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CHAPTER 10

Taxes on Individual Incomes

DIRECT TAXATION of individual incomes is a powerful fiscal device for transferring to the Treasury a portion of civilian money incomes, and thus restricting civilian spending and combatting inflation. The individual income tax, like other taxes, has the advantage over borrowing that it leaves no heritage of public debt. It also has the advantage over certain other fiscal devices that it can be designed with approximate precision to distribute sacrifices among citizens according to some predetermined public policy. For example, it is regarded as having an advantage over corporation taxes in that the corresponding burdens on citizens can be allocated more precisely according to prevailing notions of equity. A tax on income which lays the same total burden on the taxpayer as excises leaves him a greater freedom of choice in his purchases; but, against this advantage, one must recognize that a specific purpose of excises may be to discourage certain purchases. Moreover, unlike excises and other indirect taxes which are sometimes 'hidden', the direct tax on income makes the taxpayer painfully aware of his sacrifice; and the psychological implications of such awareness are often cited to its advantage.

Government borrowing of the non-inflationary type draws mainly from income which is currently saved by individuals or corporations, whether such saving is purely voluntary, is necessitated by the unavailability of goods for purchase, or is compelled by some direct means. Corporate taxes absorb money incomes which might remain in the hands of corpora-

tions and be either spent or saved by them, and restrict the dividends disbursed to individuals, thereby denying them freedom either to spend or to save that amount of income. Excises absorb money incomes, in some cases of individuals and in others of enterprises, as an incident to expenditure on the specific commodities or services taxed. The individual income tax absorbs only money income which has already come into the possession of individuals, and does so regardless whether they spend all or save a portion.

1 RATES AND OTHER PROVISIONS UNDER THE 1941 ACT

The individual income tax under the Revenue Act of 1941 includes a normal tax of 4 per cent and surtaxes ranging from 6 per cent on the lowest bracket (up to $2,000) to 77 per cent on the highest (over $5,000,000). The bases to which these two parts of the income tax are applied differ somewhat, and are called normal tax net income and surtax net income, respectively. Normal tax net income excludes interest on certain partly exempt federal securities; also an amount designated the earned income credit, the effect of the latter being an indirect reduction of 10 per cent in the normal tax rate on what is legally defined as 'earned income'. Neither item is excluded from surtax net income. Apart from these differences, the bases of both taxes are the residue after the personal exemption and credit for dependents have been subtracted from a net taxable income arrived at by making certain legally defined deductions (for interest paid, taxes paid, charitable contributions, etc.) from the basic figure covering all receipts of taxable income.[1] The personal exemption is $1,500 for a married couple or the head of a family, and $750 for a single person; a credit of $400 is allowed for each dependent.[2]

The left section of Table 22 shows the surtax rates for selected brackets, intermediate between the minimum rate of 6 per cent and the maximum of 77. Differences between bracket rates are much greater for incomes in the lower part

of the scale than in the upper, but this difference is less pronounced for the average surtax rates in the right section. And, since this table gives surtax rates only, the normal tax of 4 per cent must be added to obtain the full effect of the income tax upon each bracket.[3] The range of graduation for the entire income tax extends from 10 per cent for the lowest bracket of surtax net income to 81 per cent for the highest.

From the bracket rates the severity of the tax at various levels of income cannot be thoroughly understood, although the top bracket rate applicable to the income of an individual may well have an important bearing upon his incentives as an investor or producer. Leaving aside the normal tax and considering the surtax alone, we find in *average* rates, such as those in the right section of Table 22, a direct measure of severity. The figures of Table 22 are for selected income levels; the full record for all levels is shown in the 1941 curve

TABLE 22

Surtax Rates at Selected Levels, Act of 1941
(money figures in thousands of dollars)

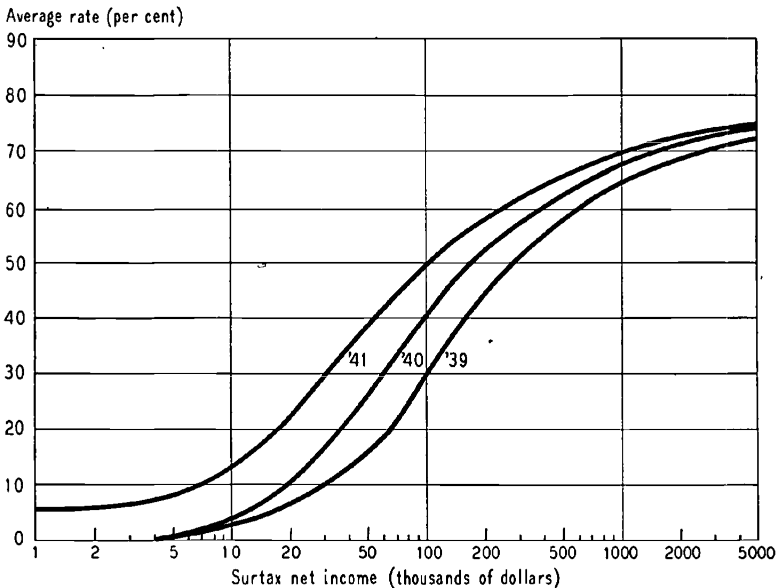
LIMIT OF BRACKET		BRACKET RATE	TOTAL SURTAX ON ENTIRE SURTAX NET INCOME		
Lower	Upper	%	Surtax net income	Surtax	Avg. rate %
8	10	21	8	.90	11.25
12	14	29	12	1.82	15.18
16	18	35	16	3.04	19.00
22	26	44	22	5.32	24.18
32	38	50	32	9.90	30.94
50	60	57	50	19.38	38.76
70	80	61	70	30.98	44.26
100	150	65	100	49.78	49.78
250	300	69	250	148.78	59.51

of Chart 8. For comparison, the chart shows also corresponding curves for the surtax as amended by the Revenue Act of 1940 and for the surtax as it applied to incomes of 1939 under the preceding act. The Act of 1940 brought no change in average rates for the very low levels of surtax net income, but

increased the severity of the tax at all levels above $6,000. The increase was greatest for incomes between $50,000 and $80,000; and this reflected a shifting toward the left of the steepest part of the curve, the part for which, with a given

CHART 8

Average Surtax Rates on Surtax Net Incomes of Stated Sizes under the Revenue Acts in Effect for 1939, 1940, and 1941



percentage increase in surtax net income, the advance in average rate is greatest.[4] The Act of 1941 brought a more general increase in the severity of the surtax, with important advances in the average rate for all levels of surtax net income. The maximum increases ranged over levels from somewhat above $10,000 to about $100,000; and again the steepest part of the curve moved toward the left. This shift toward the left, and to a less extent the increasing severity of the tax

at low levels, are almost inevitable in any attempt to enlarge greatly the surtax revenue. The Acts of 1940 and 1941, aimed at enlarging that revenue, had to be designed with the foreknowledge that not much additional revenue could be obtained from the top brackets; because they were already taxed so severely that doubt existed in some quarters whether higher top bracket rates would yield *any* new revenue and because they might encourage further splitting of income by taxpayers among members of their families. Some further realization of revenue from somewhat higher top bracket rates may for various reasons be possible now than was regarded possible in 1940 or 1941; but even now the highest incomes, under any feasible advances in rates, can produce only a minor fraction of the new revenue needed from the income tax.[5]

In exploring the possibility of utilizing the individual income tax to absorb excess money incomes, changes in rates for both the normal tax and the surtax must be considered. And this exploration, if thorough, must go beyond changes in rates, i.e., to the base to which these rates apply—the definition of taxable income, and the various allowances and credits—and to methods of collecting the tax (see Ch. 11). Finally, for practical reasons, how to prevent avoidance of taxes under the present rates or any others that might be adopted must be considered.

2 CHANGES IN INCOME TAX RATES

The most obvious means of increasing the total tax on individual incomes, within the framework of the present law, is to raise rates. No reason appears for raising the normal rate; in fact, good reasons stand against it, especially as the present law already includes a substantial surtax upon every income which is subject to the normal tax. An advance would, under the present law, be inapplicable to interest received on partly tax-exempt federal obligations; whereas an equal advance in the lowest bracket rate of surtax would apply to such interest.

Likewise, an advance in the normal rate would be subject to an offset on account of the earned income credit, whereas an equal advance in the surtax rate would not. On these grounds, an advance in the normal rate would be less satisfactory than an equivalent advance in the lowest bracket of surtax rates.

