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THE REVENUE ACT OF 1964: A CRITICAL ANALYSIS

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IN its inception the Revenue Act of 1964¹ was intended to achieve the dual objectives of reducing the rates of the income tax and closing some of its more egregious loopholes. After the Kennedy administration professed its willingness to accept tax reduction without tax reform, any serious effort to improve the structure of the law was abandoned. The result is that the new act accomplishes some rate reduction, but does little in the way of tax reform.

RATES

The most significant achievement of the 1964 Act is rate reduction. This is scheduled to take place in two stages during 1964 and 1965, with approximately two-thirds of the total reduction taking effect in 1964.

The income tax rates for individuals are reduced for 1964 from a top bracket of 91 percent and a bottom bracket of 20 percent to a top bracket of 77 percent and a bottom bracket of 16 percent. In 1965 the maximum bracket becomes 70 percent and the minimum 14 percent.² Actually, individual tax savings are less substantial than they seem in view of the proposed increases in the social security tax. For example, a married taxpayer with an income of

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¹ 78 Stat. 19 (1964).

² Under prior law the minimum tax of 20% was applicable to the first \$2,000 of taxable income. Under the 1964 Act, the corresponding 1964 tax is 16% for the first \$500 of taxable income, 16.5% for the next \$500, 17.5% for the next \$500, and 18% for the final \$500. In 1965 the rates will be 14%, 15%, 16% and 17% for corresponding brackets of taxable income. INT. REV. CODE OF 1954, § 1, as amended, Revenue Act of 1964, § 111, 78 Stat. 19 (1964).

\$5,400 will save \$56.60 in income taxes under the 1964 Act in 1965. However, if the increases in the social security tax, which are pending in Congress as this is written, are passed, his social security tax will increase by \$31.20, so that the net saving will be only \$25.40. If the same taxpayer is self-employed and pays the self-employment tax, his net tax saving will be only \$8.³

As far as corporations are concerned, the new act reverses the rates of the normal tax and the surtax with the result that for 1964 and succeeding years the corporate normal tax will be 22 percent, as contrasted with 30 percent under prior law. Although this means a substantial rate reduction for small corporations, the 1964 Act raises the corporate surtax (after an exemption of \$25,000) from 22 percent to 28 percent for 1964 and to 26 percent for 1965.⁴ Consequently, in 1964 the corporate tax for larger corporations will be 50 percent, or only 2 percentage points less than the tax for 1963. In 1965 and succeeding years the corporate tax will be 48 percent, or 4 percentage points less than the tax imposed under prior law. As a matter of fact, it is doubtful whether larger corporations will benefit to any extent from the new rates. Under prior law a corporation whose estimated income tax exceeded \$100,000 was required to pay 50 percent of the excess in advance during the current taxable year. Under the 1964 Act the estimated tax payments which must be made in advance are scheduled to be stepped up continuously, until by 1970 corporations will be required to pay 100 percent of their estimated income tax in excess of \$100,000 in advance.⁵ This speed-up in payment of the corporate tax should offset any benefit that larger corporations will derive from the lower rates.

While the 1964 Act was pending in Congress, most of the discussion of the new law revolved around the wisdom of reducing taxes in a period of prosperity when the government was already running a sizeable deficit. The justification for the apparent indifference to national solvency manifested by the new law is embodied in a preliminary "Declaration by Congress," which asserts that

It is the sense of Congress that the tax reduction provided by this Act through stimulation of the economy, will, after a brief transitional period,

³ U.S. News & World Report, July 20, 1964, p. 24.

⁴ INT. REV. CODE OF 1954, § 11, as amended, Revenue Act of 1964, § 121, 78 Stat. 25 (1964).

⁵ INT. REV. CODE OF 1954, § 6154, as amended, Revenue Act of 1964, § 122, 78 Stat. 25 (1964).

raise (rather than lower) revenues and that such revenue increases should first be used to eliminate the deficits in the administrative budgets and then to reduce the public debt.⁶

One can only hope that congressional optimism about lower taxes producing higher revenues will prove justified. Certainly past experience affords no basis for presuming that any increased revenues will be used to balance the budget and pay off the public debt, rather than finance increased expenditures.

AVERAGING

The one substantial structural achievement effected by the new law is the introduction of a new system of income averaging.⁷ This could be a significant milestone in the progress of the income tax.

One of the serious inequities of a progressive tax imposed upon income earned in a taxable period, such as the taxable year, is that it imposes an undue burden upon the taxpayer who has an irregular income which "bunches" up in a single taxable period. For example, if one lawyer earns a salary of \$10,000 a year for ten years, while another lawyer works on a single case for ten years, receiving a contingent fee of \$100,000 in the tenth year, both have equal amounts of income over the same period. However (apart from any relief against "bunching"), the second lawyer's tax liability will be much greater than that of the first. The 1963 law contained a number of haphazard, *ad hoc* provisions directed against bunching.

⁶ Revenue Act of 1964, § 1, 78 Stat. 19 (1964).

⁷ The 1964 Act replaces §§ 1301-1307 of the 1954 Code, which permitted various forms of averaging in specified situations, with new §§ 1301-1305. Revenue Act of 1964, § 232 (a), 78 Stat. 105 (1964). However, an individual who receives compensation from an employment that extended over thirty-six months or more and commenced before February 6, 1963, may still elect to compute his tax under the old provisions. Revenue Act of 1964, § 232 (g) (2), 78 Stat. 112 (1964). The new rules also replace the old provisions under which lump sum payments from annuity, endowment or life insurance policies could be spread over a three year period. Revenue Act of 1964, § 232 (b), 78 Stat. 110 (1964). They do not apply, however, to capital gains, certain income from gifts and bequests, wagering gains, or premature payments from a self-employed pension plan subject to the penalties prescribed by § 72 (m) (5) of the Code. INT. REV. CODE OF 1954, § 1302 (b), as amended, Revenue Act of 1964, § 232 (a), 78 Stat. 105 (1964). There are special rules for averaging by married couples. INT. REV. CODE OF 1954, § 1304 (c), as amended, Revenue Act of 1964, § 232 (a), 78 Stat. 105 (1964). Moreover, averaging is limited to individual taxpayers who are citizens or residents of the United States during the entire taxable year, and, with certain exceptions, may not be utilized by a taxpayer if he and his spouse furnished less than half of his support during any base period year. INT. REV. CODE OF 1954, § 1303, as amended, Revenue Act of 1964, § 232 (a), 78 Stat. 105 (1964).

These provisions followed no uniform pattern and laid down different formulae for different situations, rather than providing any general panacea for the problem of bunching. The new act replaces these sections with a general prescription by which the taxpayer who has an exceptionally large income in a given year is afforded relief regardless of the source of his income. The basic concept underlying the new provisions is simple, although like any tax law it can get quite involved when it becomes enmeshed with the details of a specific situation. If the taxpayer's income exceeds one and one-third, or $133\frac{1}{3}$ percent, of his average income for the previous four years, or base period, by more than \$3,000, he can compute the tax on this excess, which is called his "averageable income," as though it had been received rateably over a five year period. This is achieved by computing a tax on one-fifth of the averageable income at the rates for the current, or computation, year, and multiplying the result by five. Of course, the amount of tax on one-fifth of the taxpayer's averageable income depends upon the bracket at which the tax is computed. Generally, the tax is computed at the bracket beginning where the tax on $133\frac{1}{3}$ percent of the taxpayer's average base period income plus his average base period capital gains leaves off. For example, suppose that a single taxpayer's average base period income was \$6,000, his income for the computation year amounts to \$12,000, and he has had no capital gains or other income requiring special treatment under the averaging provisions. His current income for the computation year exceeds $133\frac{1}{3}$ percent of his average base period income (\$8,000) by more than \$3,000 (\$4,000), so he is entitled to compute the tax under the averaging provisions. He does this by computing a tax (ignoring deductions and exemptions) on \$8,800 (\$8,000 plus one-fifth of \$4,000), which amounts in 1964 to \$1,994. Then he computes a tax on \$8,000, which amounts to \$1,750. The difference between these two taxes, or \$244, is the tax on one-fifth of the taxpayer's averageable income computed at the bracket above $133\frac{1}{3}$ percent of his average base period income. Consequently, his total tax is \$1,750 plus five times \$244, or \$2,970. If the taxpayer had chosen not to average, his tax upon an income of \$12,000 would have been \$3,040. Thus, he saves \$70 by averaging. Of course, the savings due to averaging increase with the size and disproportion of the taxpayer's income.

CAPITAL GAINS AND LOSSES

The new provisions for averaging suggest a felicitous solution for taxing capital gains. Unfortunately, it is a solution that Congress did not adopt. The 1964 Act was conceived amid talk of reforming some of the abuses connected with the taxation of capital gains whereby such things as the profits from selling timber, mining coal, raising livestock, growing crops and selling patents, along with the gains from lump sum pension payments and stock options, are treated as capital gains. By the time the proposed act emerged from the House of Representatives, the crusade to separate "true" from bogus capital gains had crystallized in the form of an additional preference for "true" capital gains. Gains from the disposition of "true" capital assets held for more than two years were to be included in taxable income only to the extent of 40 percent, with a maximum alternative tax of 21 percent. Other capital gains were to be taxed as they were under the prior law, that is, 50 percent of the gain from the disposition of assets held for over six months was to be included in taxable income, with a maximum alternative tax of 25 percent.⁸ Fortunately, this monstrosity was deleted by the Senate Finance Committee. The campaign to reform the taxation of capital gains ended in an extension of capital gains treatment to royalties from mining iron ore,⁹ obviously an equitable result in view of the fact that royalties from coal mines are granted the same preferential treatment. This is about par for this type of tax reform.

Some minor changes were made by the 1964 Act in connection with the computation of the capital loss carryover. The rules for corporations were not changed. In the case of individuals, however, the new law removes the five year limitation on the carryover of capital losses, with the result that such losses may now be carried over indefinitely. A capital loss carryover, which automatically became a short-term loss under the prior law, retains its original character under the new law. This means that when a long-term loss is carried over it must be offset first against long-term gains. The new law also provides that in offsetting a net capital loss against \$1,000 of ordinary income, short-term losses must be applied first.¹⁰

⁸ H.R. REP. NO. 749, 88th Cong., 1st Sess. 95-100 (1963).

⁹ INT. REV. CODE OF 1954, §§ 272, 631 (c), 1231 (b) (2), as amended, Revenue Act of 1964, § 227, 78 Stat. 97 (1964).

¹⁰ INT. REV. CODE OF 1954, § 1212, as amended, Revenue Act of 1964, § 230, 78 Stat. 99 (1964).

