explored. As part of the plan of making individual taxpayers pay their income taxes as their incomes are earned, certain taxpayers are required to file, in addition to the return after the close of the taxable year for the income earned during that year, a declaration of the estimated tax upon the income anticipated during the current year. This is a topic which can also be discussed more conveniently after further consideration of some basic income tax concepts.

C. Gross Income

The first step in computing an individual's income tax is to list his gross income for the taxable year. Gross income has a technical meaning under the income tax. It indicates those receipts or benefits which are taxed as income under the statute. Unfortunately, the 1954 Code uses the expression "taxable income" as synonymous with net income—that is, gross income less deductions. Taxable income is such a convenient synonym for what the statute calls gross income, or the income which is taxed under the statute, however, that we shall use it in that sense in this discussion, except where the context indicates that it is used in the technical statutory meaning.

The question of what benefits are treated as gross income is quite complex. For the purposes of this discussion, it will be sufficient to notice that statutory gross income is not identical with gross income in an economic or accounting sense, since there are a number of benefits which an accountant or an economist would designate as income which are expressly excluded from gross income by the statute or for legalistic or constitutional reasons are not treated as taxable income. Thus, for example, such things as interest on state and municipal bonds, gifts and bequests, life insurance proceeds paid because of the death of the insured, damages for personal injuries, the use of the taxpayer's own property, and various other items are excluded from gross income.

D. Deductions; Taxable Income

The income tax is actually computed upon net or taxable income—that is, gross income less the deductions which the statute allows to be subtracted from gross income. In the case of individual taxpayers, deductions fall into three classes. First of all, the taxpayer is allowed certain deductions based upon his personal status, which are called exemptions. The theory underlying exemptions is related to the ability-to-pay ideal behind the tax. Exemptions are supposed to represent the amounts below which there is presumed to be no ability to pay a tax. Although a taxpayer is not required to pay a tax unless his income exceeds his exemptions, a wealthy taxpayer is allowed the same exemptions as a poor person, despite his greater ability to pay a tax. Moreover, since exemptions take the form of deductions from gross income, rather than a credit against the tax, exemptions are far more valuable to a wealthy man than they are to one in more modest circumstances. Thus, for example, an exemption of $600 to a taxpayer in the twenty per cent bracket results in a tax saving of $120; while to a taxpayer in the ninety-one per cent bracket, the exemption is worth $546.[4]

[4] The alternative is to treat exemptions as credits rather than deductions, as some state income taxes do. Thus, under the credit system, a taxpayer might be allowed

The other deductions allowed individual taxpayers by the statute are divided into: (1) deductions which are subtracted from gross income to get what the statute calls adjusted gross income and which, for lack of a convenient statutory designation, may be called adjusted-gross-income deductions; and (2) other deductions. The purpose of this division is to give the taxpayer his choice of deducting his actual other deductions or a standard deduction. The standard deduction is fixed at ten per cent of the taxpayer's adjusted gross income, with a ceiling of $1,000 in the case of single taxpayers and married taxpayers filing joint returns, and $500 in the case of married taxpayers filing separate returns. The principal function of adjusted gross income is to fix the amount of the standard deduction, although it is also used to determine the maximum amount which an individual may deduct for charitable contributions[5] and the part of the taxpayer's medical expenses which is disallowed in computing the deduction for medical expenses.[6] The amount of adjusted gross income may also determine whether a taxpayer can compute his tax under the tax table.

Speaking very loosely,[7] the deductions which are subtracted from gross income to get adjusted gross income are those which are directly connected with earning income, as distinguished from other deductions, such as the deductions for medical expenses, alimony, and charitable contributions, which are granted by Congress to alleviate hardship or to further some public policy. The idea behind the division of deductions into adjusted-gross-income deductions and other deductions is to permit the taxpayer to deduct the items directly connected with earning income and then to give him the option of deducting either his actual other deductions or the standard deduction, which presumably approximates the average amount the average taxpayer expends in other deductions.

to subtract $120 (20%, the starting income tax rate, of $600) from his tax for each exemption, regardless of the amount of his income.

[5] The deduction for charitable contributions is limited in the case of individuals to 20% of the taxpayer's adjusted gross income, with an additional 10% allowance for gifts to churches, schools, hospitals, and certain medical research organizations. INT. REV. CODE OF 1954, § 170(b).

6. A taxpayer who is less than 65 years old and whose spouse is also under that age, can only deduct medical expenses in excess of 3% of his adjusted gross income. *Id.* § 213(a). Regardless of the taxpayer's age, the deduction for medicines and drugs is limited to expenditures for these items in excess of 1% of the taxpayer's adjusted gross income. *Id.* § 213(b).

[7] For example, although § 62 of the 1954 Code classifies all of the business expenses of a self-employed person as adjusted-gross-income deductions, an employee in computing his adjusted gross income can only deduct reimbursed expenses, travel expenses, transportation expenses, and expenses incurred as an outside salesman.

An individual taxpayer is allowed to deduct his personal exemptions, however, regardless of whether or not he elects the standard deduction.

The steps involved in computing net or taxable income may be expressed in the following formulae:

gross receipts — exclusions from gross income = gross income
gross income — adjusted gross income deductions = adjusted gross income
adjusted gross income — other deductions or the standard deduction, and the taxpayer's exemptions = taxable or net income

E. Exemptions

It is scarcely feasible to comment upon the various deductions allowed by the statute in a summary discussion of this kind. It seems advisable, however, to devote a few words to exemptions, since they involve basic mechanics which are often slighted in a casebook consideration of the tax. Individual taxpayers are allowed to deduct $600 for each exemption to which they are entitled. Exemptions fall into three classes: (1) personal exemptions, (2) exemptions for a spouse, and (3) exemptions for dependents.

Every individual taxpayer is entitled to a persoual exemption of $600. He is allowed an additional exemption of $600 if he has attained sixty-five years of age by the end of the taxable year and still another $600 exemption if he is blind on the last day of the taxable year.[8] Thus, a single man without dependents who was sixty-five years old and blind at the end of the taxable year would be entitled to exemptions of $1,800.

A married taxpayer may claim an exemption of $600 for his spouse, if she has no gross income and is not the dependent of another, with additional exemptions of $600 if the spouse is sixty-five years old or blind. If the spouse has any gross income, however, the taxpayer cannot claim her exemptions. The only way to take advantage of the spouse's exemptions when she has income is to have her file a separate return or to join in filing a joint return, upon which she can claim her own exemptions.

A taxpayer may also claim an exemption of $600 for each dependent whom he supports during the taxable year. No additional allowance is made, however, for the dependent's old age or blindness. Thus, a

[8] A person whose sixty-fifth birthday falls upon January 1 may claim an old-age exemption upon his return for the precediug calendar year, siuce in legal contemplation, he is 65 years old on the day before his birthday.

man who supports his ninety-year-old blind indigent mother can claim only a single $600 exemption for her.

Under the statute, a person to qualify as a dependent must meet five tests: (1) the support test, (2) the gross-income test, (3) the member-of-the-household or relationship test, (4) the citizenship test, and (5) the joint return test.