On the assumption that surtax rate advances are to be set with a view to absorbing a predetermined total of money income, as nearly as the great difficulties of estimating will allow, how are the burdens to be distributed along the income scale? The cynic may suggest that political considerations will rule: that politicians, recognizing that voters are vastly more numerous in the lower than in the intermediate and higher brackets, will place none or as little as possible of the burden upon the lower brackets. This does not mean that a purely political handling of the distribution would necessarily place no burden below some moderate level of income and all above, or that such a boundary, between incomes escaping and those subjected to burden, would necessarily be as high as it could be placed if nearly all of each income above that level were taken by nearly confiscatory taxes.[6] Politicians may believe that *some* increase in the burden upon the low brackets would alienate fewer votes than would be lost through the alternatively necessary increase in the severity of new burdens upon individuals in somewhat higher brackets. The curve of average rates traced by a purely political handling of the question, in other words, might not include an abrupt jump from the low rate applied on low bracket incomes to a plateau of high rates applied upon all larger incomes. It might instead show an elongated-S shape similar to that of the curves in Chart 8.

Political considerations will undoubtedly play some part in determining the rate curve actually established by law; but other considerations will also play an important, perhaps decisive, part; and the latter are the considerations deserving more detailed examination here. They cover chiefly the wartime incentives of taxpayers in various income groups; the

degree to which taxpayers in various groups have fixed incomes, or enjoy instead incomes enlarged during the war; the degree to which incomes are drawn down by state income taxes and similar fixed charges; the degree to which incomes are drawn down by excises or other indirect taxes or by social security taxes; and the amount of more or less automatic savings from consumption expenditures because less can be spent on consumer goods. Some of these considerations are related to others; and, in any case, they must be studied in combination in comparing feasible increases in the tax burden at various income levels.

A weighty consideration bearing upon tax policy concerns the protection of the wartime incentives of citizens, in order to call forth their maximum effort. Any new tax burden so severe as to compel very large sacrifices by the taxpayers of a particular class, especially if their sacrifices seem to them out of proportion to those of other classes, may seriously weaken incentives and obstruct the war effort. The way in which incentives bear upon the war program and the degree to which damage to the incentives of particular classes of individuals can impede it cannot be known or predicted with any approach to precision; yet a rough qualitative appraisal of the differences among classes is possible, and helpful for present purposes. The most obvious broad classes of individuals to be considered are wage workers, hired managers and executives, farmers, other owners of unincorporated businesses, professional specialists, investors. Many individuals fall into more than one of these categories; but nearly every individual belongs mainly to some one category, and has interests which affect his incentives, and economic functions which affect his capacity to promote or impede the war effort, mainly characteristic of that category.

Many factors besides taxes affect the incentives of various individuals, and they vary among the above categories and to some extent within any one category. For example, most wage workers have obtained or are obtaining steadier employment

or higher wages or both as a result of the war, and this positive incentive factor may offset in whole or in part the negative factor of a fairly heavy tax. Likewise, numerous managers and executives are receiving larger money rewards and deriving such intangible satisfaction and benefit as comes from the reputation of successful management; and these favorable incentive factors may not be offset by even substantial increases in the tax burden. On the other hand, great numbers of professional specialists and perhaps the majority of investors receive little or no benefit from the war program, and of course have in any case little direct part in the great task of war output. Their incentives may therefore seem of little moment. Moreover, for the population in general, numerous noneconomic factors—confidence in leadership, pride in achievement, and other psychological elements—affect incentives, and affect them in varying degrees for different categories or groups of people. Taxation is thus merely one of several factors influencing war incentives.

One may contend in particular that the incentives of investors have little bearing upon the volume and speed of war-goods production, except to the degree that the new plant and equipment of war industries is financed by private investors and not by government, and except as their vigorous response is needed to offerings of government bonds. In truth, with respect to several categories and subgroups within a category, opinions differ concerning how essential protection of incentives is to the war effort. We may be certain that the incentives of the moderate number of managers and executives in enterprises making war goods are vastly more important than those of similar individuals in less vital enterprises, but whether the former are more important than the incentives of the large number of wage workers in war industries is more open to doubt. This doubt, in practical terms, takes rather the following form: granting that taxes must be so heavy as perhaps to do some harm to incentives all along the line, doubt may exist that the possible harm to incentives of

the executive-manager class will, for a proposed distribution of new tax burdens, be more or less serious for the war program than the possible harm to incentives of wage workers. Similar doubts may arise in comparing the effects of tax burdens on other categories of individuals, in terms of possible damage to incentives and to the war effort; and yet those responsible for tax policy must, as best they can, resolve these doubts in order to design a program such that taxes shall exert a minimum depressive effect upon output. Moreover, responsible authorities will recognize that the effect of a tax on incentives may need to be appraised in terms of the tax on a marginal addition to income, rather than of the entire tax on the entire income; and they will recognize also that in some cases an additional tax may prove to be a positive incentive: one may work harder to maintain his former income after taxes.

While the several categories mentioned above are not confined within specific income brackets, some rough correlation exists: most wage workers and farmers are in the low and lower intermediate brackets, most owners (other than farmers) of unincorporated businesses are in the lower intermediate, most professional specialists are in the intermediate, executives and managers fall mainly in the intermediate and lower high brackets with a moderate fraction scattered in still higher brackets, most investors are in the intermediate and high brackets.[7] Thus, granting that a workable opinion can be reached concerning which categories need greater protection of their incentives in the interest of the war, we have a rough guide to the distribution of tax burdens along the income scale. In this connection, the relative severity of new burdens merits consideration: the incentives of the mass may be damaged if they feel that more fortunate citizens get off too lightly.

Incentives have been discussed at some length, partly because of their great capacity to affect war output and partly to point out the great difficulty of making precise allowances

in a tax program to the end of protecting vital incentives. The other major considerations listed above are now discussed more briefly. Taxes, other than the federal surtax, constitute drains upon income all along the size scale of income. Social security taxes affect the low and lower intermediate brackets, and any drastic increase in them (the part assessed against the worker, see Ch. 12) will restrict the feasibility of extremely heavy increases in the surtax on the lowest brackets. Selective excises and sales taxes (see Ch. 9) drain income from all consumers; but, with some reservations for the more narrowly selective excises, the drain is much greater as a percentage of income at low and intermediate than at high levels. Any drastic increase will limit possible increases in the surtax on the low brackets, and in less degree on the intermediate. State income taxes affect mainly the intermediate and high brackets; and there they constitute a definite bar to the approach of the total federal income tax to a 100 per cent levy on income. Even with a federal tax substantially below 100 per cent, the combined federal and state taxes might be confiscatory.[8] The very slowness with which top bracket surtaxes have in recent tax revisions been advanced reflects this limitation; another factor has been the belief that rates could not be advanced much further without causing such evasion or avoidance, perhaps through purchase of tax-exempt securities, as would cancel any intended increase in total revenue.

Despite the vigor and extent of the war boom, it has brought to a very large number of taxpayers, chiefly in the intermediate and lower high brackets, no increases in earnings; and they remain dependent on fixed incomes. Many of these individuals have also large elements of fixed or nearly fixed costs—taxes on their homes and perhaps interest on residential mortgages, state income taxes, insurance premiums, and (though these are less clearly 'fixed') costs of carrying to completion the education of their children. In view of the advances in living costs that have already taken place, a very

severe advance in the federal income tax might render these individuals unable to meet some of their fixed charges. Such an outcome would mean a sacrifice in standard of living for these middle group people, a standard which has, to be sure, been above any attainable by people in the low brackets. The notion prevails in some quarters that all or as nearly as possible all the sacrifices of war should be laid upon those members of the community heretofore regarded as more fortunate, but the fact should not be overlooked that most people can probably bear more easily a restriction on increases in their spending than absolute curtailment.

An important incidental consequence of the war effort is the development of automatic savings as a result of the unavailability of certain consumer goods (see Ch. 3 and 6). The amount of these automatic savings is heightened by the enlargement of the incomes of many taxpayers due to the war boom. Chapter 3 has shown that those two factors combined, larger incomes and shortages of goods, will result in an enormous excess income in the middle range of incomes, and a somewhat less enormous excess in the high range. This excess income and its distribution along the income scale are important guides in setting surtax rates.

The foregoing considerations, which can be weighed only in broad and mainly qualitative terms, are among the chief factors, entirely apart from purely political considerations, bearing upon the distribution of new tax burdens, through advances in surtax rates, along the income scale. Just how the various considerations will be balanced and combined in arriving at a practical selection of rates cannot be foreseen; and, in weighing any such considerations, notice must always be taken of the probability that they apply in different degree to different taxpayers in the same income bracket. In all matters of taxation, practical decisions must be made in terms of averages pertaining to groups of taxpayers, and the actual schedule may fit more closely the circumstances of some members than of others. Extreme hardship on indi-

viduals can usually be ameliorated by special provisions, but no law can be so intricate as to allow adequately for all the ordinary differences in circumstances among taxpayers. Differences in income constitute merely one measure, though perhaps the most significant, of differences in circumstances which make tax burdens more easily borne by some than by others.