Several interesting provisions of the new law are indirectly connected with the problem of taxing capital gains. One of these is the new provision for taxing "unstated interest."¹¹ Since interest is taxed as ordinary income, taxpayers have resorted to deferred credit sales in order to conceal interest charges beneath a flat price, thus converting ordinary interest income into capital gain. For example, suppose that A is about to sell Blackacre to B for \$10,000, payable \$1,000 down and in nine annual installments of \$1,000 each. Instead of taking B's notes for \$9,000 at 6 percent interest, an arrangement which would yield about \$2,700 in ordinary interest income over the nine year period, A might sell the property for \$1,000 cash and nine annual installments, each in the face amount of \$1,300, in order to realize the interest as capital gain. The 1964 Act seeks to put an end to this practice by providing that where installment payments are to be made in connection with a deferred payment sale for \$3,000 or more, any installment due more than one year from the date of the sale shall be deemed to contain an element of "unstated interest," unless the contract calls for interest at the rate within 1 percent of a rate to be fixed by the Treasury.¹² There is a complicated statutory formula for discounting future payments to determine unstated interest. The new provision for taxing unstated interest points up another evil relative to the preferential treatment of capital gains in addition to its inequities. Most of the complications under the income tax are referable to the capital gains differential. Congress, however, persists in treating symptoms rather than the disease, as is the case with regard to the new tax on unstated interest. Instead of going to the source of the evil and repealing the preferential tax on capital gains, Congress seeks to prevent ordinary income from being converted into capital gain by piecemeal legislation which is complicated and generally ineffective.

There is another new provision in the 1964 Act which is a classic example of legislative deviousness in dealing with capital gains. One method of utilizing the preferential tax on capital gains to avoid income taxes is to realize a partially taxable capital gain in return for a fully deductible loss. For example, a taxpayer might purchase an office building for \$1,000,000, paying \$100,000 in cash

¹¹ INT. REV. CODE OF 1954, § 483, added by Revenue Act of 1964, § 224 (a), 78 Stat. 77 (1964).

¹² *Ibid.*

and taking subject to a mortgage of \$900,000. Assuming that the building has an estimated life of ten years and produces gross rentals of \$100,000 a year, the rental income may be offset entirely by deductions for depreciation. At the end of ten years when he has depreciated the building down to zero, the taxpayer might sell it for \$800,000. Although this would result in a capital gain of \$800,000, which would be subject to a maximum capital gains tax of \$200,000, he would have escaped a tax on \$1,000,000 in rental income, which under the prior law might have been taxed as high as 87 percent. In 1962 Congress sought to put a stop to the capital gains-ordinary loss gambit by adding section 1245 to the Code. This section provides that when a taxpayer sells depreciable property (excluding buildings and their structural components), the gain from the sale shall be taxed as ordinary income to the extent of depreciation deducted after 1961. This provision leaves untouched the capital gains-ordinary loss maneuver in connection with buildings where the greatest abuse occurs. The 1964 Act undertakes to remedy this omission in a peculiarly cautious and ineffective manner. The new law adds section 1250 to the Code, under which gain from the sale of a building is taxed as ordinary income to the extent of the "applicable percentage of additional depreciation" deducted by the taxpayer after 1963.¹³ If a taxpayer sells a building within one year after its acquisition, any gain from the sale is taxed as ordinary income to the extent of any depreciation deducted after 1963. If, however, he holds the building for longer than one year, the taxpayer will realize no ordinary income unless he computed the depreciation taken on the building by one of the accelerated methods. Moreover, ordinary income treatment is limited to the amount by which depreciation computed under the accelerated method exceeded straight-line depreciation. Finally, even though the taxpayer used accelerated depreciation, the additional depreciation (excess of depreciation under the accelerated method over straight-line depreciation), which is taxed as ordinary income, is reduced by one percentage point for every full month over twenty during which the taxpayer held the property before disposing of it. This means, of course, that if a taxpayer holds section 1250 property for more than ten years before disposing

¹³ INT. REV. CODE OF 1954, § 1250, added by Revenue Act of 1964, § 231, 78 Stat. 100 (1964).

of it, he will realize no ordinary income. It is difficult to understand why Congress phrased section 1250 in the manner in which it did, unless it wanted to insure that gains from the sale of buildings would not be taxed as ordinary income. The logical way to deal with the capital gains-ordinary loss gambit in connection with buildings would have been to extend section 1245 to that type of property. It is difficult to see any useful purpose that is served by computing the ordinary income derived from the sale of a building differently from that resulting from a sale of other depreciable property. This becomes particularly striking when it is noted that at the same time it adopted section 1250, the 1964 Act provided that elevators and escalators should be covered under section 1245.¹⁴ This means that when a building is sold, the ordinary income attributable to disposition of the building must be computed under the formula laid down by section 1250, while that arising from the sale of any elevators or escalators in the building must be computed under section 1245. There is, however, a much better solution for the capital gains-ordinary loss problem than either section 1245 or section 1250.

Sections 1245 and 1250 represent the culmination of an incredibly circuitous and devious legislative scheme. Section 1221 (2) provides that depreciable business property and business real estate are not capital assets. If the Code stopped there, any gain from the sale of section 1245 or section 1250 property would be ordinary gain from the sale of a non-capital asset without the aid of those sections. Section 1231, however, provides that any gain from the sale of depreciable business property (which is not a capital asset under section 1221 (2)) shall be treated as a long-term capital gain if the property has been held for more than six months prior to its disposition, although losses from the sale of such property are denominated ordinary losses. The forthright solution to the capital gains-ordinary loss manoeuver would be to repeal section 1231 and tax the gain from depreciable business property as gain from the sale of a non-capital asset. Instead of adopting this simple solution, however, the Code first says that depreciable business property is not a capital asset, and then that gains from the sale of such property shall be treated as though it were, except to the extent that the gain

¹⁴ INT. REV. CODE OF 1954, § 1245 (a), as amended, Revenue Act of 1964, § 203 (d), 78 Stat. 35 (1964).

represents the recapture of depreciation according to the divergent formulae laid down for buildings and other depreciable property by sections 1245 and 1250.

The only satisfactory solution for the capital gains problem is to repeal the differential in favor of capital gains entirely. One of the most serious objections to the current system of taxing capital gains is that it creates most of the complexities which attend the income tax. Sections 1245 and 1250, along with a host of other provisions, represent intricate legislative responses to the tax avoidance possibilities of the capital gains tax which make administration of the income tax in the way in which it is written practically impossible. In addition, it is obvious that the capital gains tax is inequitable. It is absurd to tax the lawyer or the doctor who works for his income at roughly three times the rate enjoyed by the stock speculator. The only argument in favor of the capital gains tax from the viewpoint of individual equity is that capital gains may be earned over a long period of time and realized in a single taxable period, so that it is unfair to tax them at the rates applicable to regularly recurrent income. The basis for this argument was in large measure eliminated, however, when Congress reduced the holding period for long-term capital gains to six months. If the argument has any merit, the perfect answer is the new averaging provisions for irregular income. There is certainly no reason, insofar as the equity of the individual taxpayer is concerned, for treating capital gains differently from other irregular income, or for conceding any more favorable treatment to capital gains than is accorded other income under the averaging provisions.

In addition to the "equity" argument, the principal contention of the proponents of the capital gains differential has been a kind of *in terrorem* policy plea. It has been argued that if capital gains are taxed in the same manner as other income, this will discourage people from selling appreciated assets; gains will be "locked in," resulting in artificial scarcities, inflation, and all sorts of vague, horrendous consequences. The thing which would thaw out frozen capital gains quicker than anything else, however, would be adoption of the kind of provision with which Congress flirted in its deliberations over the 1964 Act, but ultimately rejected. Most of the pressure to keep appreciated property stems from the fact that if the property is retained until the owner's death, it acquires a new basis:

the fair market value of the property at the date of his death, or one year after his death if the alternate valuation date is used in valuing his estate for estate tax purposes. This means that if appreciated property is retained until death, it may then be sold by the owner's successor with no taxable income being realized. For many years it has been argued that gain accruing to property during the owner's life should be subjected to the income tax at his death. If this were the case it would remove any incentive to hold appreciated property. In fact, a man who owned appreciated property might deliberately sell it during his life in order to realize the gain and ease the income tax problems of his estate following his death. Thus, there is an equitable way in which to tax capital gains. They should be taxed in the same manner as ordinary income, subject to the averaging provisions in any year in which there is an unusual amount of such gain. To remove any inducement to retain appreciated property, gains accruing to the property during the owner's life should be taxed at his death. Any lingering reluctance to part with appreciated property during the owner's life might be overcome by a general reduction in tax rates made possible by eliminating capital gains and other loopholes in the law.

PERCENTAGE DEPLETION

Percentage depletion also affords an interesting insight into the legislative process. Aside from the preferential treatment of capital gains, percentage depletion represents the most indefensible loophole in the income tax. Everyone, with the possible exception of the oil and gas interests and their congressional satellites, admits that percentage depletion is unsound in principle and pernicious in practice. Those interested in federal tax matters have long brooded over the taxpayer who had an income of \$14,000,000 from oil and gas holdings, yet paid an income tax of only \$80,000 (an effective rate of 6/10 of 1 percent) due to percentage depletion and its kindred horror, the expensing of intangible drilling costs.¹⁵ For years percentage depletion has been like the weather: everyone talks about it but no one does anything about it. In connection with the 1964 Act, the Kennedy administration advanced the very gentle and modest suggestion that percentage depletion for oil and gas should

¹⁵ SURREY & WARREN, *FEDERAL INCOME TAXATION* 392-93 (1960 ed.) (Statements of the Secretary of the Treasury, *Hearings Before the House Committee on Ways and Means*, 81st Cong., 2d Sess., vol. 1 (1950)).

be reduced. The suggestion got nowhere. The only reference to percentage depletion in the new law is an innocuous provision imposing some limitations on the aggregation of operating interests for the purpose of computing percentage depletion.¹⁶

CORPORATIONS

A. Multiple Corporations

The 1964 Act made some interesting innovations in the taxation of corporations. When Congress lowered the normal tax from 30 percent to 22 percent, this increased the pressure to divide corporate income among a number of corporations in order to obtain multiple benefit from the \$25,000 exemption against the corporate surtax. To offset this tendency, the 1964 Act provides that a controlled group of corporations shall be limited to a single surtax exemption which will be prorated among the group unless they elect an unequal division.¹⁷ A controlled group of corporations includes a parent-subsidiary group connected by 80 percent stock ownership, a brother-sister group owned to the extent of 80 percent by a single individual, trust or estate, and combinations of parent-subsidiary and brother-sister groups.¹⁸ For example, if A owns 80 percent of the stock of X Corporation (by voting power or value) and 80 percent of the stock of Y Corporation, which in turn owns 80 percent of the stock of Z Corporation, a single surtax exemption will be allowed for all three corporations.