A person is deemed to support a dependent when he furnishes over half of the support of the dependent during the taxable year.[9] In this connection, however, a scholarship in an educational institution is disregarded in determining what constitutes support of a child, stepchild, or adopted child of the taxpayer. Moreover, if no one furnishes more than half the support of an individual, but over half of his support is supplied by two or more persons, each of whom, but for the support test, could claim the person supported as a dependent, any one of these persons who furnishes more than ten per cent of the support may claim to have supported the dependent, with the consent of the others similarly situated. For example, if four brothers each furnish twenty-five per cent of the support of their mother, any one of them, with the consent of the others, may claim her as a dependent.

A person will not qualify as a dependent if his gross income during the taxable year amounts to $600 or more. An exception to this rule is made, however, in the case of a child under nineteen years of age or enrolled as a full-time student in an educational institution[10] for at least five months during the taxable year. The parent of such a child (which includes stepchildren) is allowed to claim him as a dependent, regardless of the child's income.

A dependent must live in the taxpayer's household as a member of his household during the taxable year or he must be related to the taxpayer in a degree specified by the statute.[11] Those who are sufficiently

[9] If the dependent is only in existence for part of the year, the taxpayer may still claim an exemption for him, provided that he furnished over half of the dependent's support during the part of the year when he was in existence. No exemption may be claimed, however, for an unborn or a stillborn child. INT. REV. SERV., TREASURY DEP'T, YOUR FEDERAL INCOME TAX 15 (Pub. No. 17, 1958).

[10] ". . . or pursuing a full-time course of instructional on-farm training under the supervision of an accredited agent of an educational institution or of a state or political subdivision of a state." INT. REV. CODE OF 1954, § 151(e).

[11] Where a husband and wife file a joint return, it is sufficient if the person claimed as a dependent stands in the prescribed relationshp to one of the spouses, even though his support is furnished by the other. Thus, for example, a husband who supports his wife's niece may claim an exemption for the niece upon a joint return, although

related to the taxpayer to qualify as dependents include: (1) children (including adopted children and stepchildren), (2) a descendent of a child (but not a stepchild's descendant), (3) brothers and sisters (including half brothers and sisters and stepbrothers and sisters), (4) ancestors, (5) stepparents (but not stepgrandparents), (6) uncles and aunts, (7) nephews and nieces, (8) mothers and fathers-in-law, sisters and brothers-in-law, sons and daughters-in-law.[12] Ordinarily, cousins are not sufficiently closely related to qualify as dependents. An exception is made, however, in the case of a cousin who is receiving institutional care and who, before receiving such care, was a member of the taxpayer's household.

Ordinarily a person may not claim a nonresident alien as a dependent. An exception to this rule is made, however, in the case of a dependent who is a citizen or resident of Canada, Mexico, the Canal Zone, or the Republic of Panama.[13]

The final requirement for a dependent is that the person who is claimed as a dependent must not have filed a joint return with his or her spouse. Although the purpose of this restriction is apparently to prevent two people from claiming an exemption for the same person, a taxpayer may claim an exemption for another person who claims an exemption for himself. For example, a father who supports a son while the son is in college may claim an exemption for the son, although the son has a summer job and earns income against which he claims his own personal exemption.

F. The Taxable Period

Since income involves a flow of wealth between two points of time, an income tax must tax income for some specific period. Otherwise,

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neither spouse could claim the niece as a dependent if they filed separate returns. U.S. Treas. Reg. § 1. 152-2(d) (1957).

[12] Even after the relationship which made a person an in-law ceases to exist, he may be claimed as a dependent. For example, a widower who supports his deceased wife's parents may claim them as dependents, if the other requirements for a dependent in addition to relationship are met. *Ibid.*

[13] Another exception is made by § 152(b)(3) of the 1954 Code, which allows a child who was born to or adopted by the taxpayer in the Philippine Islands before January 1, 1956, while the taxpayer was a member of the armed forces, to be claimed as a dependent, if the child is a resident of the Philippine Republic. Moreover, § 152(b)(5) of the 1954 Code, which was added by § 4 of the Technical Amendments Act of 1958, provides that a legally-adopted child of a United States citizen who resides in the taxpayer's household during the taxable year may be claimed as a dependent, even though the child is neither a resident nor a citizen of the United States.

there would be no way of measuring the income subject to the tax. As an annual tax, the federal income tax is normally imposed upon income earned during a year, known as the taxable year. In some cases, as where, for example, a taxpayer dies during the taxable year, the taxable period may be less than a year.[14] It is never longer, however, except where the taxpayer elects to use a fifty-two—fifty-three week year.

The taxable year may be the calendar year from January 1 to December 31 or a fiscal year ending on the last day of any month except December. Under the 1954 Code, taxpayers may also use a fifty-two—fifty-three week year—that is, a year which always ends on the same day of the week, which may be the last time the day of the week occurs in the calendar month or the date upon which the day occurs which is nearest the end of the month. For example, a taxpayer could use a tax year which always ended on the last Saturday in December or which ended on the Saturday nearest the last day in December.

When a taxpayer files his initial return, he may adopt any taxable year which he chooses, provided he keeps his books on the same basis. After a taxpayer has elected a particular kind of taxable year, however, he cannot shift to another without the permission of the Commissioner.

G. Methods of Accounting

Since the income tax is imposed upon income for a specific taxable period, it is necessary to have some system for allocating income and deductions to the proper period. For example, suppose that a lawyer earns a fee in 1956 which he collects in 1957 and that he incurs a liability to his secretary for her services during 1956 which he pays in 1957. Should he report the fee as income for 1956 or 1957? Should he deduct his secretary's salary in 1956 or 1957? The proper period to which to allocate income and deductions is determined by the taxpayer's method of accounting.

Two principal methods of accounting are used to report income: (1) the cash method, and (2) the accrual method. There are other systems of accounting which are used to report income, such as the installment method and the methods for long-term construction contracts. For present purposes, however, it will be sufficient to notice the cash and accrual methods.

[14] Other illustrations of short taxable years are where a corporation starts in business during the year or a taxpayer shifts from one taxable year to another, such as a change from a fiscal year to the calendar year.

Under the cash method of accounting for income, a taxpayer reports income when he receives it in cash or the equivalent of cash and deducts deductions when he pays them in cash or the equivalent of cash. Thus, for example, the lawyer who earned a fee in 1956 which he collected in 1957 and who incurred liability for his secretary's salary in 1956 which he paid in 1957 would report the fee as income and deduct the salary as a deduction in 1957, if he were on the cash basis.

Under the accrual system, income is realized when the right to it arises, and deductions are deductible when the liability to pay the deductible amount becomes fixed. Thus, if the lawyer in the hypothetical case were on the accrual basis, he would report the fee and deduct the secretary's salary in 1956.