Various Scales of Progression

Average surtax rates on Chart 8 for 1941, ranging from 6 per cent on the lowest taxable incomes to 74.5 per cent at $5 million, and a still higher figure, though under 77 per cent, for incomes above that level, give some notion of the maximum possible advances at various income levels, particularly if the above figures are increased by about 4 to cover the normal tax also. Any advance in the *average* surtax rate plus the normal rate by as much as 19 per cent for incomes above $5 million would confiscate all income above the minimum intended to be tax free through the personal exemption and credit for dependents. Moreover, the imposition of the federal surtax plus normal rates even approaching 100 per cent on an average basis would greatly strengthen the incentive to evade or avoid taxes, already so serious a tendency under present rates as to call in doubt the possibility of getting any bigger tax yield by an advance in the rates on very high incomes. As some of the latter objections may be reduced by patriotism and other factors peculiar to the war, some advance in the average rate on very high incomes is probably feasible. Careful consideration by governmental and other specialists of all the factors involved may indicate the maximum feasible advance; but limitations of the sort mentioned above mean that the maximum advance will fall far short of 19 per cent (the difference between the present highest average rate of 81 and 100) and may well be not over 6 to 8 per cent, from 77 to 83 or 85, in the surtax rate for the top bracket. Even confiscation of large incomes would not, how-

ever, remove the need for heavy increases in taxes upon smaller incomes, if inflation, with all its destructive consequences for the low income groups as well as for others, and other evils are to be averted. If the entire amount of incomes above $100,000 were taxed away, the total so raised would be somewhat less than $1 billion and would be a small fraction of the inflationary excess which should be transferred to the Treasury. Moreover, as existing taxes take a large fraction of such incomes, the *additional* levy would yield much less than $1 billion.

At the other end of the income scale, where the average rate is now 10 per cent, and in the intervening ranges, much more room for rate advances exists. Moreover, at the low end of the scale, a larger proportion of the income received is spent on consumption than at the high end. Consequently, an income tax program designed chiefly to combat inflation, in a situation where saved income may largely be absorbed by government borrowing, may be expected to apply greater rate advances on low and intermediate than on large incomes.

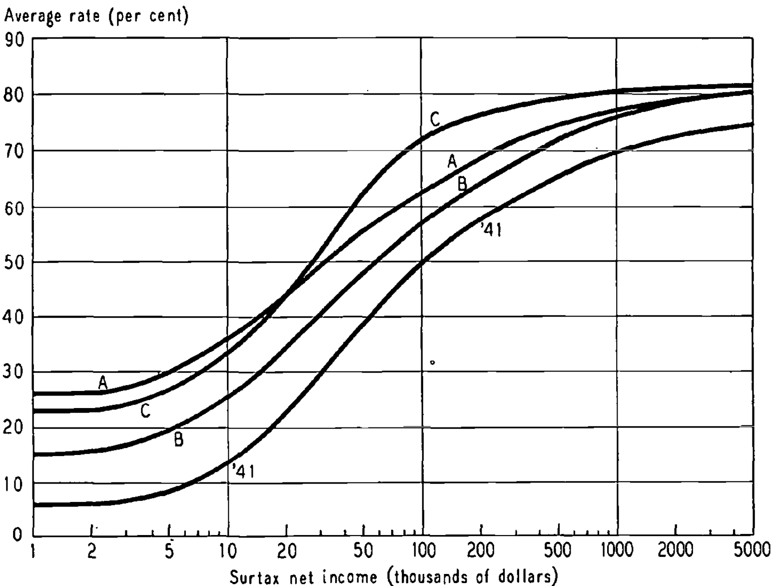
Opinions can differ widely about what rates should be set for the low and intermediate brackets. We do not suggest the appropriate rate schedule, but show instead in Chart 9 selected tentative curves representing *average* surtax rates. For comparison, the curve corresponding to the Act of 1941 is shown. The curves have been so drawn that they rise smoothly and regularly. Any bulges, such as the upward bulge for large incomes and the downward bulge for small incomes in the curve for the 1941 Act, necessarily make for greater steepness in some parts of the curve than in others, implying a more severe application of progression in one part of the income scale than in others. Such bulges may be justified in wartime by the considerations outlined above, but the desirability of treating every particular taxpayer as nearly as possible like those who have somewhat smaller or larger incomes remains very strong.

All the tentative curves have been drawn with an indicated

advance in the average surtax rate of 6 per cent for a surtax net income of $5 million, which may be about the maximum feasible increase at that level. The curves show selected distributions of the new burden among incomes of different

CHART 9

Average Surtax Rates on Surtax Net Incomes of Stated Sizes under the 1941 Act and for Three Tentative Schedules of Higher Rates



sizes. We emphasize again that these curves are tentative pictures of possibilities, regarded as feasible if other parts of the total tax structure are adapted to these arrangements for the income tax, and are not suggestions as to what is wise policy. Curves A and B are essentially of the same shape; but the rate advance for A is much higher than for B at the lowest level, and this difference tapers off as the income increases. Revenue under schedule A would be much greater than

under B. If A may be regarded as the most severe schedule of rates feasible at present, with the existing or even moderate advances in excises, then much heavier excises or a heavy general sales tax might suggest some such generally lower schedule of average surtax rates as is implied by B. Though the precise amount of the shift from A to B might not be that shown in the chart, the *direction* would be that indicated.

Curves A and C are *not* essentially of the same shape. Curve A has somewhat less prominent bulges—the downward bulge between about $5,000 and $20,000, and the upward bulge between about $50,000 and $500,000—than the 1941 curve; which is another way of saying that the steepest part of Curve A is somewhat less steep than that of the 1941 curve. On the other hand, the bulges of Curve C are much more pronounced than those for 1941, and the steepest part of Curve C is much steeper than that for 1941. A rate schedule like that of Curve C, while it might be designed to yield the same total revenue as that of Curve A, would imply a heavier burden on the high brackets and lighter burdens on the low and intermediate, than the Curve A schedule. Also, in the middle of the high bracket, from about $20,000 to about $100,000, the progression is more rapid for C than for A: two taxpayers at somewhat different points in that range have a much greater *difference* in tax burden under C than under A. Curve C also carries the extremely high (perhaps nearly confiscatory) rates to a lower level of high incomes than A.

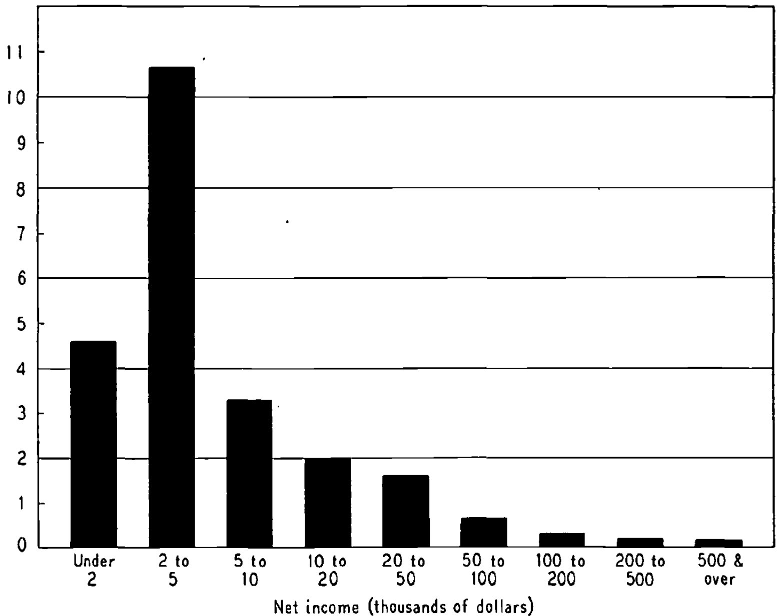
No careful attempt has been made to draw Curves A and C so that each would yield the same total revenue; but they do take account of the fact that a given change (of, say, 5 points) in the rate brings much more revenue from small than from large incomes, because of the much greater aggregate income at low than at high levels (see Chart 10, which shows, for 1939, the distribution of income at various levels). For this reason the shift downward from Curve A to C for small and moderately larger incomes is much less than the shift upward near $100,000. We repeat that these differences,

between the shifts at low and at high levels, have not been determined precisely so that A and C would yield the same total revenue. But their *direction* is correctly indicated: the downward shift for low levels would have to be less than the

CHART 10

Distribution of Income by Income Groups, 1939

1939 Aggregate income
(millions of dollars)



upward shift for high levels. The obstinate fact noted earlier confronts us again here: if a specified large total of new revenue is to be obtained, no considerable limitation of the additional burden on a low bracket individual can be achieved even by adding greatly to the burden on a high bracket individual.