The denial of multiple surtax exemptions for controlled groups of corporations is complicated by rules for determining pertinent percentages of stock ownership or control, involving in some cases constructive stock ownership¹⁹ and in others disregard of certain classes of stock.²⁰ The denial is further complicated by an election available to the controlled group whereby multiple surtax exemptions may be taken in return for payment of a penalty tax of 6 per-

¹⁶ INT. REV. CODE OF 1954, § 614, as amended, Revenue Act of 1964, § 226, 78 Stat. 94 (1964).

¹⁷ INT. REV. CODE OF 1954, § 1561, added by Revenue Act of 1964, § 235 (a), 78 Stat. 116 (1964).

¹⁸ INT. REV. CODE OF 1954, § 1563, added by Revenue Act of 1964, § 235 (a), 78 Stat. 116 (1964).

¹⁹ INT. REV. CODE OF 1954, § 1563 (d), (e) and (f), added by Revenue Act of 1964, § 235 (a), 78 Stat. 116 (1964).

²⁰ INT. REV. CODE OF 1954, § 1563 (c), added by Revenue Act of 1964, § 235 (a), 78 Stat. 116 (1964).

cent on the first \$25,000 of each corporation's income.²¹ This is another of those situations in which the taxpayer is invited to play Russian roulette with the tax collector, and the amount of the tax turns not upon ability to pay, but upon cleverness in tax avoidance. Ordinarily, it will be more advantageous to elect multiple surtax exemptions and pay the 6 percent penalty tax than to forego the additional surtax exemptions. This follows from the fact that a surtax exemption of \$25,000 can save \$7,000 in taxes in 1964 and \$6,500 in 1965, while 6 percent of \$25,000 amounts to only \$1,500. In some cases, however, where the aggregate income of a group of corporations is only slightly more than \$25,000, it will be more economical to forego multiple surtax exemptions and avoid the penalty tax.²²

Even before the new law denied multiple surtax exemptions to a controlled group of corporations, section 1551 provided that when one corporation transferred property to another new or inactive corporation, and after the transfer, the transferor or its stockholders, or both, were in 80 percent control of the transferee, the transferee could not claim a surtax exemption (or for that matter a credit against the accumulated earnings tax), unless it established by a clear preponderance of evidence that securing the exemption (or credit) was not a major purpose of the transfer. Section 1551 did not apply, however, to a transfer of money by one corporation to another. The 1964 Act broadens section 1551 to cover indirect transfers of property by one corporation to another, thus embracing any transfer of money where the transferee corporation uses the money to purchase property from the transferor. Under the 1964 Act section 1551 also includes direct or indirect transfers of property by five or fewer individuals to a corporation where the transferors are in control of another corporation.²³

In a further effort to discourage multiple corporations, the 1964

²¹ INT. REV. CODE OF 1954, § 1562, added by Revenue Act of 1964, § 235 (a), 78 Stat. 116 (1964).

²² For example, in 1964 a group of five corporations, each having taxable income of \$40,000, will pay a tax of \$93,000 if they do not elect multiple surtax exemptions, as contrasted with a tax of only \$72,500 if they do so elect. However, a group of three corporations with taxable incomes of \$20,000, \$6,000 and \$4,000 will pay a tax of \$8,400 if they elect multiple surtax exemptions, as contrasted with a tax of \$8,000 if they do not do so.

²³ INT. REV. CODE OF 1954, § 1551, as amended, Revenue Act of 1964, § 235 (b), 78 Stat. 125 (1964).

Act repealed the 2 percent additional tax on consolidated returns.²⁴ At the same time Congress provided that an affiliated group of corporations choosing not to file a consolidated return may elect a 100 percent deduction for intercorporate dividends.²⁵ If this election is made, however, the affiliated group is limited to (a) one surtax exemption; (b) one \$100,000 credit against the accumulated earnings tax; (c) one \$100,000 annual deduction for exploration expenses, with an overall ceiling of \$400,000; (d) one \$100,000 exemption for filing estimated tax returns; (e) one \$25,000 limitation on the small business deduction of life insurance companies under sections 804 (a) (4) and 809 (d) (10). Moreover, all of the corporations in the group must elect to treat foreign income taxes as either a deduction or a credit, and, if they elect the credit, all must make the same election about the "per country" or "overall" limitation on the credit.²⁶

One of the interesting things about the new provisions dealing with multiple corporations is that they represent a very complicated solution to a problem which should not even exist. The tax fact which creates the pressure to multiply surtax exemptions is the progressive corporate income tax. Since there is no rational basis for a graduated corporate income tax that is totally unrelated to the ability of the stockholders, who are in fact the owners of the corporation, to pay the tax, it seems obvious that the simplest way to solve the problem of multiple surtax exemptions would be to repeal the progressive corporate income tax in favor of a flat tax with no exemptions.²⁷ Unfortunately, the new provisions relating to controlled corporate groups illustrate a common method of dealing with tax problems. Instead of striking directly at the heart of a problem by excising the offensive provision that creates the problem, legislatures are prone to attack indirectly with a myriad of complex provisions calculated to contain the more baleful consequences of the problem. This is, for example, precisely the tech-

²⁴ INT. REV. CODE OF 1954, § 1503 (a), as amended, Revenue Act of 1964, § 234 (a), 78 Stat. 113 (1964).

²⁵ INT. REV. CODE OF 1954, § 243, as amended, Revenue Act of 1964, § 214 (a), 78 Stat. 52 (1964).

²⁶ INT. REV. CODE OF 1954, § 243 (b) (3), as amended, Revenue Act of 1964, § 214 (a), 78 Stat. 52 (1964).

²⁷ At times corporate income has been taxed at a uniform rate by the federal government while at other times the corporate tax has been graduated. HARVARD LAW SCHOOL, WORLD TAX SERIES: TAXATION IN THE UNITED STATES 113 (1963).

nique that has been adopted for dealing with the problem of capital gains. Instead of denying the capital gains myth and repealing the tax preference in favor of such gains, Congress has embraced the capital gains illusion as a fundamental article of tax faith, while at the same time multiplying prophylactic provisions designed to prevent its poison from corrupting the income tax completely.

B. Stockholders

When the 1954 Code, in an effort to mitigate the double taxation of corporate income, provided that domestic dividends received by individual stockholders should be excluded from gross income to the extent of \$50 (\$100 in the case of a joint return), with an additional credit of 4 percent of the balance of the dividends against the stockholder's tax, these provisions were attacked as an unwarranted discrimination in favor of wealthy taxpayers. This attack culminated in the repeal of the dividend credit over a two year period by the 1964 Act. The credit is reduced to 2 percent in 1964, and abolished entirely in 1965.²⁸ The new law continues, however, to pay lip-service to the double taxation argument by increasing the dividend exclusion from \$50 to \$100 (\$200 in the case of joint returns).²⁹ Although the committee report declares that repealing the credit "removes the discrimination in present law in favor of high bracket shareholders,"³⁰ It is difficult to see why the increased exclusion, which may be worth \$77 to a taxpayer in the top 1964 bracket and only \$16 to a taxpayer in the bottom bracket, is so patently nondiscriminatory.

C. Personal Holding Companies

The vigor with which the 1964 Act attacks personal holding companies would seem to indicate that few congressmen number personal holding companies among their constituents. The 1964 Act begins by abolishing the nonsensical graduated personal holding company tax of 75 percent on the first \$2,000 of undistributed personal holding company income and 85 percent of the balance, in favor of a lower flat rate of 70 percent.³¹ Actually, however, on

²⁸ INT. REV. CODE OF 1954, § 34 (a), as amended, Revenue Act of 1964, § 201 (a) and (b), 78 Stat. 31 (1964).

²⁹ INT. REV. CODE OF 1954, § 116 (a), as amended, Revenue Act of 1964, § 201 (c), 78 Stat. 32 (1964).

³⁰ H.R. REP. NO. 749, 88th Cong., 1st Sess. 33 (1963).

³¹ INT. REV. CODE OF 1954, § 541, as amended, Revenue Act of 1964, § 225 (a), 78 Stat. 79 (1964).

a comparative basis, this raises the tax. Under prior law the rates of the personal holding company tax were somewhat lower than the maximum individual tax rate. The 1964 Act, on the other hand, sets the personal holding company tax at the maximum 1965 individual rate.

In general, a personal holding company is a closely held family corporation, the income of which is predominantly passive income from investments. More specifically, there are two requisites for a personal holding company: its stock must be held by a limited number of stockholders, and a certain proportion of its income must be personal holding company income. In the past, taxpayers have avoided the personal holding company tax by either diversifying the stock ownership of a corporation, or making sure that enough of its income was other than personal holding company income to keep it out of the personal holding company category. Personal holding companies were frequently used to shelter dividend income which, when realized through a corporation, is taxed at only a fraction of the rate applicable to such income when it is received by an individual, due to the intercorporate dividend deduction. For example, if a corporation whose income does not exceed \$25,000 receives dividend income, the tax on this income is only 3.3 percent (22 percent of 15 percent), due to the 85 percent deduction for intercorporate dividends. If the corporate income is taxed at 50 percent, the tax on the dividends will be only 7.5 percent (50 percent of 15 percent).