The period during which income and deductions are claimed may make a considerable difference not only in the taxpayer's over-all income, but the amount of his tax, since the income tax is progressive. Thus, for example, a taxpayer will pay a lower tax if he shows taxable income of $10,000 a year over a five-year period than he will pay if he shows an income of $1,000 a year for four years and $46,000 in the fifth year.[15] Consequently, taxpayers are constantly seeking to deflect income and deductions into the most profitable period. This may obviously be done more easily by a cash-basis taxpayer who reports income and deductions when they are collected, rather than when they are earned. The law has devised several safeguards against a cash-basis taxpayer's arbitrarily moving income from one taxable period to another. One of these is the doctrine of constructive receipt, under which a cash-basis taxpayer is deemed to have received income when it becomes unqualifiedly available to him. For example, a cash-basis taxpayer realizes income when interest is credited to his savings account or a bond coupon matures, even though he makes no withdrawal from the account and does not cash in the coupon. Another preventative against shifting income from one period to another is the doctrine that a cash-basis taxpayer realizes income when he receives an item in property which has a cash equivalence or a fair market value. Thus, for example, a cash taxpayer who sells property and receives a negotiable note in payment realizes income to the extent of the fair market value of the note.

[15] Assuming that the taxpayer was single and was not the head of a household, the respective taxes for the five-year period would be $12,300 and $23,940.

H. Tax Rates; Computation of the Tax

The income tax due from a particular taxpayer is determined by multiplying his net or taxable income by the tax rates applicable to that taxpayer to get his gross tax, and then subtracting any permissible credits against the tax to get the net tax or the final tax due the Government. As far as tax rates are concerned, individual taxpayers are divided into: (1) single taxpayers who are not the head of a household and married taxpayers filing separate returns, (2) married taxpayers filing joint returns, and (3) heads of a household.

Single taxpayers who are not heads of a household and married taxpayers filing separate returns are taxed under a schedule of rates which starts at twenty per cent for the first $2,000 of taxable income and reaches a peak of ninety-one per cent on taxable income in excess of $200,000.

Married taxpayers who file joint returns are taxed under the same schedule of rates as single taxpayers who are not heads of a household and married taxpayers filing separate returns, except that before applying these rates, the aggregate taxable income of the couple is divided by two. Then, the tax rates are applied, and the result is multiplied by two. The result is, of course, that the income on a joint return is taxed at the rates for an income half of the size of the income shown upon the return. Although the Code contains rate schedules only for single persons and heads of a household, the instructions provide a table of rates for married taxpayers filing a joint return, which dispenses with the necessity of dividing the couple's aggregate income by two and multiplying the tax computed on half their income by two. The device of allowing married taxpayers to split their incomes came into the law with the 1948 Act in an effort to eliminate the income tax discrimination in favor of married taxpayers in community-property states. Since married taxpayers in community-property states shared equally in each other's earnings, each spouse could report half of their community-property income as his or her separate income. This meant, for example, that where a husband earned $100,000 and his wife had no independent income, they could each report an income of $50,000. This gave a considerable tax advantage to married couples in community-property states over married persons in common-law states, where income earned by a spouse belonged solely to that spouse and had to be reported as his separate income for tax purposes. To offset this advantage, the statute was amended to permit married couples in any state to split their income by filing a joint return, dividing the aggregate income shown upon the return by two, computing a tax, and multiplying the tax by two. In addition to equalizing the income tax treatment of married couples in common-law and community-property states, the privilege of splitting income removed the incentive, which under the prior law led to considerable litigation, to try to split income between spouses by various devices such as family partnerships, trusts, and contractual arrangements.

The privilege of splitting income with a deceased spouse and paying a lower tax may be exercised by a surviving spouse in the year when his spouse dies.[16] Moreover, the 1954 Code extends the privilege of splitting income to a surviving spouse for two years after his spouse's death, provided that he maintains a household, which is the principal place of abode for a child or a stepchild for whom he is entitled to claim an exemption as a dependent, and he does not remarry. The surviving spouse will, of course, actually split his income with himself during the two years after his spouse's death. The justification for this privilege is that prior to the deceased spouse's death, the family income was taxed upon a split income basis, and this helps to ease the transition to the taxation of the family income without income-splitting.

The privilege of splitting income accorded married persons leads to a considerable differential in the tax rates for single persons and married couples. To bridge this gap, the Code creates a third category of taxpayers, who pay at rates midway between those for single and married persons and who are called heads of a household. Although the rates for the head of a household start at twenty per cent (the same starting rate as that for other individual taxpayers) and reach an eventual peak of ninety-one per cent (the maximum rate for other individuals), the progression in the rates for a head of a household is midway between that for single and married taxpayers. Thus, for example, the maximum rate for single taxpayers is achieved at $200,000, as contrasted with $300,000 in the case of heads of a household and $400,000 in the case of married taxpayers filing joint returns.

To qualify as a head of a household, a taxpayer must be unmarried on the last day of the taxable year and he must maintain a home for himself and an unmarried descendant or stepchild or for some other relative for whom the taxpayer is entitled to claim an exemption as a

[16] With the acquiescence of the decedent's executor or administrator. INT. REV. CODE OF 1954, § 6013(a)(3).

dependent, or he must maintain a separate home for his mother or father whom he is entitled to claim as a dependent.

A taxpayer meets the requirement of being unmarried if, on the last day of the taxable year, he is divorced or legally separated from his spouse or if his spouse is a nonresident alien at any time during the year. A person is not considered as unmarried, as far as claiming the status of a head of a household is concerned, if his spouse died during the taxable year or if he qualifies for the privilege of splitting income as a surviving spouse. In other words, he cannot claim the status of the head of a household as long as he is entitled to split income as a spouse or a surviving spouse.

Ordinarily, the head of a household must maintain a home or household where he and the person who gives him his status as head of a household reside together. An exception is made to this rule, however, in the case of the taxpayer's mother or father. A taxpayer may claim to be the head of a household if he maintains a separate home for his mother or his father whom he is entitled to claim as a dependent, or for both of them as long as he can claim at least one of them as a dependent.

The requirement that the head of a household must maintain a household means that he must pay more than half of the expenses of the household. The requirement that the household must be the principal place of abode of the person who gives the taxpayer his status as head of the household means that this person must reside continuously in the taxpayer's home as his principal residence, although temporary absences for vacations or due to illness or school attendance will not interrupt the requirement of continuous residence. Moreover, a taxpayer is regarded as maintaining a household for a person who was born or died during the taxable year if this person resided in the taxpayer's household during the portion of the year when he was in existence.

The person whom the taxpayer must maintain in his home (or a separate home in the case of a parent) in order to qualify as the head of a household need not be a dependent of the taxpayer if he is an unmarried descendant (child, grandchild, etc.) or an unmarried stepchild of the taxpayer. However, any other related person whom the taxpayer relies upon for his status as head of a household must be one for whom the taxpayer can claim an exemption as a dependent. Thus, for example, if a widower maintains a home for himself and his daughter, he may claim to be the head of a household if the daughter is unmarried, regardless of whether or not he can claim an exemption for her as a dependent. If, however, the daughter is married, the taxpayer cannot claim the status of a head of a household unless he is entitled to claim an exemption for the daughter as a dependent.