Some shifting of burden from one part of the income scale to another can be achieved by such changes in the shape of

the curve as are implied in passing from A to C, and how far such shifting will be attempted will depend partly on political considerations and partly upon considerations of the sort outlined above. Thus, numerous curves besides C could be drawn, all aimed at yielding the same total revenue as A and all differing from A in the amount by which they shift the burdens implied by A at various income levels to different levels. The extreme case was mentioned in another connection and would be reflected by a curve nearly horizontal at the bottom brackets, rising almost vertically at some higher level (but still a small income, if the same total revenue as under A were to be obtained), and then nearly horizontal and very high for all incomes above that level. Such an extreme arrangement could not fail to arouse hostility among great numbers of taxpayers, those whose incomes reached considerably above the critical level at which the rate advanced so sharply as well as those whose incomes just passed that level, for they would be aware that many individuals receiving only moderately smaller incomes were escaping with strikingly lighter tax burdens. No such extreme application of the distortion of Curve A, with a view to shifting burdens upward along the income scale, is likely to receive serious attention. But *any* curve which has a very steep portion, such as even Curve C, would arouse hostility of the same sort though in less degree: individuals whose incomes are in the range marked by the steepest part of the curve are aware that their tax burdens are much heavier than those of people having only moderately smaller incomes.

Various considerations, including especially the weight of the intended tax burdens involved in changes in social security taxes and in excises and other indirect taxes, will determine whether the surtax burden actually imposed by new legislation will be heavier (as in A) or lighter (as in B). Other considerations will determine whether the total burden will be distributed along the income scale according to a curve (such as A) which changes direction very slowly, or according

to a curve (such as C) which shifts burdens from small to large incomes. These choices will be made in the legislative process by a rough balancing of considerations, some of which are conflicting. We do not attempt to predict the choices at which this process will arrive. Nor do we make any careful estimate, based upon the elaborate application of suggested advances in rates to probable incomes in the calendar year 1942, of the revenue yield of various alternatives. We believe, however, that a moderately steep advance in present rates (such as implied roughly by Curve B) might increase revenue $1 billion, and that a steeper advance (such as roughly implied by A) might increase revenue $2 billion. Departure from Curve A, in the direction of Curve C, *could* be designed to maintain the same increase in revenue, and corresponding departure from Curve B could be worked out in the same manner.[9] The above indications of possible increases in revenue pertain only to what can be accomplished by rate advances, with other features of the 1941 Act unchanged.

3 CHANGES IN THE BASE OF THE TAX

The argument for absorbing money incomes through higher tax rates on personal incomes points also to a consideration of changes, directed to the same end, in the base on which the tax is levied. The personal exemption and credit for dependents, the distinction between earned and other income, the unit of reporting, the deductions permitted, and the possibility of including income not now taxable, should all be examined. In this exploration the question of equity will have to be considered because it is implicit in each of these issues. Fortunately, however, it is present, not in the broad and highly controversial sense of the justice of the existing distribution of wealth and income, but in the narrow and more manageable sense of giving equal treatment to persons whose circumstances are similar.

Personal Exemption and Credit for Dependents

The personal allowance under the Act of 1941 consists of exemptions of $1,500 for married couples or heads of families and $750 for single persons, and a credit of $400 for each dependent. The logical basis for a personal allowance is that some income is needed to purchase the absolute necessaries of life, and should be free from tax; and the argument is especially strong in wartime because of the urgency to maintain public health and morale. Differences in the personal responsibilities of taxpayers to provide the minimum of necessary consumption for their dependents are also recognized. No matter how drastically consumption is to be reduced and how much income will correspondingly have to be transferred to the Treasury, these differences will always support the case for differences in the personal allowance. The relevant issue is not the existence of these allowances, or differences according to family status, but their amounts and distribution among taxpayers.

Under the 1941 Act the personal allowance for families with two children, approximately the average number, means the exemption of the first $2,300 of income. With a national income of $92 billion ($88.9 billion paid out) families having incomes of $2,300 or less may be expected to receive in the aggregate about $27.5 billion. Single persons with incomes of $750 or below would receive about $1.5 billion. Therefore, if we consider only the group with incomes so low that, after the allowances, they are not subject to tax, $29 billion of individual incomes totaling $89 billion would be exempt. This figure does not include, moreover, the very large aggregate allowance for the groups which do pay taxes.

On questions of this kind exact answers are not possible. But in the present crisis, the wisdom of exempting, because of the personal allowance, a fraction running well above one-third of the income received by individuals may fairly be

questioned. If those responsible for public policy decided to reduce the personal exemptions to $1,200 for married couples and $600 for single persons, with a credit of $300 for each dependent, the amount exempt would be reduced about $8 or $9 billion. The lower of these two, if added to the income subject to taxation and taxed at, say, 30 per cent (normal plus surtax), would yield about $2.2 billion.[10] The bulk of this additional revenue would come from persons in the higher brackets, through the reduction of their allowances. Such reduced allowances as those illustrated above could less easily be justified if a heavy *general* excise, or sales tax, were adopted (see Ch. 9).

The benefit of the deduction of the personal exemption and credit for dependents might be limited to the first bracket of income subject to taxation, bearing the normal tax and the lowest surtax. This allowance may now be deducted for purposes of both the normal tax and any surtax. Hence it is worth more to a rich person than to one of small or moderate means, as may be seen by a simple example. The present scale of rates at which income is taxed ranges approximately from 10 to 81 per cent. The exemption under the Act of 1941 is worth 10 per cent of $2,300, or $230, to a married man with two children in the lowest bracket of taxable income, because it saves him from paying that much more in taxes.[11] To a person in similar domestic circumstances whose income is so large that at least $2,300 of it is taxed in the top bracket, the exemption is worth 81 per cent of $2,300, or $1,863, because the exemption saves him from paying that much more in taxes.

The personal exemption and credit for dependents could be given the same value for every taxpayer by permitting the deduction from his total tax of the amount of the normal tax and first surtax which this personal allowance saves paying, instead of deducting the allowance itself from his income. In short, under the 1941 Act a single man would receive a tax credit of $75, and a married man one of $150,

plus $40 for each child. But a tax credit of $150 is 10 per cent of a personal exemption of $1,500. Hence, if the rate of the combined normal tax and surtax were raised, the credit would need be changed in order to be equivalent to an exemption of $1,500.[12] An additional revenue of about $200 million might be yielded by this limitation on the personal allowances, at their figures under the 1941 Act. The additional revenue yielded after the personal allowances had been reduced to some such magnitudes as noted above would be somewhat less.

Credit for 'Earned Income'

A distinction is made in the 1941 Act and several previous acts between earnings from personal exertion and income from property whereby earnings, somewhat artificially defined and limited, are given a credit of 10 per cent against the normal tax. All net incomes of $3,000 or less are, however, for purposes of this credit, assumed to be earned, irrespective of origin. Incomes in excess of $3,000 are entitled to the credit only as they accrue from personal exertion, but the credit is limited to $1,400. Hence, in the sense of the tax law, no one may 'earn' more than $14,000. Additional income is denied the benefit of the exemption, whether realized from personal effort or from property.

The basis for this different treatment of incomes according to source springs from an economic difference between income from personal exertion and from property. Earnings are subject to the contingencies of accident and sickness, and to inevitable cessation owing to the enfeeblement of age and death. Property income, on the other hand, *may* continue after the owner retires, and perhaps long after his death, to endow his children and grandchildren. Some logical warrant exists for a distinction in taxation. But the case is less clear in wartime when the risks which imperil the permanence and certainty of property income may well increase more than the corresponding risks incident to 'earned'

income. A program of war taxation might accordingly include at least a temporary abandonment of the earned income credit, especially as its elimination would remove one perplexity of the taxpayer in calculating his tax and would reduce the administrative task of the Treasury. With income tax burdens as now visualized, perhaps reaching to a minimum rate of 30 per cent, the relief granted by the credit is in truth relatively small, because the credit stands merely against the normal tax.[13] We do not find any conclusive argument for abandoning or for maintaining the credit and believe the decision may well hinge upon whether, in view of the impelling need for raising new taxes, it may be continued without imposing some alternative burdens upon its beneficiaries. The revenue involved would run to about $200 million.

Capital Gains and Losses

Another respect in which the present law treats one source of 'income' differently from another is in the special provisions concerning capital gains. Whether such gains are in fact income and should be subject to tax has long been controversial. At a time like the present, when a primary objective of additional taxation is to absorb spending power which might otherwise be used in bidding up prices, the case for taxing such gains has peculiar force, because little doubt exists that numerous individuals are in fact stimulated by capital gains to spend more, especially on consumer goods. In any case, we accept the fact that public policy regards and has for many years regarded capital gains as income subject to taxation.