Since a stockholder in a personal holding company is regarded as owning not only the stock that he owns directly, but also the stock which is owned by other members of his family and various legal entities in which he is interested, it is difficult to remove a family corporation from the personal holding company category by diversifying stock ownership. Consequently, the 1964 Act does not tamper substantially with the stock ownership requirement for personal holding companies. Before the 1964 Act, however, it was comparatively easy to escape the personal holding company tax by diversifying corporate income. The 1964 Act makes a determined effort to prevent this type of tax avoidance. Under prior law a company was not classified as a personal holding company unless 80 percent of its gross income was personal holding company income. The 1964 Act reduces the fatal percentage that will lead to personal

holding company classification to 60 percent.³² Moreover, under prior law personal holding company income was compared with gross income, including capital gains, in order to determine if the statutory percentage was present. Since only capital gains from the sale or exchange of stocks, securities and commodity futures were treated as personal holding company income, a corporation could escape personal holding company status by realizing capital gains from the sale of other types of property, thus raising the corporation's gross income so that it would no longer have the fatal percentage of personal holding company income. This particular loophole is closed by the 1964 Act through the exclusion of capital gains from both personal holding company income and the income with which personal holding company income is compared in order to determine if the requisite percentage exists.³³ Under prior law if gross income from rents exceeded 50 percent of the taxpayer's adjusted gross income, the rental income was not treated as personal holding company income. This meant that a substantial amount of dividend income could be sheltered in a personal holding company if rental property yielding a large gross income was also transferred to the corporation. For example, a man might transfer stocks yielding dividends of \$50,000 a year to a wholly owned corporation. If he also transferred rental property yielding gross rents of \$51,000 to the corporation, this would prevent the corporation from being classified as a personal holding company, even though the net rentals from the property only amounted to a nominal sum. This is no longer possible under the 1964 Act. Rents are still excluded from classification as personal holding company income, provided adjusted income from rents exceeds 50 percent of the company's adjusted ordinary gross income and meets certain other requirements. The rentals which are taken into account in order to determine whether such income constitutes personal holding company income must first be reduced by subtracting deductions for depreciation, amortization, property taxes, interest and rents attributable to the rental income. The rental income thus adjusted is then compared with the corporation's total adjusted ordinary income, and only if the adjusted rental income exceeds 50 percent of the company's other income will it es-

³² INT. REV. CODE OF 1954, § 542 (a), as amended, Revenue Act of 1964, § 225 (b), 78 Stat. 79 (1964).

³³ INT. REV. CODE OF 1954, § 543 (b) (1), as amended, Revenue Act of 1964, § 225 (d), 78 Stat. 81 (1964).

cape classification as personal holding company income.³⁴ In the hypothetical case referred to above, for example, if the gross income from rents was \$51,000 and the adjusted rental income amounted to only \$1,000, the company's adjusted rental income would be less than 2 percent of its total adjusted income. Thus, 100 percent of the company's income would be personal holding company income under the 1964 Act. The act lays down somewhat similar rules under which income from mineral, oil and gas royalties must also be reduced by certain deductions before being compared with a corporation's adjusted income to determine whether there is a sufficient percentage of income from these sources so that it will not be classified as personal holding company income.³⁵ There are various other provisions designed to tighten loopholes under the personal holding company tax, as well as some escape hatches which are provided for corporations classified as personal holding companies under the new law, but not so classified during at least one of the two years preceding enactment of the new law.³⁶

It would be naive to assume that Congress has successfully plugged all of the loopholes in the personal holding company tax. Many of the old loopholes have been eliminated, however, and the new law should at least challenge the ingenuity of tax lawyers in finding new ones. One line of inquiry that the 1964 Act seems to have overlooked in its approach to personal holding companies is whether there is a more satisfactory solution to the problem presented by the personal holding company than the personal holding company tax. The success of a personal holding company depends not only upon the ability of the shareholders to accumulate income in a corporation, but also upon their being able to eventually withdraw the accumulations from the corporation without incurring more than

³⁴ INT. REV. CODE OF 1954, § 543 (a) (7), as amended, Revenue Act of 1964, § 225 (d), 78 Stat. 81 (1964).

³⁵ INT. REV. CODE OF 1954, § 543 (a) (3), as amended, Revenue Act of 1964, § 225 (d), 78 Stat. 81 (1964).

³⁶ The personal holding company tax was extensively revised by § 225 of the 1964 Act. The text discusses only a few highlights of the revision. Some changes were also made in connection with foreign personal holding companies. INT. REV. CODE OF 1954, §§ 553, 554, as amended, Revenue Act of 1964, § 225 (e), 78 Stat. 85 (1964). One provision dealing with foreign personal holding companies increases the basis for inherited stock in such a company by adding to the decedent's basis for the stock, the proportionate part of the estate tax paid in connection with the excess of the value of the stock over his basis. INT. REV. CODE OF 1954, § 1022, added by Revenue Act of 1964, § 225 (j) (1), 78 Stat. 92 (1964) (former § 1022 redesignated as § 1023).

nominal tax liability. Such withdrawals are possible under the present law because of the fact that when a corporation is liquidated, the redemption of the stockholders' shares is treated as a sale of the stock to the corporation. This means that the profits accumulated in a personal holding company can be withdrawn at capital gains rates by liquidating the corporation or selling its stock. Withdrawal of the profits may be accomplished without any tax liability at all if they are retained by the corporation until the stockholder dies and his stock acquires a stepped-up basis. If the capital gains differential and the stepped-up basis for property at death were eliminated from the income tax, the personal holding company would be a much less appealing device, and the need for a special personal holding company tax might well be obviated.

D. Employee Stock Options

One of the provisions of the income tax which, along with capital gains and percentage depletion, deserves classification as totally unwarranted tax preference is the restricted stock option. The restricted stock option is a device whereby highly compensated corporate executives may receive additional salary payments which are exempt from the income tax. Under a restricted stock option, a corporation gives an executive the privilege of purchasing its stock at a price equal to a prescribed percentage of the stock's value. If the statutory formula is followed, the executive will realize no income either when he receives the option or when he exercises it. When the stock acquired under the option is sold, the executive will realize only a capital gain, and if the stock is retained until his death it can be sold completely free of income tax consequences. The 1964 Act undertakes to reform restricted stock options by reclassifying them as "qualified stock options" and "employee stock purchase plans."⁸⁷

The qualified stock option is simply the old restricted stock option with a few additional formal requirements that will not impair its usefulness as a device to avoid income taxes. In order for an option to be classified as a qualified stock option under the new law, the option price must be 100 percent of the value of the stock at the time the option is issued, instead of the old requirement of at

⁸⁷ INT. REV. CODE OF 1954, §§ 421, 6652 (a), as amended, Revenue Act of 1964, § 221, 78 Stat. 63 (1964); INT. REV. CODE OF 1954, §§ 422-25, 6039, added by Revenue Act of 1964, § 221, 78 Stat. 63 (1964) (former § 6039 redesignated as § 6040).

least 85 percent. The executive must hold the stock acquired under the option for three years before disposing of it, as contrasted with the requirement under prior law that he not dispose of the stock within two years from the date when the option was issued nor within six months from the date he acquired the stock. The qualified stock option must have stockholder approval and may run for only five years, as opposed to ten years under prior law. Moreover, the option must not be issued to a person owning stock possessing more than 5 percent of the voting power of the corporation, its parent or a subsidiary.³⁸

Employee stock purchase plans are subject to substantially the same conditions as the old restricted stock option. The only significant difference is that an employee stock purchase plan must be generally available to employees upon a nondiscriminatory basis analogous to the nondiscriminatory coverage required for a qualified pension or profit-sharing plan.³⁹

The tragic aspect of the treatment of stock options under the 1964 Act lies not in the failure of the act to achieve any real reform, but in the fact that by undertaking to reform rather than abolish restricted stock options, the 1964 Act may have perpetuated another unfortunate tax myth.

Stock options are simply a method of compensating employees in kind. There is no practical difference between paying an employee in stock and giving him the privilege of buying stock for less than its value. The only meaningful reform possible in connection with restricted stock options would be to repeal the provisions freeing such options from the income tax. If this were the case restricted stock options would be taxed as ordinary compensation.⁴⁰ The unfortunate effect of attempts to "reform" rather than abolish the preferential taxation of stock options is that this gives the erroneous impression that there are certain types of stock options which merit preferential tax treatment. This is, of course, what has happened in connection with capital gains. There has been so much discussion about how capital gains should be taxed, that many people

³⁸ INT. REV. CODE OF 1954, § 422, added by Revenue Act of 1964, § 221 (a), 78 Stat. 63 (1964).

³⁹ INT. REV. CODE OF 1954, § 423, added by Revenue Act of 1964, § 221 (a), 78 Stat. 63 (1964).

⁴⁰ Apart from any statutory exemption, restricted stock options have been held taxable as ordinary compensation by the Supreme Court. *Commissioner v. LoBue*, 351 U.S. 243 (1956); *Commissioner v. Smith*, 324 U.S. 177 (1945).

now conceive of the term capital gains as representing economic objectivity which is entitled to special tax treatment, rather than simply a shorthand expression for a type of income to which the income tax statute accords preferential treatment.

E. Miscellaneous

The 1964 Act made several miscellaneous adjustments in the taxation of corporations designed to iron out inequities in the prior law. Thus, for example, where there is a stock acquisition, or so-called "B," reorganization, the acquiring corporation may now transfer not only its own voting stock, but the voting stock of its parent. Furthermore, the acquiring corporation may pass on to a subsidiary the stock it acquires.⁴¹ This makes applicable to a "B" reorganization the same rules which prevail in the case of a "C," or asset acquisition, reorganization.

Several minor amendments were made in the provisions dealing with regulated investment companies. The time for mailing notices to stockholders setting forth the amounts taxable to stockholders has been extended from thirty to forty-five days from the end of the taxable year.⁴² Moreover, a provision was inserted to allow a unit investment trust to sell its assets in order to redeem shares without being considered to have made a preferential distribution that will deprive it of a dividends-paid deduction for the capital gain realized on the sale and distributed to the shareholder.⁴³

Finally, the new law makes several minor changes in connection with the election of small business corporations to be taxed under Subchapter S. A subchapter S corporation may now have an inactive affiliate without losing its subchapter S status.⁴⁴ Moreover, if certain formalities are observed capital gains distributed to stockholders of a subchapter S corporation by the 15th day of the third month following the close of the taxable year will be treated as having been paid within the taxable year.⁴⁵

⁴¹ INT. REV. CODE OF 1954, § 368 (a) (1) (B), as amended, Revenue Act of 1964, § 218 (a), 78 Stat. 57 (1964).

⁴² INT. REV. CODE OF 1954, §§ 852-55, as amended, Revenue Act of 1964, § 229 (a), 78 Stat. 99 (1964).

⁴³ INT. REV. CODE OF 1954, § 852 (d), added by Revenue Act of 1964, § 229 (b), 78 Stat. 99 (1964).

⁴⁴ INT. REV. CODE OF 1954, § 1371 (d), added by Revenue Act of 1964, § 233 (a), 78 Stat. 112 (1964).

⁴⁵ INT. REV. CODE OF 1954, § 1375 (e), added by Revenue Act of 1964, § 233 (b), 78 Stat. 112 (1964).

EXCLUSIONS

The 1964 Act added one new exclusion from gross income to the Code and made noteworthy changes in many of the old ones.