The taxpayer cannot claim the status of a head of a household because of any dependent other than a person who qualifies as a dependent because he is related to the taxpayer. Nor may he claim to be head of a household because of a related dependent if he does not actually furnish more than half of the dependent's support, but claims an exemption for the dependent because of a multiple support agreement.

The various rates imposed by the statute upon individuals actually consist of a normal tax of three per cent and a graduated surtax starting at seventeen per cent and reaching a maximum rate of eighty-eight per cent. The idea of two income taxes originated in the early days of the income tax when it was thought that there should be a normal tax for all taxpayers and a supertax, or a surtax, for wealthy taxpayers. Since, under the present law, the normal and the surtax both start with the first penny of taxable income and the same exemptions apply against both taxes, the distinction between the normal tax and the surtax is not particularly significant. It has been preserved to give effect to the partial exemption of certain federal obligations which are subject to the surtax, but not to the normal tax. Actually, the tax rates set forth in the statute combine the normal tax and the surtax into a single schedule of rates. The allowance for partially tax-exempt interest is effectuated by crediting three per cent of such interest against the combined tax, which is, of course, the same thing as deducting the interest for the purpose of computing the normal tax, but not the surtax.

Although the rates set forth in the statute reach a maximum of ninety-one per cent, this maximum only applies to income in the top bracket. Consequently, the average rate of tax will always be less than ninety-one per cent. Section 1(c) of the Code provides that in no case shall the total tax exceed eighty-seven per cent of the taxpayer's taxable income. Thus, for example, if a single taxpayer, who was not the head of a household, had taxable income of $1,000,000, his tax under the schedule of rates set forth in section 1(a) of the Code with the ninety-one percent rate would be $884,820. However, under section 1(c), for whatever comfort it affords him, the tax will be limited to $870,000.

I. Special Rates of Tax: Long-Term Capital Gains; Nonresident Aliens

The statute has special rates for certain types of income. In the case of individuals, two situations where a special tax rate is applied are where there are long-term capital gains and income of a nonresident alien.

A taxpayer who has what is known as a net long-term capital gain first of all computes a tax at the ordinary rates upon his ordinary income and one-half of the net long-term capital gain.[17] Then, he computes an alternative tax, which consists of a tax upon his ordinary income at the rates for ordinary income, plus twenty-five per cent of the net long-term capital gain. The tax due is the lower of the tax computed in the regular way or the alternative tax. The result is that long-term capital gains are taxed at one-half of the regular income tax rate or twenty-five per cent, whichever is lower. For example, a taxpayer whose taxable income did not exceed $2,000 and who had a long-term capital gain would pay a tax on the capital gain at an effective rate of ten per cent. At the other extreme, a taxpayer whose taxable income fell into the ninety-one per cent bracket would pay a tax of only twenty-five per cent on any long-term capital gains which he happened to have.

Since capital gains are given preferred tax treatment, the statute imposes some restriction upon the deduction of capital losses. Capital losses can be offset, without limit, against capital gains. However, net capital losses may only be deducted up to $1,000 against ordinary income, with a carryover of any excess loss for five years, during which the carryover may be offset against any net capital gains without limitation and against ordinary income up to $1,000 a year.

Capital gains and losses are divided into short-term gains and losses and long-term gains and losses. Short-term gains and losses are gains and losses from the sale or exchange of capital assets held six months or less. Long-term gains and losses are gains and losses from the sale or exchange of capital assets held over six months. Short-term gains and losses and long-term gains and losses are, first of all, offset against each other, with any resultant net short-term gain or loss being offset against any net long-term gain or loss to get the taxpayer's net capital gain or loss. If the taxpayer ends up with a net short-term gain, the gain is taxed as ordinary income. If his net long-term gain exceeds any net short-term loss, so that he ends up with a net long-term gain, the gain is taxed according to the method set forth in the preceding para-

[17] This is achieved by means of a deduction for capital gains of 50% of the amount of any net long-term capital gain. *Id.* § 1202.

graph. Any net capital loss, regardless of whether it is short-term or long-term, is deductible only to the extent of $1,000 from ordinary income, with a five-year carryover.

A capital gain or loss is a gain or loss from the sale or exchange of a capital asset. This definition is not as simple as it seems, however, since the statute has a very involved description of a capital asset, as well as an intricate and artificial definition of a sale or exchange. The basic distinction between ordinary income and losses and capital gains and losses (if there really is any distinction) is that a capital gain or loss is a gain or loss from the sale of property other than that which a taxpayer holds primarily for sale in the course of his trade or business. It is a gain or loss from a casual sale of a capital asset, rather than ordinary income or loss from normal business operations of selling stock in trade or property held primarily for sale to customers. The favorable treatment which is accorded the taxation of long-term capital gains, however, has led to a very involved statutory definition of a capital asset and a sale or exchange in order in some instances to prevent the conversion of ordinary income into capital gains and in others to convert ordinary income into capital gains.

There is considerable controversy about whether or not capital gains should be taxed as income at all and, if they should, whether they should be taxed differently from ordinary income.[18] It seems quite clear, however, that the special treatment accorded long-term capital gains is responsible for most of the complications and the bulk of the litigation under the income tax. Since long-term capital gains are taxed so much more leniently than ordinary income, taxpayers are constantly casting about for some scheme to convert ordinary income into capital gains. The efforts of Congress and the courts to frustrate such schemes are responsible for much of the complex detail of the Internal Revenue Code, as well as a great deal of the litigation over the income tax. This has also a more unattractive aspect. Congress is quite vocal about publicizing its efforts to plug up loopholes in the tax laws. It is much more reticent about its activities in creating loopholes. One of the most prolific sources of intended loopholes in the statute is the capital gains provisions, which in recent years have been frequently amended to favor some particular taxpayer or class of taxpayers by designating ordinary income as capital gains.

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[18] The constitutionality of taxing capital gains as income was settled by the Supreme Court in Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921).

In addition to the special tax treatment for long-term capital gains, another situation where individual incomes are taxed at abnormal rates occurs in the case of nonresident aliens who are not engaged in business in the United States. The income from United States sources[19] of such taxpayers is subject to a gross income tax of thirty per cent if the nonresident alien's domestic income does not exceed $15,400. If it exceeds this figure, the nonresident alien is taxed upon his net income from United States sources at the ordinary rates for residents and citizens, unless the tax computed in this fashion is less than the gross income tax of thirty per cent, in which event the gross income tax is the final tax which is due.

J. Credits against the Tax

The final step in computing the federal income tax consists of subtracting from the gross tax, obtained by multiplying taxable income by the appropriate tax rates, any credits to which the taxpayer is entitled, to get the net tax. In the case of individuals, the principal credits against the tax are for taxes withheld or paid at the source, for foreign income taxes, for partially tax-exempt interest, and for retirement income.