One provision of the 1941 Act with respect to capital gains is that the *portion* of any gain regarded as income for tax purposes depends on the interval between purchase and sale. This portion is 100 per cent for short term gains (those realized when the interval is not over 18 months), and is scaled down as the time between purchase and sale becomes longer,

until the portion reaches a minimum of 50 per cent. Therefore, except for short term gains, a capital gain does not bear the full weight of the income tax. The essential purpose of this scaling down is to make a rough allowance for the assumption that the total gain accrued over the entire interval following purchase. Otherwise a taxpayer who held an asset for five years, then realized a large capital gain, might be taxed (on his capital gain) more heavily than if he realized each year the part of the gain which accrued that year and was taxed on it. The decisive point is that realizing the single large gain in one year might so augment his total income that some of the gain would be taxed at a much higher bracket rate than if the same gain had been realized in installments during the intermediate years. The scaling down of the portion taxable does not precisely correct this disparity but tends to do so.

Whether this ameliorating feature of the law should be retained (or retained in part) during the war requires consideration. During 1941 and the first quarter of 1942 prices did not in general advance in capital markets; but unless policies directed toward the prevention of inflation are effective, an advance is not unlikely. And, even while the general market is sluggish, the prices of particular securities or other capital assets may advance sharply because of special circumstances affecting their market value. Whether such price advances during wartime are general or for particular assets alone, capital gains will accrue and may be realized. But for any such gain realized in wartime, the presumption may be far from strong that the gain accrued over the entire interval during which the asset was held. On the contrary, with respect to an asset held five years, very strong presumption may exist that all or nearly all of the gain accrued in the last year or two, and was due entirely to conditions peculiar to the war. In these circumstances, the case for scaling down the gain, before entering it as an item of income subject to tax, may be much less strong than under ordinary conditions.

The issue is not likely to be serious unless prices advance sharply in security and other capital markets, but in such an event the government may again question the wisdom of scaling down long term capital gains by the percentages provided under the 1941 Act. Reducing the relief from taxes granted through these scaled percentages might also discourage dangerous advances in capital markets. The analysis on this aspect of the case is intricate and uncertain, especially as the treatment of capital losses is also involved. Indeed, question may well be raised whether the tax on capital gains should be made more severe without granting corresponding concessions on capital losses; and, if this were done, a decline in market prices might lead to substantial reduction in revenue on account of capital loss offsets against income.

Joint Returns

The House Committee on Ways and Means, impressed by inequities arising under the option given husband and wife of filing separate returns, strongly recommended in 1941 compulsory joint returns, a measure which, if made law, would have brought an additional revenue then estimated at $287 million.[14] When released for public inspection this proposal was viewed in various lights. Some saw it as an attack on women's rights. Others, especially persons from the community property states whose citizens have an advantage under the present procedure, were concerned about states' rights. And many, including some church leaders, held that marriage among rich persons might not be found preferable to other relationships if it cost more in taxes. Hence, the proposal never received the serious consideration of the country on the central issue the Committee sought to raise, namely, whether the family or the individual is the more appropriate unit for income taxation.

The Senate Committee on Finance, aware of the reception given the recommendation of the corresponding committee in the House, proposed a measure of limited scope, whose

broad language was designed to conform to the constitutional requirements of geographical uniformity in taxation, and yet, in practice, to apply with special force in the community property states. The tax on earned income was to be assessed against the person who earned it. The tax on community property income was to be assessed against the person managing the assets. Accordingly, in community property states the husband, because he usually manages the property, would be taxed on nearly all income, and the advantage in taxation given marital partnerships would be removed. This measure did not propose a compulsory joint return, and consequently did not arouse the popular opposition the Ways and Means proposal did. Nevertheless, it suffered the fate of the other recommendation, defeat by the parent body.

The compulsory joint return is a question of taxation, not of states' rights or of morals. Either the individual, or the family as represented by husband and wife, may be regarded as the unit of taxation. Appropriate rates can absorb the same aggregate purchasing power whether the one or the other is taxed. The issue basically is that of treating persons in similar circumstances alike. On this question the Committee on Ways and Means argued that the compulsory joint return:

1) "prevents the income tax law from operating unfairly with respect to a family where all the income is received by one spouse as compared with a family where the income is received by both;

2) removes the discrimination under the present law against earned income in favor of investment income; and

3) treats a family living in one part of the United States in the same manner as a family living in another part of the United States, thus removing the discrimination at present existing in favor of those residing in community property states."

Various arguments are offered against the solution favored by the Committee. It is said that men, having paid a gift

tax in order to endow their wives, ought not to be denied the privilege of filing separate returns. The right to file a separate return is a link in a long chain of hard won rights of women to property, the removal of which might weaken the chain as a whole. And from the community property states comes the plea, made with force by Senator Connally, that "to treat the rights of the wife under the constitutions and statutes of eight great states as non-existent flies in the very face of the heretofore well-recognized principle that the states control the ownership of property and income".[15]

The first of these arguments assumes an implied contractual obligation which does not exist. The payer of a gift tax buys no right to a continuance of the *status quo* in the taxation of personal income. Moreover, that the gift tax serves primarily as a less expensive substitute for the estate tax is usually ignored by those who advance this first argument. The second argument ignores the fact that under the proposal of the Committee on Ways and Means, the married man and the married woman are treated alike. Moreover, either spouse might elect to have the liability in the return apportioned according to individual obligation. The Committee sought merely to shift the basis of reporting from the individual to the family unit, as measured by the combined income of husband and wife.

The third argument reasons from the right of the states to define ownership of income to the right of the federal government to tax. Its basis is the established legal principle that ownership of income or property according to state law entails federal recognition of such title. On substantive grounds, the federal government may wish to lay a tax which runs counter to the interests of certain income receivers or property owners in community property states. Whether the above-mentioned principle is a bar to compulsory joint returns is for judicial determination.

The Ways and Means Committee proposal has also been criticized for not distinguishing separate or noncommunity

income from community income. For, under its plan, the income of the woman, independent of her marriage, would be incorporated with that of her husband for taxation at higher rates. Accordingly, a provision has been favored stating that "the amount reported on each return shall be determined without increase, diminution or division because of any right, title, or interest created by or dependent on the marriage relation".[16] But, if such a remedy should prove impossible of enactment, it has been suggested that all incomes be taxed as in community property states.

Both solutions would remove the special advantage of married persons in community property states. They differ, however, in their dispensation of benefits. Under the first, married couples with two incomes would be favored, as at present, over married couples with a single income. Under the second, married couples with community income would be favored both over married couples with income outside the community and over single individuals.[17] Neither makes the family income the unit of taxation as measured by the combined income of husband and wife. That view of the taxable unit is strongly indicated when taxation is designed to reduce consumption, for in general the family is the consuming unit. It may be more fundamental than elimination of the difference between the treatment of taxpayers in community and noncommunity property states, or any incidental distinction that may be made between the taxation of married and of single persons.

No one rule can apply with equal fairness to all. Undoubtedly choice of the family unit of taxation would mean higher taxes on many married couples than each would pay if taxed separately. In 1938, of 3,041,624 married couples who reported income only 175,598 filed separate returns.[18] The number would be higher under more recent laws, with their steeper rate graduation. But the possible inequities arising from uniform treatment of these couples seem less important than the inequities inevitable under the individual

unit of taxation. Why should a family to which both husband and wife contribute income pay less in taxes than a family to which only one member contributes? Most individual incomes are ultimately family incomes. The joint return simply recognizes that fact for purposes of taxation. From the viewpoint of war incentives, however, the joint return may be viewed as possibly discouraging the wife from going into productive work: her income would be subject to a rate at least as high as the highest bracket rate on her husband's income. For this reason, an additional 'earned income' credit may be advisable for cases in which both spouses report 'earned' income.

Deductions for Miscellaneous Taxes Paid

Federal taxes on various commodities and services, for example, admissions, club dues, telegraph and telephone messages, and theatre tickets, may be deducted if they are imposed, by the form of the law, on the person filing the return. State taxes on commodities and services, including retail sales, gasoline, tobacco, electricity, gas, and the like, are deductible under similar conditions. State income and automobile license taxes, and state and local taxes on real estate, except special assessments, offer opportunity for other tax-saving deductions.

These deductions have diverse and not altogether consistent bases. The test for the deduction of a tax on a commodity or service is payment by the person filing the return, and the fact of payment is established by the *form* of the law levying the tax. Thus this deduction is based on the theory that the incidence of a tax may be determined by law. On the surface, this is not to be denied: the law can prescribe the person from whom the tax is to be collected, even though some other person (e.g., a seller of gasoline) acts as the state's collection agent. But to reason from the passage of the tax money to its payment, or from no formal exchange of this kind to the nonpayment of a tax, is to hold that the incidence

or final payment of a tax may be determined by law. Acceptance of this theory under the federal income tax law now causes such anomalies as the deductibility of gasoline taxes paid in some states and denial of the deduction in others, and the deductibility of some state tobacco taxes while other state taxes and the federal tax on this commodity may not be deducted. Moreover, the theory itself is false. Determination of the final and therefore sole true payment of a tax is the function of economic analysis, not of the statutory form.