As part of a continuing concern over senior citizens, the 1964 Act provides that a person sixty-five years of age or older who sells property which he has occupied as his principal residence for at least five of the preceding eight years, may elect to exclude the gain from the sale from his gross income, provided the adjusted sale price does not exceed \$20,000.⁴⁶ If the adjusted sale price exceeds \$20,000, the taxpayer may exclude part of the gain proportionate to the ratio between \$20,000 and the adjusted sale price. For example, if A, after attaining age sixty-five,⁴⁷ sells his residence which has a basis of \$21,000 for \$30,000, he may exclude \$6,000 ($\$20,000/\$30,000$ of the \$9,000 gain) from his gross income. It is perhaps worth noting that the new exclusion operates independently of the preexisting privilege of avoiding the recognition of gain from the sale of a residence by investing in a new residence, within a prescribed period, the adjusted sale price received from the sale of an old residence.⁴⁸ Thus, in the hypothetical case above if the taxpayer invests at least \$24,000 in a new residence he will realize no taxable income. In determining the amount which must be invested in a new residence in order to avoid a tax under the preexisting provision, any gain excluded under the new section is ignored. Of course the two provisions operate on different principles. The new exclusion is an exclusion; the gain exempted under that provision is ignored entirely and does not reduce the basis of any new residence acquired by the taxpayer. On the other hand, the gain which is disregarded under the older section is postponed rather than exempted, and to the extent that it is not recognized, the gain reduces the basis of the new residence.

The new exclusion for gains from the sale of residences by senior citizens seems ill-advised. As is the case with so many tax exemptions, the new exclusion appears to be a generous gesture when it is viewed

⁴⁶ INT. REV. CODE OF 1954, § 121, added by Revenue Act of 1964, § 206 (a), 78 Stat. 38 (1964) (former § 121 redesignated as § 122).

⁴⁷ The new exclusion does not apply unless the taxpayer has attained age sixty-five at the time of the sale. It is not enough that he is sixty-five at the end of the taxable year in which the sale is made.

⁴⁸ Any taxpayer, regardless of age, who sells his principal residence at a gain may avoid recognition of the gain if within one year before or after the sale, he invests the adjusted sale price of the old residence in a new residence. INT. REV. CODE OF 1954, § 1034.

in isolation. Upon comparative consideration, however, its true preferential character emerges. There is no particular reason why wealthy persons should not shoulder their proportionate share of the tax burden regardless of age. The exemption of a person from the income tax on the basis of age rather than economic status is difficult to justify. The new exclusion is part of an expanding pattern of tax preferences for older persons which finds expression in the additional \$600 old-age exemption,⁴⁹ the increased deduction allowances for medical care expenses of elderly persons⁵⁰ (which were further increased by the 1964 Act),⁵¹ and the retirement income credit.⁵²

In addition to creating the new exclusion for senior citizens, the 1964 Act made adjustments in several of the existing exclusions. The previously discussed exclusion for domestic dividends received by individual shareholders was doubled by the 1964 Act.⁵³

Several exclusions were reduced by the new law. By virtue of long-standing regulations, group life insurance premiums paid for employees by an employer have been excluded from the employees' income.⁵⁴ The 1964 Act taxes such premiums to employees to the extent that the group insurance coverage of an employee exceeds \$50,000.⁵⁵ The premium that the employee must include in his gross income is computed from a uniform table prescribed by the committee reports⁵⁶ pending dissemination of a table by the Treasury. The amount taxed to the employee is the premium computed under this table for any group insurance coverage in excess of \$50,000, less any contributions which the employee makes to the insurance. The new tax on group life insurance premiums seems sound. This is the kind of fringe benefit the value of which is readily computed and which represents additional compensation (rather than a working condition) to the employee. The only question that can legitimately be raised in connection with the new provision is whether it

⁴⁹ INT. REV. CODE OF 1954, § 151 (c).

⁵⁰ INT. REV. CODE OF 1954, § 213 (a) and (g).

⁵¹ INT. REV. CODE OF 1954, § 213 (b), as amended, Revenue Act of 1964, § 211 (a), 78 Stat. 49 (1964).

⁵² INT. REV. CODE OF 1954, § 37, as amended, Revenue Act of 1964, § 202, 78 Stat. 33 (1964).

⁵³ See text accompanying note 29 *supra*.

⁵⁴ Treas. Reg. § 1.61-2 (d) (2) (1957).

⁵⁵ INT. REV. CODE OF 1954, § 79, added by Revenue Act of 1964, § 204 (a), 78 Stat. 36 (1964).

⁵⁶ H.R. REP. NO. 749, 88th Cong., 1st Sess. 41 (1963).

goes far enough. If group life insurance represents the kind of benefit which should be treated as part of the taxable income of an employee, why stop short of taxing the entire amount of the benefit to the employee? When the proposed act initially emerged from the House, the amount to be taxed to the employee was the premium for coverage in excess of \$30,000.⁵⁷ This figure was raised to \$70,000 by the Senate,⁵⁸ and was finally fixed at \$50,000 by a conference committee.⁵⁹ It might well have been lowered.

The changes made in connection with the sick pay exclusion by the 1964 Act illustrates the unhappy results of legislation by compromise, a technique often employed in the passage of tax laws. Under prior law sick pay up to \$100 a week was excluded from an employee's income after a waiting period of seven days in the case of illness not resulting from injury. The waiting period was waived in the event that the employee was hospitalized for one day during the period of illness. The House decided that this exclusion encouraged malingering, and provided under the 1964 Act that the sick pay exclusion should not apply until the employee had been away from work for thirty days.⁶⁰ The Senate felt that this was too rigorous. Accordingly, in its final form the 1964 Act provides for the exclusion of sick pay up to \$100 a week after an employee has been absent from work for thirty days due to illness or injury. During the first thirty days of an absence, however, a sick pay exclusion limited to \$75 a week is allowed, with a waiting period of seven days in the case of both illness and injury unless the employee is hospitalized for one day during the period of absence. The exclusion during the first thirty days is further conditioned upon sick pay benefits being limited to 75 percent of the employee's regular compensation. If the payments exceed this amount, no exclusion for sick pay is allowed during the first thirty days.⁶¹ It is difficult to see any reason for the 75 percent limitation imposed by the new provision which can only serve to discriminate against low paid employees and generous employers. For example, suppose that two employees are absent from work for thirty days due to illness, and each is hos-

⁵⁷ H.R. REP. NO. 749, 88th Cong., 1st Sess. 42 (1963).

⁵⁸ S. REP. NO. 830, 88th Cong., 2d Sess. 46 (1964).

⁵⁹ H.R. REP. NO. 1149, 88th Cong., 2d Sess. 2 (1964) (conference report).

⁶⁰ H.R. REP. NO. 749, 88th Cong., 1st Sess. 44-45 (1963).

⁶¹ INT. REV. CODE OF 1954, § 105 (d), as amended, Revenue Act of 1964, § 205, 78 Stat. 38 (1964).

pitalized for more than one day during the absence. Their employer pays each of them \$100 a week while they are ill. One employee's regular salary is \$150 a week, while the other earns only \$100. The employee who earns \$150 a week may exclude sick pay of \$75 a week, since the \$100 that he receives does not exceed 75 percent of his regular compensation. The other employee, however, although receiving exactly the same amount during the period of absence, is entitled to no exclusion at all, since the amount he receives exceeds 75 percent of his regular compensation.

The 1964 Act made one minor change in connection with the exclusion of earned income by non-resident citizens. Under prior law a non-resident citizen was entitled to exclude foreign earnings of \$35,000 a year from gross income after he had been a non-resident for three years. Under the 1964 Act this exclusion is reduced to \$25,000.⁶²

NEW DEDUCTIONS

The 1964 Act, although originally advertised as a measure designed to reduce deductions and broaden the tax base, initiated several new deductions. The additional deduction of significance to the greatest number of persons is probably the minimum standard deduction. Under preexisting provisions a taxpayer was given the option of itemizing and deducting his "other" deductions or taking a standard deduction of 10 percent of his adjusted gross income. The standard deduction was limited to \$1,000 except in the case of married persons filing separate returns where the ceiling on the standard deduction was \$500 for each spouse. The 1964 Act provides that the taxpayer who elects the standard deduction shall deduct the larger of the 10 percent deduction or a new minimum standard deduction of \$200 (\$100 in the case of a married person filing a separate return), plus \$100 times the number of exemptions claimed by the taxpayer.⁶³ The ceilings for the minimum standard deduction are the same as the ceilings on the 10 percent deduction. A taxpayer still has his option of itemizing deductions or claiming the standard deduction. Once he has elected the standard deduction, however, he does not have the option of claiming the 10 percent deduction or

⁶² INT. REV. CODE OF 1954, § 911 (c) (1) (B), as amended, Revenue Act of 1964, § 237, 78 Stat. 128 (1964.)

⁶³ INT. REV. CODE OF 1954, § 141 (c), as amended, Revenue Act of 1964, § 112 (a), 78 Stat. 23 (1964).

the minimum standard deduction. He must take the larger. An exception is made to this rule in the case of a married person filing a separate return. Where married taxpayers file separate returns, one spouse may not use the minimum standard deduction if the other spouse uses the 10 percent deduction. If, however, one spouse uses the minimum standard deduction, the other spouse may also take the minimum standard deduction in order to achieve the lowest overall tax for both spouses, even though it is less than the 10 percent deduction for that spouse.⁶⁴

The minimum standard deduction, which is keyed to the taxpayer's status rather than his income, really represents an increase in the personal exemptions of low-bracket taxpayers which will eliminate a number of these persons from the tax rolls. Under prior law, for example, a single person did not encounter the income tax until his income exceeded \$667 (allowing for a \$600 exemption and a \$67 standard deduction). Under the minimum standard deduction such persons will not be subject to the income tax until their income exceeds \$900 (\$600 exemption plus a \$300 minimum deduction). Married taxpayers encountered the income tax when their incomes exceeded \$1,333 under the old law. They can now earn \$1,600 without being subjected to the tax.

A number of taxpayers will be affected by a new deduction for moving expenses provided by the 1964 Act. Under prior law (apart from one Tax Court decision)⁶⁵ employees were not allowed to deduct the cost of moving to a new job, since this was regarded as a personal expense. A partial exception to this rule was made when an employee moved at the behest of an existing employer and was reimbursed by the employer for his expenses. The employee was allowed to exclude the reimbursement from his gross income, although he was not allowed to deduct any additional expenses for which he was not reimbursed.⁶⁶ Moreover, in the case of a new employee moving to a job, neither an exclusion nor a deduction was allowed for his moving expenses. The new law permits both the new and the old employee to deduct moving expenses.⁶⁷ Reimbursed

⁶⁴ INT. REV. CODE OF 1954, § 141 (d), as amended, Revenue Act of 1964, § 112 (a), 78 Stat. 23 (1964).

⁶⁵ Walter H. Mendel, 41 T.C. 32 (1963).

⁶⁶ Rev. Rul. 429, 1954-2 CUM. BULL. 53.