There are a number of situations where income taxes are required to be withheld at the source and paid directly to the Government. The most familiar instance is the tax which the law requires an employer to withhold in connection with wages paid to an employee. Withholding is also required in connection with certain other income payments, such as income paid to nonresident aliens. Obviously, when part of a taxpayer's tax has been withheld from his income and paid at the source, it would be inequitable to require him to pay the tax over again. This is forestalled by allowing the taxpayer to claim a credit for the tax paid at the source when he files his return. If the tax which was withheld exceeds the tax shown to be due on the return, the taxpayer may claim a refund for the excess.

At one time, it was fairly common for corporations to issue what are known as tax-free covenant bonds under which the corporate obligor covenanted that it would pay directly to the Government part of the bondholder's income tax upon the interest from the bonds. Ordinarily, when one person, as part of a business transaction, undertakes to discharge the legal obligation of another, the discharge of the obligation

[19] Generally speaking, citizens and residents are taxed upon all of their income, irrespective of its source, while nonresident aliens are only taxed upon income from United States sources. INT. REV. CODE OF 1954, § 872(a).

constitutes income to the obligor whose obligation is discharged. Thus, for example, it has been held that the payment by an employer of an employee's income tax constitutes additional income to the employee.[20] In the case of tax-free covenant bonds, however, the statute provides that the tax paid by the corporate obligor shall not be treated as additional income to the bondholder, but simply as a credit against the bondholder's income tax. The credit for tax-free covenant bonds is limited to bonds issued before January 1, 1934, and, in the case of resident and citizen bondholders, is restricted to two per cent of the interest on the bonds.

In addition to the credits which the statute allows because part of the taxpayer's income tax has been collected at the source, there are several credits which are designed to alleviate the hardship of double taxation. This is true, for example, of the credit which is allowed for foreign income taxes and income taxes imposed by possessions of the United States. Citizens and residents of the United States who have income from foreign sources are apt to encounter a double tax upon the same income, since all of their income is subject to the federal income tax and that part of their income derived from abroad will usually be taxed by the source of the income. To ease the hardship of the double tax in this situation, the federal income tax allows citizens and resident aliens to credit the income taxes paid foreign countries on income from those countries against the federal tax. The credit is a matter of right in the case of citizens. In the case of resident aliens it is contingent upon the country of the alien's nationality extending a similar comity to United States citizens residing there. There are certain limitations on the credit for foreign income taxes, which are designed in general to limit the credit to the amount of the federal tax upon the foreign income. Moreover, the credit cannot be claimed at all if, instead of electing to credit the foreign income tax against his federal income tax, the taxpayer elects, as he is entitled to do, to deduct the foreign tax from gross income.

As we shall see later, the federal income tax treats corporations as independent taxable entities. Corporate profits are taxed, first of all, to the corporation as income of the corporate entity, and then again to the stockholders as income of the stockholders when distributed to them in the form of dividends. This results, of course, in a double tax upon the same income. To ease the burden of the double tax, corporate stock-

[20] Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).

holders are allowed to deduct eighty-five per cent of the dividends which they receive from domestic corporations. Individual stockholders are allowed to exclude the first $50 of their dividends from domestic corporations from gross income entirely and to credit four per cent of any such dividends in excess of the exclusion against their income tax. Thus, for example, if *A* received $1,000 in dividends from domestic corporations during the taxable year, he would exclude $50 of this sum from his gross income and credit four per cent of the remaining $950, or $38, against his gross tax.

At one time, federal bonds were issued with a congressional immunity against the federal income tax to enable them to compete in the money markets with state bonds, which are exempt from the federal tax. The immunity of federal bonds was withdrawn progressively until it was abolished completely by providing that the interest on federal obligations issued on or after March 1, 1941, shall be fully subject to the federal income tax. There are still outstanding, however, federal obligations which were issued before this legislation and which enjoy a limited immunity. The most common example is United States Treasury bonds issued before March 1, 1941. The interest from these bonds is fully exempt from the federal income tax to the extent of interest from $5,000 principal of the bonds. Any interest in excess of this amount is subject to the surtax, but not to the normal tax. Interest from federal bonds which is entirely exempt from the federal income tax is treated as an exclusion from gross income. Interest which is partially exempt in the case of an individual taxpayer is treated as a credit against the tax. Suppose, for example, that part of the taxpayer's income consists of $150 interest from $5,000 principal amount of three per cent Treasury bonds issued in 1935 and $250 interest from $10,000 worth of two and one-half per cent Treasury bonds issued in 1938. Since the taxpayer is entitled to exclude the interest from $5,000 of any of the bonds which he owns, he will naturally select for this purpose the bonds paying the higher rate of interest, or the three per cent bonds, and exclude the interest from these bonds, or $150, from his gross income. The interest of $250 from the remaining bonds is subject to the surtax, but not the normal tax. The exemption from the normal tax is achieved by crediting three per cent (the rate of the normal tax) of $250, or $7.50, against the taxpayer's gross tax computed under the rate schedule which combines the normal tax and the surtax.

The final credit against the tax for individual taxpayers is the credit for retirement income. The idea behind the credit for retirement income is that since old-age benefits paid under the social security system are not taxed as income, a taxpayer whose retirement income comes from some other source is unfairly discriminated against unless he is given some sort of tax immunity with respect to this income. In dealing with the retirement credit, it is important to keep the reason for the credit in mind, since the social security analogy explains the complex and seemingly senseless limitations on the credit.

The credit for retirement income cannot exceed twenty per cent of $1,200 retirement income or $240. It is only available to persons who have attained sixty-five years of age by the end of the taxable year or who, though under that age, are receiving a pension from a public retirement system. To qualify for the credit, the taxpayer must have earned more than $600 a year in each of any ten calendar years prior to the taxable year or must be the surviving spouse of a person who had such earnings. Retirement income on which the credit is based includes pensions and annuities, rents, and dividends in the case of a person who has attained sixty-five years of age. In the case of a person who has not attained that age, retirement income is limited to pensions and annuities under a public retirement system.

In computing the retirement income upon which the credit is based, the actual amount of the taxpayer's retirement income, or $1,200, whichever is lower, must be reduced by any pensions or annuities which the taxpayer received under the Social Security Law or the Railroad Retirement Acts of 1935 or 1937, and, in addition, any earned income in excess of $900 if the taxpayer had not attained sixty-five years of age by the end of the taxable year, or in excess of $1,200 if he had attained sixty-five, but had not reached seventy-two years of age. The earnings of taxpayers seventy-two years old and older do not cut down the credit for retirement income. However, a taxpayer under sixty-five years of age would get no retirement credit at all if his earned income during the taxable year amounted to $2,100, since this exceeds $900 by $1,200, which would wipe out any retirement income. The same thing would be true of a taxpayer sixty-five years of age or older who had not attained seventy-two years of age and who earned $2,400 during the taxable year, since his earnings in excess of the permissible $1,200 would be $1,200, which would wipe out any retirement income.[21]

[21] The credit for retirement income is fairly complex. Some idea of how it works may be gathered from the following example, which is based upon the illustration appearing at YOUR FEDERAL INCOME TAX, *op. cit. supra* note 9, at 51. Assume that the taxpayer is 67 years old and has earned more than $600 a year in 10 calendar