But once that function is performed and the burden of a tax on a commodity or service is located, the tax should not necessarily be deducted from the income of the person making the final payment. He may have been recompensed through the benefit of some public enterprise financed by the tax. When no special benefit is received, he may still have paid through the tax a share of governmental costs properly chargeable to him. Or, as in the instance of a tobacco or liquor tax, the state may intend that purchases of this sort shall be especially burdened. No one of these situations offers clear support for favoring within the same income classification the purchaser of taxed articles over the purchaser of untaxed articles, or for distinguishing his situation respecting the deduction from that of purchasers with incomes exempt from the income tax and therefore not relieved by the deduction.[19]

Another deduction, long permitted under the revenue acts, is interest paid, regardless of the purpose of the indebtedness: interest on loans to purchase houses or for consumption or other personal purposes stands on the same footing as interest incurred as a cost of producing income. If, in determining whether interest is deductible for calculating taxable income, the government wishes to distinguish between business and nonbusiness loans, precedent can be found in various provisions of tax statutes where the test has been whether the expenditure was incurred in the expectation of profit. Denying the deduction of interest paid on nonbusiness loans would

lead, in the aggregate, to a very substantial increase in the total net income subject to tax.

Deductions for nonbusiness interest payments and for taxes on commodities and services, and the automobile license, could be eliminated simply by their denial, yielding a revenue of perhaps $200 million.[20]

4 TAX AVOIDANCE

Action to augment the yield of the personal income tax, including especially advances in rates, would make avoidance even more tempting. The higher the tax payment on a given income, the greater the reward for avoidance; the temptation is sharpened by graduated rates, because any decrease in income subject to taxation reduces the amount to which the highest rates apply and becomes especially effective in reducing the tax payment. Hence it becomes necessary at this point to consider measures which might be taken to prevent or reduce avoidance of the personal income tax.

Tax Exempt Securities

Many methods formerly available for avoiding payment of income taxes have been invalidated by successive changes in the law. The principal method still available is the purchase of tax-exempt securities, which changes the tax status of income. State and local bonds and some federal issues are wholly tax exempt. The purchaser who converts a portion of his income-yielding assets into these securities reduces the amount of income subject to tax and his taxes. If he invests all his assets in tax-exempts, he will pay no tax whatever on property income.

On June 30, 1941, approximately $20 billion of state and local government securities, interest from which is wholly exempt from both normal tax and surtaxes, were outstanding.[21] About $4.8 billion were held by federal, state, and local government trust and investment funds, and the re-

mainder was in private hands. Of the federal debt outstanding in the hands of the public, only $4.8 billion, consisting mainly of low interest short term notes, were exempt from surtaxes; though to this amount should be added about $1.1 billion of wholly tax exempt Federal Land Bank and Joint Stock Land Bank bonds. The public also held some $30 billion of partly exempt federal securities, which are less effective as instruments of tax avoidance because they are exempt from the normal tax alone.

The federal government has provided by law for the taxation of all future issues of its securities. State and local obligations, however, may still be issued on a tax-free basis. Moreover, even if future issues were made taxable, the huge amount already outstanding, much of which is still held by individuals and institutions subject to relatively low rates of tax as compared with the rates applicable to the higher levels of individual incomes, would constitute a reservoir of tax-exempt issues, purchasable in the open market, for investors seeking to avoid federal income taxes. Even under 1941 rates, Secretary Morgenthau has estimated that $200 million of additional revenue would be received if the tax immunity of state and local government securities were removed.[22] Transfers of existing tax exempt securities from individuals subject to relatively low rates to those subject to higher rates could greatly augment the present revenue loss of the federal government arising from the existence of such securities. The recent and expected further advances in income tax rates, moreover, provide a strong incentive for just such transfers. For example, to an individual with a $5,000 net income from other sources, a 4 per cent municipal bond offers the same net yield after allowing for taxes as a taxable security returning 4.60 per cent; but to an individual with a $100,000 net income from other sources, it offers as large a net yield as a 12.50 per cent return from a taxable security. Under the rate schedule proposed by Secretary Morgenthau before

the House Ways and Means Committee on March 3, 1942, a man with a net income of $100,000 from other sources would obtain a larger net yield after taxes from a 4 per cent municipal bond than from a 33 per cent return on a taxable investment.[23] The wartime need for revenue and his desire to prevent holders of tax exempt securities from avoiding wartime advances in tax rates, as well as other considerations, led Secretary Morgenthau to propose, in his March 3 statement, the immediate taxation of all income from present and future issues of tax-exempt securities. But a constitutional question exists respecting the right of the federal government to tax income from the securities of state and local governments. The Treasury Department has announced its intention of bringing the issue before the Supreme Court as quickly as possible. Meanwhile, Congressional action has been proposed as a speedier solution, and one more likely of favorable action, than a Constitutional amendment.

The treatment of tax-exempt securities is complicated by considerations of equity and good faith with respect to investors, many of whom were moved to buy the securities because the latter were believed to be tax free. To withdraw the privilege of tax exemption, or to withdraw it without compensation, would be regarded by some as a breach of faith, although, technically, the federal government has never made a commitment to maintain the tax immunity of state and local obligations. (Secretary Morgenthau has not proposed to withdraw the immunity from outstanding federal obligations possessing it.) The solution is also complicated by the reluctance of state and local governments to face the prospect of higher interest costs on future obligations, by reason of the withdrawal of tax immunity, although all levels of government taken as a whole would gain more in revenue than they would lose in additional interest costs. Granted constitutional freedom of action, Congress is confronted with the task of resolving these conflicting considerations.[24]

Undistributed Corporate Profits

A corporate device important until recent years as a means of avoiding personal income taxes was the personal holding company. A wealthy man may organize a personal holding company to receive income from his investments. Since the company created by him is subject to his control, he may in its name and through its facilities purchase and sell securities, borrow money, manage properties, and carry on other financial transactions. Indeed, such a corporation may serve many purposes besides tax avoidance. In its custody, income is taxed at rates applicable to such an organization, whereas, in the possession of the owner, it would be subject to the personal income tax. By limiting his personal receipt of income from the company to living expenses, a wealthy person could formerly profit from the difference between the corporate income tax and the rate at which income in his personal possession would be taxed. The temptation to use so adaptable an instrument was formerly correspondingly great. The advantages of the personal holding company as a means of avoiding taxes have been countered by the imposition of a special tax on personal holding companies at the extraordinarily high rates of 71½ per cent of all undistributed income up to $2,000 and 82½ per cent of all undistributed income in excess of that amount. Therefore only the richest persons can now realize any tax advantage from the organization of a personal holding company. Moreover, the legal definition of a personal holding company offers little hope to the person who would seek to form an incorporated enterprise to accomplish the purposes of a personal holding corporation without becoming liable to the special holding company tax. Consequently, this method of tax avoidance seems to be effectively blocked.

The business corporation may, however, be used indirectly and to a limited extent as a device to avoid the personal in-

come tax. Sometimes this effect is sought and brought about by design. A group of wealthy directors, owning stock in a closely held corporation may vote to retain earnings not so much because of the needs of the business as on account of the large surtaxes for which they would be personally liable were these earnings disbursed.[25] Again, the earnings may be needed by the enterprise, and retention may be decided solely with respect to that need. Even so, the effect of the decision, regardless of the underlying motive, is to avoid payment of such personal income tax as would fall upon dividends if distributed.

Corporations 'improperly accumulating a surplus', that is, retaining earnings in excess of reasonable business needs, are subject to a special tax of 27½ per cent on the first $100,000, and 38½ per cent on any additional amount. Prevention of intentional avoidance alone is sought; if a good reason exists for retaining profits in the business, this may be done without penalty. Even so, in the present situation, this tax may prove to be a powerful weapon against tax avoidance. Under the system of allocating resources according to a priority schedule, companies making military or essential civilian supplies alone are permitted to expand. Consequently the use of retained earnings is limited to situations in which plant expansion is held to be in the national interest. Other companies, being unable to enlarge their facilities or even their inventories, will find difficulty in justifying the accumulation of a large surplus in the form of cash or securities. With the burden of justification on them, they will probably pay out a large part of their earnings. The retained earnings of corporations engaged in war work will enable their stockholders to avoid paying as much in personal income taxes as they would if all earnings were distributed; but the wartime rates of corporate income and excess profits taxation will probably reduce this possibility of avoidance to relatively small proportions during the next few years.