⁶⁷ INT. REV. CODE OF 1954, § 217, added by Revenue Act of 1964, § 213, 78 Stat. 50 (1964) (former § 217 redesignated as § 218). Moving expenses are deducted in computing adjusted gross income. This means, of course, that the taxpayer may deduct

expenses of existing employees, however, apparently continue to be excluded from the employees' gross income under prior law, rather than being deducted under the new Act.⁶⁸ Although an exclusion operates in much the same way as a deduction insofar as its effect on tax liability is concerned, this distinction can be important. In order to deduct moving expenses under the new law, the employee must work in the place to which he moves for at least thirty-nine weeks out of the year following the move, although not necessarily for the same employer.⁶⁹ If he fails to work for this period the employee forfeits the deduction. This limitation does not seem to apply, however, to the old employee who is reimbursed for his moving expenses and excludes the reimbursement from his gross income. Apart from the phrasing of the new provision, it is difficult to see any justification for this distinction.

Moving expenses are defined by the statute as the cost of moving the household goods and personal effects of the taxpayer and the members of his household, along with living expenses in transit.⁷⁰ The new provision states that the taxpayer's new principal place of work must be "at least 20 miles farther from his former residence than was his former place of work."⁷¹ Since the statute conditions the deduction for moving expenses upon the distance between the taxpayer's new place of work and his former residence, rather than the distance between his old and new homes, it would be possible under the literal wording of the statute for the taxpayer to incur deductible moving expenses by moving into the house adjacent to his old home upon being transferred to a new place of work twenty miles further from his old residence than was his old place of work. In such

moving expenses even though he elects the standard deduction. INT. REV. CODE OF 1954, § 62, as amended, Revenue Act of 1964, § 213 (b), 78 Stat. 52 (1964).

⁶⁸ "No deduction is provided under this provision for moving expenses for which the taxpayer receives reimbursements which are not included in his gross income. Thus, existing employees may continue to exclude reimbursed moving expenses from their gross income in the same manner as under present law. Their status, in this regard, is left entirely unchanged." H.R. REP. NO. 749, 88th Cong., 1st Sess. 60 (1963).

⁶⁹ INT. REV. CODE OF 1954, § 217 (c) (2), added by Revenue Act of 1964, § 213 (a), 78 Stat. 50 (1964).

⁷⁰ INT. REV. CODE OF 1954, § 217 (b), added by Revenue Act of 1964, § 213 (a), 78 Stat. 50 (1964).

⁷¹ INT. REV. CODE OF 1954, § 217 (c) (1) (A), added by Revenue Act of 1964, § 213 (a), 78 Stat. 50 (1964). If the taxpayer had no former principal place of work, his new place of work must be at least twenty miles away from his former residence. INT. REV. CODE OF 1954, § 217 (c) (1) (B), added by Revenue Act of 1964, § 213 (a), 78 Stat. 50 (1964).

a case, however, it would appear that the change in residence was not motivated by the change in the taxpayer's place of work, and, therefore, that the expenses incurred were not really deductible moving expenses.

Several years ago the Service ruled that losses attributable to expropriation of business and investment properties by the Cuban government were deductible.⁷² Prior to the 1964 Act, however, no deduction at all was allowed for losses resulting from Cuban expropriation of non-business or non-investment property such as a taxpayer's personal residence, since these losses were not incurred in connection with a trade or business or a transaction entered into for profit. Castro, although an international disaster, was not regarded as a casualty in the tax sense. The 1964 Act provides that losses resulting from Cuban expropriation of personal property shall be deductible as casualty losses.⁷³ Due to an oversight the 1964 Act failed to specify an effective date for this provision. This has been remedied by subsequent legislation which provides for the deduction of losses sustained after 1958 and before 1964.⁷⁴ The amendatory legislation also allows the deduction of losses attributable to expropriation of intangible non-business and non-investment property such as bank accounts, although casualty losses ordinarily are limited to tangible property. The 1964 Act provides that taxpayers who have sustained foreign expropriation losses may elect to carry them over for ten years.⁷⁵

The new provision for taxing the unstated interest element in deferred payment contracts also provides a correlative deduction for such interest.⁷⁶ There is another new deduction for interest in the form of carrying charges in connection with educational contracts. Under a preexisting provision a taxpayer who purchases

⁷² Rev. Rul. 197, 1962-2 CUM. BULL. 66.

⁷³ INT. REV. CODE OF 1954, § 165 (i), added by Revenue Act of 1964, § 238, 78 Stat. 128 (1964) (former § 165 (i) redesignated as § 165 (j)).

⁷⁴ Pub. L. No. 348, 88th Cong., 2d Sess. § 3 (June 30, 1964).

⁷⁵ INT. REV. CODE OF 1954, § 172, as amended, Revenue Act of 1964, § 210, 78 Stat. 47 (1964). Losses due to expropriation by any foreign power may be carried over for ten years at the taxpayer's election if the expropriation losses account for at least 50% of the taxpayer's net operating loss for the taxable year. If the ten year carry-over is elected there will be no carryback. That portion of the operating loss which is not due to expropriation, however, will continue to be carried back for three years and forward for five years.

⁷⁶ INT. REV. CODE OF 1954, § 483, added by Revenue Act of 1964, § 224 (a), 78 Stat. 77 (1964).

goods on credit is allowed to deduct part of the carrying charges in connection with the sale equal to 6 percent of the average unpaid monthly balance during the taxable year.⁷⁷ This same privilege is extended by the 1964 Act to carrying charges in connection with contracts for the purchase of educational services.⁷⁸

SOME NEW PROVISIONS FOR OLD DEDUCTIONS

New limitations were imposed on a number of existing deductions by the 1964 Act, but these were more than offset by generous treatment of other items. One of the popular panaceas for reforming the federal income tax involves broadening the tax base in order to reduce the rates of the tax. This would be accomplished by the elimination of such personal deductions as those for personal taxes, interest on personal loans, and casualty losses of pleasure property. As a tentative step in this direction the administration proposed in connection with the 1964 Act that personal deductions be disallowed except to the extent that they exceeded a prescribed percentage of the taxpayer's income. This proposal might have received a warmer reception if it had taken the form of a recommendation to abolish the deductions entirely. The purport of the proposal was obscured by the percentage qualification which, although designed to limit personal deductions to extraordinary expenses, was regarded by many as a purely arbitrary provision. At any rate the suggestion was received by the public with an almost complete lack of comprehension and greeted in Congress with an equal lack of enthusiasm. The 1964 Act did impose some minor limitations on the deductions of taxes, casualty losses of non-business property, charitable contributions, and interest. These were offset, however, by more liberal treatment of charitable contributions, medical expenses, expenses of child and dependent care, and expenses of combined business and pleasure trips.

With certain stated exceptions taxes were deductible under prior law. The 1964 Act limits the deduction for taxes to those explicitly stated to be deductible⁷⁹ which do not fall within an

⁷⁷ INT. REV. CODE OF 1954, § 163 (b).

⁷⁸ INT. REV. CODE OF 1954, § 163 (b), as amended, Revenue Act of 1964, § 224 (c), 78 Stat. 79 (1964).

⁷⁹ INT. REV. CODE OF 1954, § 164, as amended, Revenue Act of 1964, § 207 (a), 78 Stat. 40 (1964).

enumeration explicitly declared to be nondeductible.⁸⁰ Taxes no longer deductible because of the new provision include foreign personal property taxes and foreign, state and local excises, other than state and local general sales taxes and taxes on gasoline. Thus, for example, it is no longer permissible to deduct state taxes on liquor, tobacco, auto registrations or drivers' licenses. The new law provides, however, that nondeductible state, local and foreign taxes "shall be allowed as a deduction [if they] . . . are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income)."⁸¹ It is arguable that these items will be deductible as taxes rather than business or non-business expenses, and, therefore, should be fully deductible even though they are capital in nature. For example, a state transfer tax paid in connection with the purchase of stock should be currently deductible rather than treated as a capital addition to the basis of the stock.⁸²

Casualty losses of personal (in the sense of non-business) property are still deductible under the 1964 Act, although the first \$100 of each such loss is disallowed.⁸³ The disallowance does not apply to casualty losses connected with a trade or business or a transaction entered into for profit. The committee reports suggest that the \$100 disallowance will be construed liberally. Thus, a single force inflicting damage upon several pieces of property will be treated as a single casualty insofar as disallowing \$100 of the loss is concerned.⁸⁴ Moreover, on a joint return spouses will be treated as a single taxpayer for purposes of determining the \$100 disallowance. For example, suppose that a thief breaks into a residence and steals a man's watch and a bracelet belonging to his wife. Assuming that the watch had a cost and value of \$150 and the bracelet had a cost and

⁸⁰ INT. REV. CODE OF 1954, § 275, added by Revenue Act of 1964, § 207 (b) (3) (A), 78 Stat. 42 (1964).

⁸¹ INT. REV. CODE OF 1954, § 164, as amended, Revenue Act of 1964, § 207 (a), 78 Stat. 40 (1964).

⁸² U.S. TREASURY DEP'T, YOUR FEDERAL INCOME TAX 116 (1964).

⁸³ INT. REV. CODE OF 1954, § 165 (c) (3), as amended, Revenue Act of 1964, § 208 (a), 78 Stat. 43 (1964).

⁸⁴ "For this purpose, in determining what is a single casualty, it is intended that the law be interpreted liberally. Thus, for example, where an individual's property is damaged by wind from a hurricane and this is followed by additional damage resulting from water, it is intended that the combination of these events be treated as one casualty and, therefore, that all amounts over \$100 damage be deductible." H.R. REP. No. 749, 88th Cong., 1st Sess. 52 (1963).

value of \$250, the couple can deduct \$300 as a theft loss on a joint return. On the other hand, if they file separate returns the husband may claim a deduction of only \$50, and the wife will be limited to a deduction of \$150.⁸⁵

The 1964 Act forbids the deduction of interest on loans which are part of a plan to systematically borrow amounts equal to part or all of the increase in the cash surrender values of insurance policies in order to pay part or all of the premiums on the policies. There are four exceptions to the new rule under which interest on such a loan is deductible: (1) where any four of the first seven annual premiums are paid with funds that are not borrowed; (2) where the total interest on such loans for the taxable year does not exceed \$100; (3) where the loans were incurred because of an "unforeseen substantial loss of income or unforeseen substantial increase in financial obligations"; and (4) where the loan was incurred in connection with the taxpayer's trade or business.⁸⁶ It requires no particular prescience to foresee that this provision is going to be difficult to administer. It is part of a complex scheme designed to deny an interest deduction in connection with loans incurred to purchase life insurance and annuities.⁸⁷ These provisions do not represent the happiest solution for the problem they are intended to solve.