K. Returns

The individual taxpayer may have his choice of several forms of return in reporting his income. The simplest kind of return is known as Form 1040A. The taxpayer who elects this form need only enter upon the card, upon which the return is printed, his name and address, social security number, the amount of his wages or salary along with any taxes withheld upon such wages or salary, any other income which he received during the taxable year, and the exemptions which he claims. The taxpayer may compute the tax upon the income shown upon the return, or he may mail the return to his District Director of Internal Revenue, who will compute the tax for him and bill him for any tax still due or refund any excess tax which was withheld. In either case, if the taxpayer's gross income is less than $5,000, the tax is computed under a tax table, which sets forth the amount of tax due upon various amounts of income. The table contains a built-in standard deduction and sets forth the amount of tax upon different blocs of income. In this connection, it is perhaps worth noting that the tax under the tax table is computed at the midpoint of the bloc, with the result that the tax shown by the table may be greater or less than the tax computed under the regular method of computing the tax, depending upon whether the taxpayer's taxable income falls below or above the midpoint of the appropriate bloc. For example, a taxpayer with one exemption, adjusted gross income

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years preceding the taxable year, so that he qualifies for the retirement income credit. Assume further that his income for the taxable year is as follows:

Dividends (less $50 exclusion)		$ 240.00
Railroad retirement pension (nontaxable)		500.00
Disability benefits under Workman's Compensation Act (nontaxable)		400.00
Rental income (gross rents)		600.00
Purchased annuity ($600 minus $140 return of investment of $140 excluded from gross income)		460.00
Earned income from odd jobs		1,500.00
The Taxpayer's retirement income will include:		
Dividends (less the $50 excluded from gross income)		$ 240.00
Rents (gross rents)		600.00
Annuity (only the part included in gross income)		460.00
Total retirement income		$1,300.00
However, the statute limits the retirement income upon which the credit is computed to		$1,200.00
Less railroad retirement pension	$500.00	
Earned income over $1,200	300.00	
Therefore, the retirement income which qualifies for the credit is		400.00

And the credit is 20% of $400 or $80.00.

of $4,950, and other deductions of $495 will show a tax of $813 under the table and a tax of $808.10 if the tax is computed by the regular method.

If the other requirements are met, a married couple may file a joint return upon Form 1040A. A married person may also file a separate return upon Form 1040A, provided his spouse does not file a return upon which she itemizes her deductions. Since the tax upon Form 1040A is computed under the table which uses the standard deduction, a taxpayer cannot use this method of reporting his income upon a separate return unless his spouse elects to use the standard deduction, since both spouses must use the standard deduction before one is entitled to do so.

Form 1040A is designed as a simple return for taxpayers whose incomes are simple. Consequently, it may be used only where the taxpayer's income is less than $10,000 and consists entirely of wages, interest, and dividends, not more than $200 of which comes from income upon which a tax has not been withheld. A person who claims the status of a head of a household or a surviving spouse may not use Form 1040A. Nor may Form 1040A be used by one claiming a credit for retirement income, or for dividends, or an exclusion for sick pay. Form 1040A cannot be used by a taxpayer who claims a deduction for travel, transportation, or "outside salesman" expenses, or an estimated tax payment credit. Before 1958, the use of Form 1040A was limited to taxpayers whose gross income was less than $5,000 and whose income from sources not covered by withholding did not exceed $100. A recent announcement by the Internal Revenue Service raised the limits upon income which may be reported upon Form 1040A to $10,000 and $200, respectively.

Taxpayers who are eligible to use Form 1040A may also use Form 1040, which is designed for larger and more complex incomes; and, of course, a taxpayer who cannot use Form 1040A must use Form 1040. Form 1040 is the standard form for individual taxpayers. The taxpayer who files upon Form 1040 is required to list his gross income and his adjusted gross income deductions. If his adjusted gross income is less than $5,000, he has the option of computing his tax under the tax table, with its built-in standard deduction, or of itemizing his other deductions and computing the tax upon the taxable income shown by this method. The only way in which a taxpayer whose adjusted gross income is less than $5,000 can avail himself of the standard deduction is by computing his tax under the tax table. If his adjusted gross income amounts to $5,000 or more, the taxpayer cannot use the table to compute his tax. In this situation, however, he has his option of itemizing and deducting his actual other deductions or invoking the standard deduction.

Ordinarily, the choice of whether to use one's other deductions or the standard deduction will depend upon whether the total other deductions are greater or less than the standard deduction. However, the statute provides that a taxpayer who elects the standard deduction (or computes his tax under the tax table) forfeits any credits for tax-free covenant bond interest, foreign income taxes, and partially tax-exempt interest. Consequently, in deciding whether to elect the standard deduction, any such credits must be kept in mind.

It is perhaps worth noting that different results may be obtained by filing upon Form 1040A and computing a tax upon Form 1040 under the tax table, since Form 1040, unlike Form 1040A, allows the taxpayer to deduct his adjusted gross income deductions. For example, suppose that a taxpayer has gross income of $4,950 and traveling expenses of $1,000. He is a single man with one exemption. His tax upon Form 1040A would be based on an income of $4,950 and would be $813. If he computed his tax upon a Form 1040, using the tax table, the tax would be based upon an adjusted gross income of $3,950 ($4,950 less $1,000 traveling expenses) and would be $615.

Individual taxpayers are required to pay the tax on their income as it is earned. In the case of most taxpayers, this is achieved through the withholding tax on wages and salaries. The withholding tax does not, however, reach income from other sources, nor does it fully discharge the liability of a taxpayer whose income reaches into the higher brackets, since the withholding tax is set at a flat eighteen per cent. In order to put these taxpayers on a pay-as-you-go basis, the statute requires them to file a declaration of estimated tax and to pay the difference between the estimated tax shown upon the declaration and the estimated withholding tax. In the case of a calendar-year taxpayer other than a farmer, the declaration is required on April 15, the same day when the final return for the preceding year is due. The estimated tax may be paid in four equal installments on April 15, June 15, September 15, and January 15 of the following year. Farmers who receive at least two-thirds of their gross income from farming may wait until January 15 of the year after their income is earned to file their declarations of estimated tax, but they will be required to pay the full amount of the estimated tax at that time if they do so.

The taxpayer must estimate his tax within seventy per cent of the tax actually due in order to avoid a penalty, unless he is a farmer, in which case 66⅔ per cent accuracy will suffice. However, any penalty upon a declaration of estimated tax may be avoided by using last year's tax or the tax on last year's income with the exemptions and rates of the current year as the estimated tax.

If it does not appear until after the date for filing the declaration of estimated tax has passed that the taxpayer will be required to file such a declaration, he may file his initial declaration upon the next date for paying an installment of the estimated tax after he discovers his liability to file such a declaration. Thus, for example, a taxpayer who discovered for the first time on September 1 that his income would probably reach a bracket where he would be required to file an estimated tax could file his declaration of estimated tax on September 15. Moreover, when a taxpayer discovers that his original declaration was wrong, he may file an amended declaration upon any date when an installment of the tax would be due, increasing or decreasing his original estimate.