5 TAXATION OF ESTATES AND GIFTS

Because of certain theoretical and practical relations between taxation of individual incomes and taxation of estates and gifts, the latter is discussed briefly in this chapter. In comparison with corporation and individual taxes and excises, levies on estates and gifts are secondary sources of revenue. Under the schedule of higher rates adopted in 1941 they may be expected to yield about $530 million in the fiscal year 1943, chiefly from the levy on estates, to which the gift tax is a mere corollary designed to accelerate the distribution of property and to assist in preventing avoidance and evasion.[26]

Since the death duties have a long tradition of service in emergency fiscal programs, it is not surprising to find that they are now being urged as a source of additional revenue. Strong objections exist to the use of either the gift or estate tax purely as a source of emergency revenue. Both are applied at irregular and frequently widely spaced intervals. Although both have narrow scope, they do place severe burdens upon some of the transfers to which they apply. Funds to pay the estate tax are not always easy to find, and the tax may bring severe hardship in a substantial minority of cases, especially when the estate consists entirely or largely of property for which no ready market exists.

Sudden or frequent rate changes would cause discriminatory treatment among individuals making transfers of like size. The heirs of someone dying in a period when the federal government needs revenue badly may well ask why they should pay exceptionally high taxes, while the heirs of another are taxed more lightly because he dies in a period of relative fiscal ease. In the case of both these transfer taxes, and especially because of the involuntary basis for the transfer in the case of the levy on estates, excellent *prima facie* argument exists for maintaining a rate schedule, a set of exemptions, and a tax law which will not be subject to drastic temporary changes.

This argument is reinforced by the fact that these taxes are poor instruments for implementing short-run fiscal policies intended to alter the volume and direction of the money flows in a capitalist society. They are very slow in producing results of the sort needed to control inflation, particularly the levy on estates, which is not due until fifteen months after the date of death and whose payment can be postponed as much as ten years more if the taxpayer can show that unusual hardship attends earlier payment.[27] Consequently the estate tax would be a most unsatisfactory method of reducing consumer income, the chief current role assigned to a system of war finance. In less degree the same thing is true of the tax on gifts.[28]

Despite these considerations, revision of these taxes deserves examination. Devices intended to produce in the present some of the revenues that will accrue in the future are well worth examining; moreover, a permanent revision of these taxes may be in order. For example, higher estate taxes persisting after the war will aid in meeting the postwar revenue needs, in which a heavy interest charge on the enlarged public debt will be a major element. Hence a strong argument can be made in favor of carrying through now any upward revision that is deliberately a matter of long-run policy, not merely a temporary device for the duration.

One plan for speeding up collections under the estate tax was offered at the Congressional hearings on the revenue bill of 1941. As presented, it provided that individuals could deposit funds in earmarked accounts at the Treasury for the purpose of meeting the tax liabilities against their estates at death. No interest was to be paid, but the accounts were to be redeemable at their face value when the estate tax came due and provision was made for refunds in the event the earmarked account exceeded the tax. The inducement was the exclusion of the account from the net estate upon which the tax would be imposed. While a device of this type is almost certain to produce an additional current demand for govern-

ment bonds, in which the funds so earmarked would presumably be invested, the extent to which that demand would arise out of current savings instead of from previous accumulations is not likely to be great, and some of the funds would doubtless be obtained from a smaller investment in insurance. The result would be at the very least a partial offsetting of one demand for government bonds by another.

However, even if the efficacy of this device as a means of bringing in money promptly can be assumed, strong objections can be raised against it. Not only is the bait that is supposed to produce immediate revenues a tax concession running to about $100 million,[29] but these accounts would clearly be relatively more attractive to larger estates, for they withdraw assets from the top bracket to which the tax is being applied. Hence the benefit realized will tend to be strongly regressive in its effects, which is a forceful argument against the prepayment scheme in this particular form.

However, an alternative has the sanction of a precedent set during World War I: granting permission to pay estate taxes with government bonds. Since the inducement is not the withdrawal of assets from the taxable estate, the obviously regressive effects of the first scheme are avoided. The inducement takes the form of a guarantee against loss resulting from a decline in the market price of the government security between the date of purchase and the date the tax is due. This would require the issuance of registered coupon bonds which would be receivable at par or at the purchase price, whichever is higher.[30]

Of course this prepayment scheme involves a risk of loss on the part of the government, but to the extent that it works, it will tend to maintain the market for government bonds and hence to lessen the risk of loss itself. Although it may well be argued that the results are uncertain and especially that the amount of government bonds which would be purchased from current savings on this account is highly questionable, the cost of the scheme is not large.

A second and more important issue to be discussed here is the desirability of a permanent reconstruction of the estate and gift taxes now. This is not the place for a thoroughgoing review of the loopholes that might be plugged in the interest of greater yield. Fortunately most of those remaining are minor and attention can be concentrated upon a few questions at the heart of current debate, namely, the concessions made to insurance, the issues involved in laws of the community property states, the relation between gift and estate taxes, and the rates imposed and the exemptions allowed under the latter.

In part the insurance problem is a matter of bringing within the scope of the tax policies which are taken out on the life of the decedent but are not payable to his estate, and in which he has retained none of the property rights the courts label the incidents of ownership. Until recently such polices were not taxable under the estate tax and hence constituted an attractive avenue of avoidance. Recently the government has been attempting to tax them in whole or in part on the basis of the payment of premiums by the insured decedent, but as this tactic has vainly been tried before in the courts it is not a certain remedy. One alternative within the power of Congress is a special levy on the transfer of insurance. However, it is doubtful that such a tax could be made to vary with either the size of the insured's estate or the total amount the beneficiary receives upon the death of the insured. If this cannot be done, the remedy will be only partial and the loophole will have been only partly closed.

Even if the proceeds of an insurance policy can be brought within the decedent's gross estate, the law excludes the first $40,000 worth of insurance from the net estate upon which the tax is applied. This concession is purely a matter of policy and can be withdrawn at the will of Congress. The arguments raised in its favor boil down to the thesis that no increment occurs at the time of death, that the funds re-

ceived do little more than compensate for the loss of the decedent's earning power, and a similar argument to the effect that insurance is merely an accumulation intended to provide for a future need. The same arguments can be advanced for other forms of savings, and do not establish a case for the special treatment of this particular form. The same conclusion may be drawn respecting the repeated suggestion that an accumulation of insurance be permitted outside the gross estate in order to provide a fund from which the estate taxes can be paid. The one really satisfactory justification for the present exclusion would be the establishment of the idea that insurance is an especially desirable method of saving from a social point of view. Against this view may be cited the development of governmental insurance schemes as well as the limited scope and peculiar distribution of the holdings of private insurance. A strong case exists for withdrawing the concession, unless Congress wishes to grant a subsidy to savings in the form of insurance.

The systems of property law used in the community property jurisdictions are a source of another major defect in the estate tax. Half of the current accumulations of a husband and wife that do not arise from what is known technically under such laws as their separate property is regarded as vested in each. Hence only half of these assets is subject to death duties on the death of either, a fact which, taken in combination with a substantial exemption and sharply progressive rates, discriminates in favor of estates passing under this system of law, and implies some reduction in the yield of the federal tax. One solution proposed is a federal tax on the power of management, all of which, under the law in community property states, is normally in the hands of the husband and passes from him upon his death.

Third among the major problems is the relation between the schedule of rates in gift and estate taxes. Each is highly progressive, each is computed independently, and the gift tax rates are decidedly lower. The net effect is to provide an in-

centive to distribute assets by gifts among the living. If the social results and the reduction in tax avoidance achieved by this preferential treatment are believed inadequate to compensate for the loss of revenue, the tactic indicated is the addition of the gifts the decedent has made during his life to his net estate upon his death, and the computation of a tax due on the basis of this total, against which tax the gift taxes which had previously been paid with respect to the assets in question will be allowed as a credit. Opinion is by no means unanimous, however, that the preferential treatment of gifts is not justified by the results.

A final question concerns the appropriate rate schedule and the exemptions of the estate tax, even if the integration just discussed is not attempted. The estate tax is characterized by a relatively large exemption, relatively low rates on small estates and even those of considerable size, and punitive rates on large fortunes. The present rates, particularly on the lower brackets, are notably less severe than those prevailing in Great Britain. There is a clear possibility of raising considerable additional revenue by lowering the exemptions and by a drastic increase in the rates applied to all except the very largest estates.

Although such action may be found expedient and desirable, it must be taken cautiously and with due consideration of the effect upon the states. The latter also have made use of these taxes for a considerable period, and a few rely upon death duties for a substantial portion of their total tax revenue in an average year. For this reason, not all the additional yield of a more aggressive federal tax should be counted upon to increase federal revenues. The estate and gift taxes could be made to contribute more to federal revenues in the immediate as well as the more remote future; how much depends upon the action taken: by drastic advances in rates, especially on smaller and medium size estates, and by lowering exemptions, the yield could perhaps be doubled, adding $500 million to the federal tax revenue.