The simplest and most equitable way in which to deal with the deduction of interest on loans incurred to purchase insurance policies would be the enactment of a general provision denying any deduction for interest on personal loans. There is no obvious

⁸⁵ "The \$100 limitation applies to a joint return by a husband and wife as well as to a separate return of either. Thus, if a husband and wife file separate returns, each is subject to a separate \$100 floor with respect to each casualty or theft, while, if they file a joint return, they are together subject to only one \$100 floor with respect to each casualty or theft whether the loss is sustained with respect to jointly, or separately, owned property." *Ibid.*

⁸⁶ INT. REV. CODE OF 1954, § 264, as amended, Revenue Act of 1964, § 215, 78 Stat. 55 (1964).

⁸⁷ Before the 1964 Act, INT. REV. CODE OF 1954, § 264(a)(2) forbade the deduction of interest in connection with an "indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract" according to the expansive definition of such contracts set forth in § 264(b). In this connection it should be noted that another Code section which denies an interest deduction was amended by the 1964 Act. The new law adds a sentence to § 265 of the Code (dealing with expenses and interest relating to tax-exempt income) by which financial institutions subject to state banking laws may deduct interest incurred on face amount certificates and paid on deposits towards their purchase, even though the institution invests in tax-exempt securities, provided that its average investment in tax-exempts does not exceed 15% of its total assets. INT. REV. CODE OF 1954, § 265, as amended, Revenue Act of 1964, § 216, 78 Stat. 56 (1964).

reason for denying an interest deduction in connection with a loan to purchase life insurance, while allowing taxpayers to deduct interest on other personal indebtedness. Why should the law be so chary about allowing a deduction for interest on a loan incurred to purchase life insurance, while it remains completely indifferent to the deduction of interest on loans to meet other personal expenses? The deduction of interest on personal loans should be disallowed entirely, since it represents a deduction for personal expenses which are normally nondeductible. Presumably the principal impact of such a disallowance would be upon persons who are buying a home and paying interest on a mortgage. Thus, the disallowance would have the desirable effect of diminishing to some extent the discrimination which the income tax permits in favor of persons who own their own home and are not taxed upon the rental value thereof vis-à-vis those who rent a home and are denied any deduction for their rental payments.

The 1964 Act both broadens and contracts the deduction for charitable contributions. Under prior law an individual was entitled to deduct his charitable contributions up to 20 percent of his adjusted gross income, with an additional 10 percent allowance for gifts to churches, schools, hospitals, medical research organizations, and foundations set up to receive and disburse contributions to colleges and universities owned and operated by state and local governments. The 1964 Act extends the 30 percent allowance to gifts made to practically all charities except private charitable foundations. Thus, the additional allowance applies to gifts to governmental units and charitable, cultural and religious organizations that derive a substantial part of their support from a governmental unit or through contributions from the general public.⁸⁸

The new law also allows an individual to carry over excess charitable contributions in the 30 percent class for a period of five years.⁸⁹ It is important to notice that the carryover is limited to contributions that qualify for the 30 percent allowance. When such excess charitable contributions are carried over they are taken into account, along with any current contributions qualifying for the 30 percent allowance, before considering any other charitable contributions. This

⁸⁸ INT. REV. CODE OF 1954, § 170 (b) (1) (A), as amended, Revenue Act of 1964, § 209 (a), 78 Stat. 43 (1964).

⁸⁹ INT. REV. CODE OF 1954, § 170 (b) (5), added by Revenue Act of 1964, § 209 (c), 78 Stat. 45 (1964).

means that contributions to private charitable foundations may be wasted for tax purposes unless they are timed with discrimination. For example, suppose that A has an adjusted gross income of \$20,000. In 1964 he gives \$8,000 to his college and \$2,000 to a private charitable foundation. In 1965 he contributes \$4,000 to the college and \$2,000 to the foundation. In 1964 A will deduct \$6,000 of the gift to the college and carry over \$2,000.⁹⁰ In 1965 his deduction for charitable contributions again will be limited to 30 percent of his adjusted gross income, consisting of the \$4,000 donated currently to the college and the \$2,000 carried over from the previous year's gift to the college. Since the gifts to the private charitable foundation cannot be deducted currently or carried over, they are wasted entirely from a tax point of view.

The new law increases the carryover of excess corporate charitable contributions from two years to five years in line with the new individual carryover provision.⁹¹ This is the only change made in connection with the deduction of charitable gifts by a corporation.

Some new restrictions are imposed upon the deduction for charitable contributions by the 1964 Act. In the past donors wishing to give property to charity without parting with the possession and enjoyment of the property during their lives, have made an immediate gift of the property to the charity and retained the right to possess and enjoy the property for life. For example, a man who had a valuable painting which he wished to give to an art museum at his death, might have made a present gift of the painting to the museum with the proviso that he be allowed to retain possession of the painting during his life. From a tax standpoint the advantages of making the gift in this form rather than leaving it to the museum by will were twofold: (1) the value of the property would not be included in the donor's estate at his death for purposes of the estate tax, and (2) the donor was entitled to an income tax deduction for a charitable gift of the remainder during his life. In its deliberations concerning the 1964 Act the House Ways and Means Committee decided that it was unfair for a taxpayer to get an income tax deduction for a gift of property to charity when he did not part with pos-

⁹⁰ There will be no carryover of the \$2,000 gift to the foundation because gifts subject to the 20% limitation do not qualify for the carryover.

⁹¹ INT. REV. CODE OF 1954, § 170 (b) (2), as amended, Revenue Act of 1964, § 209 (d) (1), 78 Stat. 46 (1964).

session of the property. Therefore, it was provided that where tangible personal property was given to charity, the donor should not get an income tax deduction until the termination of any interest retained in favor of the donor or a related person (as defined in section 267 (b)). The House added an exception to this rule, however, where the retained interest took the form of a non-transferable life interest in favor of the donor, or, in the case of a joint gift by husband and wife, a non-transferable life interest in favor of the spouses.⁹² The exception, for all practical purposes, nullified the rule. Consequently, the final version of the act eliminated the exception⁹³ except in the case of gifts made before July 1, 1964.⁹⁴ The new law does not forbid an income tax deduction where a taxpayer makes a gift of a future interest in tangible personal property to charity. It merely provides that the deduction cannot be taken until any intervening interest in favor of the donor or a related person terminates. This means, however, that if the donor retains a life estate in the donated property he will never get an income tax deduction, since his life interest will terminate only at his death. In this connection it is important to notice, that although the final version of the act is more drastic than the one which passed the House, it is far from a Draconian measure in view of its limitation to tangible personal property. A deduction may still be taken for gifts of realty or intangible personal property to charity, even though the donor retains an interest in the property in favor of himself or a related person.

Another new restriction on the deduction for charitable gifts is designed to prevent abuse of the unlimited deduction allowance. Under prior law an individual was allowed an unlimited charitable deduction if, in the taxable year and eight out the ten preceding years, his charitable contributions and income taxes exceeded 90 percent of his taxable income computed without taking into consideration charitable contributions, personal exemptions and net operating loss carryovers. Under the 1964 Act the only charitable contributions which are taken into account in determining whether the taxpayer qualifies for the unlimited deduction are those qualifying for the new 30 percent allowance and gifts to

⁹² H.R. REP. No. 749, 88th Cong., 1st Sess. 55-56 (1963).

⁹³ INT. REV. CODE OF 1954, § 170 (f), added by Revenue Act of 1964, § 209 (e), 78 Stat. 47 (1964) (former § 170 (f) redesignated as § 170 (h)).

⁹⁴ Revenue Act of 1964, § 209 (f) (3), 78 Stat. 47 (1964).

certain private charitable foundations which are actively engaged in furthering charitable objectives and do not engage in prohibited transactions as set forth in the statute.⁹⁵ Presumably the purpose of this provision is to limit the unlimited charitable deduction to the taxpayer who actually donates the bulk of his income to genuine charitable undertakings rather than to a private foundation operated for personal profit.

Most revenue acts have brought some minor adjustment in the mathematical limitations on the deduction for medical expenses. The 1964 Act is no exception. Under the new law the 1 percent limitation on the deduction of expenses for drugs is waived in the case of drugs purchased for the taxpayer, his spouse, or a dependent parent, provided such person has attained age sixty-five by the end of the taxable year.⁹⁶ In other words the 1 percent limitation on the deduction of expenses for drugs is waived in the same situations where the 3 percent limitation on the deduction of medical expenses is waived.⁹⁷

The new law expands the deduction for child and dependent care in several respects.⁹⁸ The maximum amount of the deduction has been increased from \$600 to \$900 in cases where the taxpayer has more than one dependent for whom he furnishes care. Moreover, the age limit of a child qualifying the taxpayer for the deduction has been raised from eleven to twelve years. Under prior law a working wife who claimed a deduction for child or dependent care was required to file a joint return with her husband (unless he was incapacitated and incapable of self support) and reduce the amount of the deduction to the extent that the aggregate adjusted gross income shown on the return exceeded \$4,500. Under the 1964 Act only the excess of the aggregate adjusted gross income above \$6,000 reduces the deduction. Under prior law a man could claim the deduction for child or dependent care only in the event that he was a widower or was divorced or legally separated from his wife. The 1964 Act permits a married man to claim the deduction if his wife is incapacitated or institutionalized for a period of ninety

⁹⁵ INT. REV. CODE OF 1954, § 170 (g), added by Revenue Act of 1964, § 209 (b), 78 Stat. 43 (1964).

⁹⁶ INT. REV. CODE OF 1954, § 213 (b), as amended, Revenue Act of 1964, § 211, 78 Stat. 49 (1964).

⁹⁷ See INT. REV. CODE OF 1954, § 213 (a).

⁹⁸ INT. REV. CODE OF 1954, § 214, as amended, Revenue Act of 1964, § 212, 78 Stat. 49 (1964).

consecutive days or until her death. Unless the wife is institutionalized for the requisite period, however, the married man who claims a deduction for child or dependent care must file a joint return and reduce the deduction to the extent that the aggregate adjusted gross income shown on the return exceeds \$6,000. Perhaps the most interesting thing about the deduction for child and dependent care is how complicated a trivial deduction such as this can become. One cannot help wondering whether the deduction, the merits of which are debatable at best, justifies the efforts which must go into claiming and policing it.