Taxpayers who are required to file a declaration of estimated tax fall into two classes. Any taxpayer whose estimated income not subject to withholding exceeds $100 is required to file a declaration if his estimated gross income exceeds $600 multiplied by the number of his exemptions plus $400. Thus, for example, a taxpayer who is entitled to four exemptions and whose income consists entirely of taxable interest of $3,000 would be required to file a declaration, since his estimated income exceeds $2,800—that is, $600 multiplied by four exemptions plus $400.

Taxpayers whose estimated income not subject to withholding does not exceed $100 are required to file a declaration of estimated tax if their estimated gross income exceeds $5,000 and they are single or married but not entitled to file a joint return, or they are married and entitled to file a joint return or the head of a household and their estimated gross income exceeds $10,000.

II

Other Classes of Taxpayers

In addition to taxing individuals, the federal income tax makes special provision for taxing the income of other classes of taxpayers, such as corporations, partnerships, and estates and trusts. Since the object of this paper is to provide a summary description of the general plan of the income tax, and since the basic mechanics of the tax have been set forth in connection with the consideration of individual taxpayers, other classes of taxpayers will be disposed of very briefly. The discussion will be confined to the bare minimum consistent with a general and abbreviated outline of the taxes upon other classes of taxpayers.

A. Corporations

Under the Civil War Income Tax Acts, corporations were treated as partnerships are treated today. The corporate personality was not recognized as a taxable entity, but the individual stockholders were taxed directly upon their distributive shares of the corporate income. The modern federal income tax acts, however, treat corporations as taxable entities. Corporate income is taxed to the corporate entity in the first instance and then taxed again to the stockholders when it is distributed to them in the form of dividends.

Basically, the taxable income of a corporation is computed in the same way as that of an individual taxpayer, although there are differences in the detailed treatment of the two situations.[22] Corporations are not entitled to any exemption. Moreover, corporate income is taxed under a separate schedule of rates which provides for a normal tax of thirty per cent and a surtax applicable only to taxable income in excess of $25,000 of twenty-two per cent. The full amount of any net long-term capital gains are included in corporate income, without the benefit of any capital-gains deduction. However, there is an alternative tax for long-term capital gains of twenty-five per cent, so as a practical matter, the corporate tax on long-term capital gains is limited to twenty-five per cent.[23]

The recognition of the corporate personality as an independent taxable entity, with the consequent predication of the corporate tax upon an artificial legal fiction rather than the actual economic ownership of the corporate undertaking, has several untoward consequences. Corporate income is subjected to a double tax, first when it is earned by the corpora-

[22] *E.g.*, the personal expenses which the statute permits individuals to deduct, like medical expenses, the cost of child care, alimony, etc. See INT. REV. CODE OF 1954, §§ 213-16, cannot be deducted by a corporation. On the other hand, §§ 242-48 of the Code set forth certain deductions for corporations, like the amortization of organizational expenditures, which are not available to individuals.

[23] A corporation cannot deduct a net capital loss from ordinary income to any extent. Such losses may, however, be carried forward for 5 years and offset against any net capital gains (but not ordinary income) in those years. *Id.* §§ 1211, 1212.

tion, and again when it is distributed to the stockholders in the form of dividends. Moreover, the corporate entity offers a tax front behind which there is considerable room for tax maneuvering and avoidance.

The statute attempts to ameliorate the double tax which results from treating the corporation as an independent taxable entity by permitting individual taxpayers to deduct the first $50 of their dividends from domestic corporations from gross income and to credit four per cent of the balance against their gross income tax. Corporate stockholders are allowed to deduct eighty-five per cent of the dividends which they receive from domestic corporations.

There are a number of provisions in the statute designed to frustrate schemes to avoid income taxes by means of corporations. Although it is scarcely feasible to note these in a discussion of this kind, there are two special corporate surtaxes which should be mentioned. One of the most common means of avoiding income taxes by means of a corporation is what is called an incorporated pocketbook, by which a taxpayer incorporates his estate or business in order to realize his income as corporate income, which is taxed at a lower rate than individual income. The success of an incorporated pocketbook in avoiding income taxes is usually dependent upon the corporation's ability to retain a substantial part of its earnings, since any dividends which it distributes will be taxed to its stockholders as their individual income. Consequently, Congress has sought to discourage incorporated pocketbooks by several special surtaxes aimed at corporate accumulations.

The statute imposes a penalty surtax upon any corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed."[24] This tax, which is in addition to the ordinary corporate normal tax and surtax, is imposed at the rate of 27½ per cent upon the first $100,000 of the corporation's accumulated taxable income and 38½ per cent upon its accumulated taxable income in excess of that amount.

The surtax upon corporations improperly accumulating surplus has never proved a particularly effective deterrent to incorporated pocketbooks because it takes the form of a penalty tax whose application is dependent upon proof of a purpose to use the corporation to avoid individual income taxes upon its stockholders. In an effort to deal more

[24] *Id.* § 532(a).

effectively with incorporated pocketbooks, Congress, in the reform days of the New Deal, created the surtax on personal holding companies which is still on the books. This is a tax which is not dependent upon proof of any bad motive, but applies automatically to any corporation which meets the definition of a personal holding company. The technically exact description of a personal holding company is beyond the scope of this discussion. In general, the term indicates a closely-held corporation which is primarily a holding company rather than an operating company engaged in the active conduct of a trade or business. In the context of the present discussion, a personal holding company is a corporation which is extremely apt to represent an incorporated pocketbook.

The surtax upon personal holding companies applies in addition to the ordinary corporate normal tax and surtax. However, a corporation which is taxed as a personal holding company will not be subjected to the surtax on corporations improperly accumulating surplus. The rates of the personal holding company surtax are much stiffer than those of the tax upon improper accumulation of surplus. The first $2,000 of undistributed personal holding company income is taxed at seventy-five per cent, and the balance above that amount at eighty-five per cent.

One point which must be kept constantly in mind in connection with the taxation of corporations is that the income tax has its own definition of a corporation. Section 7701(a)(3) of the Code provides that "The term 'corporation' includes associations, joint stock companies and insurance companies." The purpose of this provision is to make sure that the corporate income tax extends not only to those organizations which are formally incorporated, but to any unincorporated organization, or "association," by means of which a business may be conducted with the substantial advantages of incorporation. The characterization of an organization under local state law is not controlling for purposes of the federal income tax. Consequently, business trusts and certain partnerships may be treated as corporations by the income tax, although under the local state law, they are technically trusts or partnerships. Needless to say, it is frequently very difficult to tell whether a particular trust or partnership is to be treated for tax purposes as a trust or partnership, or as an association which is taxable as a corporation.