NOTES

[1] Taxable income may be defined with approximate accuracy as net income realized in money from all sources other than tax-exempt securities, or in things of monetary value arising in the conduct of business operations. Thus wages, salaries, commissions, profits on unincorporated businesses, royalties, net rents, dividends, interest, and gains (subject to special provisions) from the sale of property are taxable income; as are compensation in property or in board and lodging, and gains arising from the exchange of property or (with some reservations) from changes in the value of an inventory.

[2] The Act of 1941 contains an innovation: taxpayers computing payments on incomes of not more than $3,000 derived wholly from wages, salaries, compensation for personal services, dividends, interest, annuities, or royalties may file on Form 1040A. In developing this form, allowance was made for *average* deductions, as compiled from previous tax returns, taken by persons of this income group. The taxpayer has only to subtract the personal exemption and credit for dependents, if any, from his income, and find by inspection the tax on the remainder.

[3] Strictly, such addition is not wholly valid, because the basis of calculation is not exactly the same for the normal tax as for the surtax.

[4] We say here 'a given *percentage* increase in surtax net income', because the horizontal scale of the chart is on a ratio basis: equal distances along the scale represent equal percentage increases, not equal amounts of increase in income.

[5] The average rate of surtax discussed above, computed as a ratio of the total surtax to surtax net income, should not be confused with the effective rate sometimes useful in measuring the full weight of a tax burden. The essential difference is that the effective rate is obtained by dividing the total surtax (or, if the entire income tax and not only the surtax is considered, the total tax) by total net taxable income *before* personal exemption and credits for dependents have been deducted, rather than by surtax net income, which is after such deductions. Hence, the effective rate of tax is always (provided personal exemption and credits for dependents are allowed against net taxable income before computing the surtax, as under the present law) less than the average rate used above.

Because the personal exemption and dependent credits vary among taxpayers, no *single* curve of effective rates applicable to *all* taxpayers could be drawn. The best that could be done would be to construct a curve of effective rates for an 'average' taxpayer having the 'average' exemption and credits. Such a curve would show somewhat lower rates than the average rates of Chart 8, but the difference would become smaller as income increased and would be scarcely discernible for large incomes.

[6] Thus, even a person who supposes that purely political considerations controlled the rate advances of the 1940 Act would discover that, whereas it did not raise surtax rates (it did, however, raise the total income tax 10 per cent,

by the Defense Tax, applied at all levels) on incomes below $6,000, it *might* have yielded as much revenue without advancing surtax rates on incomes up to a level considerably above $6,000, if it had added still heavier burdens above that level.

[7] To indicate roughly the significance of these descriptive levels of income, we would suggest $1,750 as the upper boundary of the 'low' brackets and $10,000 as the lower boundary of the 'high.' The 'lower intermediate' brackets would run from $1,750 to about $5,000; and the 'upper intermediate' from $5,000 to $10,000. The 'lower high' brackets run from $10,000 to $20,000, and at a later stage we shall speak of the 'middle high' as running roughly from $20,000 to $100,000.

[8] They would not be confiscatory if each authority recognized a tax levied by the other as deductible from income before the calculation of its tax.

[9] The entire increase in revenue from new surtaxes imposed on income for the calendar year 1942 would not become available for the fiscal year 1943. Under the 1941 Act, the increase in the fiscal year 1943 would be only about one-half of the total increase, as only two of the quarterly installments of taxes on 1942 incomes are paid before June 30, 1943. See, however, Chapter 11, where the bearing of stoppage-at-the-source on the timing of revenue and its applicability to surtaxes are discussed.

[10] In this estimate effect is given to the earned income credit.

[11] Since the effect of the personal exemption is alone being considered, the earned income calculation is not made here.

[12] Another way of limiting the effect of the personal allowance would be to permit its deduction only from the first bracket of income subject to taxation; then the allowance would always bear the same relation to the combined rate. Either method, with present rates and exemptions, would give the same yield.

[13] A married man with two children having an income of $3,000 would count all the income earned and have a credit of $300. His personal allowance would be $2,300 and his income subject to normal tax of 4 per cent would be $400 after the earned income credit and $700 without it; the normal tax is reduced from $28 to $16 by the credit. If the first surtax rate was 26 per cent, his surtax would be $182. The $12 saved by his credit, while not negligible, is a very small part of his entire tax, about 6 per cent.

[14] Estimate of a Treasury representative, apparently for the fiscal year 1942, in *Revenue Act of 1941*, Hearings before the Senate Committee on Finance (77th Cong., 1st Sess. 1941), p. 8.

[15] This view, said to be that of "the only community property state Senator on the Finance Committee," was published as a supplement to the report of the Committee.

[16] G. T. Altman, Community Property and Joint Returns, Taxes, *The Tax Magazine*, Oct. 1941.

[17] If half the earnings of the husband were taxed to the wife, the aggregate

tax paid by both would be less under the prevailing scale of graduated rates than the tax paid by a single individual receiving an equal income.

[18] Committee on Ways and Means, Report, *Revenue Revision of 1941*, p. 16.

[19] The issue whether property taxes, most of which are imposed on real estate, should be deducted, is more complicated and can be considered best in connection with the treatment of rent. A person receiving rent must report it together with any additional income, but may deduct taxes on the rented property and other expenses incurred in obtaining this rent. The occupant of a house who is also the owner is not required to report the annual value of the occupancy, yet may deduct interest payments on the mortgage or other indebtedness as well as taxes paid on the house. A desire to foster home ownership possibly explains in part this form of subsidy; but as we are solely concerned with the taxation aspects of this question, not with the general issue of the subsidy, we merely note that home ownership could be subsidized by other means.

The tenant suffers from a one-way discrimination as compared with the landlord, and a two-way discrimination as compared with the owner-occupant. In his rent, on the average, is included the amount of the landlord's taxes on the house or apartment occupied. Yet these taxes, together with any on the ground value of the property, may be deducted from the income, for tax purposes, of the landlord. The tenant may not deduct the rent (in which the hidden tax is included) from his income, yet the owner-occupant of real property of equal annual value is not required to include that value in his income and may even deduct the taxes on the property.

To remedy this inequitable situation, the privilege of deducting property taxes on owner-occupied houses might be withdrawn, or the annual value of the owner-occupant's house might be included in his income. But denial of the deduction of taxes would do little to equalize the situation of the tenant with that of the owner-occupant. The tenant would not be able to deduct his rent, and the owner-occupant would continue to enjoy an income from occupancy on a tax-free basis. A treatment that meets both inequities would require the annual value of any real estate occupied by the owner to be included in his income. Inasmuch as the annual value would, in common with the rent of leased dwellings, include part of the real estate tax, *both* the inclusion of the annual value and the denial of the deduction of the property tax would not be fair, because a portion of the property would be taxed twice.

[20] Estimated largely on the basis of deductions for automobile ownership and operation. A much larger sum, possibly as much as $400 million at tax rates under the Act of 1941, would be realized by the inclusion of the annual value of the occupancy of owner-occupied homes. To gather such a revenue would require the addition of a considerable administrative staff to the Bureau of Internal Revenue, for checking valuations would be difficult, especially in the first years. Assuming, however, that occupancy values were determined with fair accuracy, both the cause of equal treatment and of absorbing more purchasing power would be served by the adoption of this measure. However,

when heavy administrative burdens are being added to the Bureau by other changes in the law, this further task will be advanced as an argument against changing the treatment of income from owner-occupied houses; and the political resistances to such a change may be decisive, even in the face of the exceptional fiscal needs of wartime.

[21] Secretary of the Treasury, *Annual Report, 1941,* pp. 629 ff.

[22] Statement of March 3, 1942 before the House Ways and Means Committee.

[23] After allowing a personal exemption of $1,500 in each case.

[24] See Lawrence H. Seltzer's more detailed discussion in the report of the Thirty-Fourth National Tax Conference held at St. Paul, Minnesota, Oct. 13-16, 1941: *Possibilities of Speeding the Elimination of Tax-Exempt Securities.*

[25] This is less likely to happen in a corporation the stock of which is widely held.

[26] In the fiscal year 1941 the gift tax yielded $51,864,000; the levy on estates, $355,194,000; the combined yield accounted for about 5 per cent of total federal tax revenue.

[27] The delay in collection arises because the tax is levied on the net estate and the latter cannot be determined until the affairs of the decedent have been looked into thoroughly. The extension of time beyond the ordinary due date reflects a desire to avoid penalizing unnecessarily an estate made up of assets that are not readily salable in order to get liquid funds to pay the tax. Here immediate payment would cause a severe reduction in the net estate beyond the amount this tax would take from an estate of similar size which is in liquid form.

[28] The gift tax is due on March 15 following the close of the calendar year in which the gift was made and payment may be extended for an additional six months.

[29] The estimate of revenue loss under the rates applied in 1940 mentioned by Representative Dewey.

[30] As evidence of the purchase date the broker's certificate of purchase would have to be presented when the tax is paid.

An alternative would be a special issue of bonds always receivable at par.