In 1962 Congress, as part of the crusade against expense-account living, added a new section to the Code which provided that when a taxpayer made a combined business and pleasure trip, his travel expenses to and from his business destination had to be reduced by the proportion of the time devoted to pleasure. This requirement was waived in the event that the total time away from home was not in excess of one week, or if less than 25 percent of the total time away from home was devoted to pleasure. The 1964 Act repeals this provision retroactively except in the case of trips abroad.⁹⁹ This may conceivably herald the beginning of a general retreat from the travel and entertainment expense reforms of 1962.

One change made by the 1964 Act in connection with deductions relates to the proper time for deducting an item, rather than to the propriety of the deduction itself. In *United States v. Consolidated Edison Co.*¹⁰⁰ the Supreme Court held that a contested tax could not be accrued and deducted even though the taxpayer paid the tax. The deduction could not be taken until the contest over the tax was settled and the liability had become fixed and certain. Congress has now repudiated the Court's decision, and the new law provides that contested liabilities may be accrued and deducted when payment is made.¹⁰¹ If the taxpayer later receives a refund he will simply include the amount of the refund in his gross income in the

⁹⁹ INT. REV. CODE OF 1954, § 274 (c), as amended, Revenue Act of 1964, § 217, 78 Stat. 56 (1964).

¹⁰⁰ 366 U.S. 380 (1961).

¹⁰¹ INT. REV. CODE OF 1954, § 461 (f), added by Revenue Act of 1964, § 223 (a) (1), 78 Stat. 76 (1964); INT. REV. CODE OF 1939, § 43, as amended, Revenue Act of 1964, § 223 (a) (2), 78 Stat. 76 (1964). The new provision applies generally to contested liabilities; it is not limited to taxes. It does not apply, however, to the deduction for income, war profits and excess profits taxes imposed by a foreign country or possession of the United States.

year of recovery. Perhaps the principal significance of the new provision for accruing and deducting contested liabilities lies in the insight it offers into the futility of our present procedure for settling tax cases. Without a Court of Tax Appeals it is impossible to conclusively settle the construction of a federal tax statute short of the Supreme Court. When a tax case finally gets to the Supreme Court (and a decreasing number do) the law has usually been changed, or, as was true with regard to the holding in the *Consolidated Edison* case, will be changed as soon as the case is decided.¹⁰² It would be far more sensible to create a Court of Tax Appeals to settle tax questions simply and expeditiously. This would relieve the Supreme Court of the burden of these problems and prevent their being left up in the air until Congress or the Supreme Court chooses to take action on them.

CREDITS

One of the criticisms leveled at the investment credit upon its adoption in 1962, was that it required the taxpayer to reduce the basis of the property in connection with which the credit was claimed by the amount of the credit. This, of course, reduced his basis for depreciation and deprived him of part of the benefit of the credit. The 1964 Act takes heed of this criticism by providing that the basis of property shall no longer be reduced by the amount of the investment credit.¹⁰³ Moreover, where the basis of property was reduced under the 1962 provision, the reduction will now be restored for purposes of computing future depreciation and gain or loss.¹⁰⁴ A similar provision was adopted in connection with leased property where the lessee is permitted to claim the credit. Under the 1962 Act the lessee's deductions for rent had to be reduced by the amount of the credit taken. This is no longer required.¹⁰⁵ In addition, a lessee whose deductions for rent were reduced under prior law is permitted to recoup this reduction by amortizing and deducting it over the remaining useful life of the property.¹⁰⁶ A

¹⁰² See Lowndes, *Federal Taxation and the Supreme Court*, 1 SUP. CT. REV. 222 (1960).

¹⁰³ Revenue Act of 1964, § 203 (a) (1), 78 Stat. 33 (1964); Revenue Act of 1964, § 203 (a) (4), 78 Stat. 34 (1964).

¹⁰⁴ Revenue Act of 1964, § 203 (a) (2) (A), 78 Stat. 33 (1964).

¹⁰⁵ Revenue Act of 1964, § 203 (a) (1), 78 Stat. 33 (1964); Revenue Act of 1964, § 203 (a) (4), 78 Stat. 34 (1964).

¹⁰⁶ Revenue Act of 1964, § 203 (a) (2) (B), 78 Stat. 33 (1964).

further change made by the 1964 Act in connection with lessees claiming the investment credit is that the credit shall now be computed on the basis of the fair market value of the property, regardless of whether it was constructed or purchased by the lessor, except where the lessor and lessee are affiliated corporations. In the latter case the credit is still based upon cost.¹⁰⁷

The elimination of the basis reduction requirement in connection with the investment credit entails certain collateral consequences which are taken into account by the new law. Since the basis of property will no longer be reduced because of the credit, it will not be increased when the property is disposed of prematurely and the investment credit is required to be recaptured and accounted for. Nor will a deduction be allowed for any part of the investment credit which cannot be used when the period for carrying over the credit expires.¹⁰⁸ Such a deduction was provided under prior law to compensate for the reduction in basis which no longer occurs.

With some variations the same property that qualifies for the investment credit is subject to section 1245. That provision requires gain from the disposition of depreciable property to be treated as ordinary income to the extent that it represents depreciation deducted after 1961. Since the 1964 Act qualifies elevators and escalators for the investment credit,¹⁰⁹ it also subjects such property to the provisions of section 1245.¹¹⁰ As we have seen, one unhappy result of including elevators and escalators under section 1245 is that when a building is sold the gain from the building will be governed by section 1250, while the gain from any elevators or escalators in the building will fall under section 1245.¹¹¹

The credit for retirement income is another of the income tax provisions which is remarkably complicated, considering its trivial character and the fact that it is of principal concern to the low-bracket taxpayer who can hardly be expected to have a tax expert at his elbow. A further complication has been added by the 1964

¹⁰⁷ INT. REV. CODE OF 1954, § 48 (d), as amended, Revenue Act of 1964, § 203 (b), 78 Stat. 34 (1964).

¹⁰⁸ Revenue Act of 1964, § 203 (a) (3) (B), 78 Stat. 34 (1964).

¹⁰⁹ INT. REV. CODE OF 1954, § 48 (a) (1) (C), added by Revenue Act of 1964, § 203 (c), 78 Stat. 34 (1964).

¹¹⁰ INT. REV. CODE OF 1954, § 1245 (a) (3) (C), added by Revenue Act of 1964, § 203 (d), 78 Stat. 35 (1964).

¹¹¹ See text accompanying note 14 *supra*.

Act. Under prior law the maximum amount of retirement income that qualified for the credit was \$1,524. Qualified spouses could each claim the maximum credit on a joint return, although the credits for each spouse had to be computed separately. The 1964 Act permits a maximum of \$2,286 to be treated as retirement income by spouses sixty-five years of age or over on a joint return, even though only one of the spouses qualifies for the retirement credit.¹¹² This provision reflects an effort to conform the retirement income credit to the exemption for social security payments which includes supplementary benefits to the extent of one-half of the husband's benefits for a wife who has not met covered employment requirements. The new ceiling means, of course, that where both spouses meet the requirements for the retirement income credit, taxpayers must now compute the credit in two ways in order to insure receipt of the maximum benefit.

The amount of the retirement income credit is limited to a percentage of the income eligible for the credit approximating the tax in the lowest bracket. Under prior law this was 20 percent. Under the 1964 Act it will be 17 percent in 1964 and 15 percent in 1965.¹¹³ This raises an interesting point. The justification for the tortuous details of the retirement income credit is that the credit is intended to equalize the tax of a person who is not entitled to social security with that of the taxpayer who receives such payments. For this reason retirement income, in order to qualify for the credit, is required to conform to the requirements that a person must meet in order to be eligible for social security; retirement income is reduced by earned income to the same extent that social security payments are reduced by earned income, and so on. Strangely enough, however, social security payments are exempt from the income tax, while retirement income is limited to only a modest credit. Suppose, for example, that there are two taxpayers, both of whom are in the 70 percent bracket. One receives \$1,000 in social security payments, while the other receives \$1,000 in retirement income qualifying for the retirement income credit. The first taxpayer will escape an income tax of \$700 because of the exemption

¹¹² INT. REV. CODE OF 1954, § 37 (i), added by Revenue Act of 1964, § 202 (a), 78 Stat. 33 (1964) (former § 37 (i) redesignated as § 37 (j)).

¹¹³ INT. REV. CODE OF 1954, § 37 (a), as amended, Revenue Act of 1964, § 113 (a), 78 Stat. 24 (1964).

for social security payments. The other taxpayer will get a credit (in 1965) of only \$150 against his tax.

The strangest thing of all about the retirement income credit, however, is that Congress ever adopted this form of tax relief. Since there is no reason for exempting social security payments from the income tax (and it is pretty generally conceded that such payments should be taxed), the obvious way to eliminate any discrimination between retired taxpayers who receive social security and those receiving some other form of retirement income would be to tax social security payments as income. Unhappily, however, the credit for retirement income is a fairly typical example of how tax law is apt to be made. The law first creates an unjustified preference. Congress then strives to remedy the injustice created by the preference, not by abolishing the preference, but by extending it to other taxpayers similarly situated. This has been the case, for example, in connection with percentage depletion. Percentage depletion was initially conceived for the oil and gas industry. Instead of repealing the allowance when its unfairness became obvious, Congress extended it to other depletable properties except timber, which has its own special preferences. Two wrongs may not make a right. Nevertheless, a great deal of tax legislation is predicated upon the assumption that they do.¹¹⁴

¹¹⁴ Several other provisions of the 1964 Act which are not referred to in the text are:

Revenue Act of 1964, § 219, 78 Stat. 57 (1964) providing that certain union negotiated multi-employer pension plans may be treated as qualified from the date they were created.

Revenue Act of 1964, § 220, 78 Stat. 58 (1964) permitting domestic corporations to include in their pension or profit-sharing plans employees of foreign subsidiaries or domestic subsidiaries largely engaged in foreign operations, who are citizens of the United States.

Revenue Act of 1964, § 222, 78 Stat. 75 (1964) permitting gains from retail sales under a revolving credit plan to be reported as installment sales, except where the revolving credit plan is used by a purchaser primarily as an ordinary charge account.

Revenue Act of 1964, § 228, 78 Stat. 98 (1964) making several amendments in connection with the taxation of insurance companies.

Revenue Act of 1964, § 236, 78 Stat. 127 (1964) providing that federal tax liens shall not run against a purchaser of a motor vehicle without notice of the lien.

Revenue Act of 1964, § 239, 78 Stat. 128 (1964) extending the time for claiming credits and refunds for overpaid self-employment taxes by state or local employees arising from an agreement with the state or local government extending social security coverage to the employees and imposing taxes retroactively on their wages.

Revenue Act of 1964, § 240, 78 Stat. 129 (1964) extending the time for payment of the federal estate tax on a reversionary interest to three years after termination of the prior interest.