B. Exempt Organizations

A number of organizations are exempt from the income tax. Although there may be some question about the propriety of designating an organization which is exempt from the tax as a class of taxpayer, at least it seems appropriate to call attention to the fact that such exemptions exist. The statute[25] sets forth a number of organizations which are exempt from the income tax which range all the way from government instrumentalities to religious and apostolic organizations and include such diverse groups as labor unions and chambers of commerce. At one time, a popular tax dodge grew up by which a charity would acquire and operate a private business which would be exempt from taxes because its earnings were devoted to charity. The statute has provisions designed to frustrate such schemes by taxing the unrelated business income of exempt organizations[26] and the income of "feeder" corporations,[27] which conduct a private business for an exempt organization. There are also provisions for taxing exempt organizations which engage in certain "prohibited transactions" which benefit primarily the person who donated the property to the exempt organization or one related to him.[28]

C. Estates and Trusts

Although a trust is not a legal entity like a corporation, but simply a method of holding title to property, the federal income tax treats trusts and decedent estates as independent taxable entities. Save in certain exceptional situations where trusts are ignored for tax purposes, trusts and estates are regarded as taxable entities whose income is taxed to the trustee or to the executor or administrator. In order to avoid a double tax on the same income, however, the trustee of a trust or the legal representative of an estate is allowed to deduct any income currently distributable to, or properly paid or credited to, a beneficiary. The general scheme for taxing trusts and estates is, therefore, that the income of the trust or estate which is taxable to the beneficiary is deducted by the trustee or the executor, who pays a tax upon the remaining income.

The trust or estate is not merely a taxable entity; it is also a "conduit" for transmitting to the beneficiary, income which retains in the hands of the beneficiary the same form in which it was realized by the trust or estate. Thus, for example, if a trust distributes its income, consisting of tax-exempt interest and long-term capital gains to the

[25] *Id.* § 503. See also *id* § 401(a).

[26] *Id.* § 511.

[27] *Id.* § 502.

[28] *Id.* § 503. This is designed to frustrate the private charitable foundation which is too obvious in following the injunction that charity begins at home.

beneficiary of the trust, this income will take the form of tax-free interest and long-term capital gains in the hands of the beneficiary.

Ordinarily, income which is taxed to a trustee is not taxed again when it is distributed to the beneficiary. In order to prevent trusts from being used as a device to deflect the tax upon income from a high-bracket beneficiary to a low-bracket trust, however, the statute provides for a five year "throwback" under which when a trust distributes income accumulated at any time within the previous five years, the distribution may be taxed to the beneficiary as though the income had been distributed when it was earned by the trust, with appropriate credit for the tax paid by the trust upon the income against the beneficiary's tax.

The income of a trust or estate is taxed under the rate schedule for single individuals who are not heads of a household. In general, the taxable income of an estate or trust is computed in the same way as that of an individual, although there are, of course, some significant differences between the determination of the taxable income of an individual and that of an estate or trust. The most important of these is the deduction allowed a trust or estate for income taxable to a beneficiary, which has no parallel in the taxation of individual income. There are also significant differences with respect to the charitable deduction which is allowed an estate or trust and that allowed individual taxpayers.[29] An estate or trust cannot claim the purely personal deductions which are allowed an individual, like the deductions for alimony, medical expenses, and child care. Nor may an estate or trust claim an exemption for a dependent or a spouse. However, a decedent estate is allowed a personal exemption of $600. A trust which is required to distribute all of its income currently is given an exemption of $300. Other trusts are allowed an exemption of $100.

The recognition of the trust as an independent taxable entity creates opportunities for tax avoidance by permitting the diversion of income from a high-bracket individual to a low-bracket trust. At one time, for example, taxpayers who wished to split up their incomes among their families, without losing control of the income, would create revocable trusts of part of their income-producing property. Thus, the settlor of

[29] The deduction for charitable contributions in the case of the individual taxpayer is limited to 20 or 30% of his adjusted gross income and may only be taken, even by an accrual basis taxpayer, in the year when the charitable contribution is actually paid over to the charity. *Id.* § 170(b). On the other hand, there is no mathematical limitation upon the deduction by an estate or trust of amounts paid or *permanently set aside* for charity, provided that these contributions come from the gross income of the estate or trust and are authorized by the terms of the governing instrument. *Id.* § 642(c).

the trust would retain dominion over the trust property by virtue of his power of revocation, while the income from the property would be deflected to the trustee or the beneficiary of the trust for tax purposes. Again, wealthy men would create funded insurance trusts, so that the income used to pay the settlor's insurance premiums would be taxed to the trustee of the trust in a lower bracket than it would otherwise be taxed to the settlor of the trust. To put an end to schemes like these, Congress provided that such trusts should be ignored and that the income from the trust property should be taxed directly to the settlor of the trust. In general, the 1954 Code provides that the income from a trust over which the settlor retains substantial ownership or dominion, or which may be used for his benefit, shall be taxed directly to the settlor of the trust. This principle is even carried to the extent of providing that income from a trust which is subject to the control of one other than the settlor shall be taxed to the person possessing such control, rather than to the trustee or the beneficiary of the trust.

D. Partnerships

The income of a partnership is not taxed to the partnership, but the individual partners are taxed upon their distributive shares of the partnership income, regardless of whether it is distributed to them or not. Perhaps the most original contribution which the 1954 Code made to the income tax was the provisions for taxing partnerships. In the words of the House Report[30] accompanying the 1954 Code, the statutory provisions governing partnerships in the 1939 Code were "wholly inadequate," while the "published regulations, rulings and court decisions" were "incomplete and frequently contradictory." The statutory rules governing partnerships in the 1939 Code were "wholly inadequate" because they were practically nonexistent. Moreover, grave difficulty was experienced in solving the problems which arose in connection with the taxation of partnership income upon general legal principles at administrative and judicial levels because of the conflicting conceptions of a partnership as a distinct legal entity and an aggregate of the individual partners.

In contrast to the 1939 Code, the 1954 Code lays down very detailed rules for the taxation of partnership income, without espousing either the entity or the aggregate theories of a partnership. The 1954 Code treats a partnership as an entity where this seems to reach a desirable

[30] H.R. REP. No. 1337, 83d Cong., 2d Sess. 65 (1954).

result and as an aggregation of the individual partners where this appears to be more equitable.

For example, as far as the imposition of the tax is concerned, the partnership is disregarded and the individual partners are taxed upon their distributive shares of the partnership income. The partnership serves simply as a conduit which transmits the partnership income to the individual partners in the same form in which it is realized by the partnership. Thus, for example, tax-exempt interest which is realized by the partnership retains its exemption in the hands of the partners.

The partnership is recognized as an accounting entity, however, which is required to file an informational return setting forth the taxable income of the partnership and the partners' distributive shares of the partnership income. The partnership selects its own taxable year and its own method of accounting for partnership income. Moreover, generally speaking, the various elections with regard to income and deductions which are permitted by the statute, such as accelerated depreciation or amortization of bond premium, are made by the partnership at the partnership level. When a partner deals with the partnership in some capacity other than his capacity of a partner, the partnership is treated as an independent entity, and the partner, generally speaking, is treated like an outsider.