TAX EVASION AND AVOIDANCE

HEARINGS

BEFORE THE

JOINT COMMITTEE ON TAX EVASION AND AVOIDANCE

SEVENTY-FIFTH CONGRESS

FIRST SESSION

PURSUANT TO

PUBLIC RESOLUTION NO. 40, SEVENTY-FIFTH CONGRESS, FIRST SESSION, TO CREATE A JOINT CONGRESSIONAL COMMITTEE ON TAX EVASION AND AVOIDANCE

PART 2

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TAX EVASION AND AVOIDANCE

TUESDAY, JUNE 29, 1937

JOINT COMMITTEE ON TAX EVASION AND AVOIDANCE,
Washington, D. C.

The joint committee met in the hearing room of the Committee on Ways and Means in the New House Office Building, at 10 a. m., Hon. Robert L. Doughton (chairman) presiding.

The CHAIRMAN. The committee will be in order. Are you ready, Dr. Magill?

Under Secretary MAGILL. Yes, sir.

The CHAIRMAN. I notice in some of the New York papers that certain of the statements made by witnesses relative to personal holding companies have been disputed or challenged. Have you anything to say with respect to those statements? I suppose you have seen them.

Under Secretary MAGILL. I have seen statements regarding the New York Sun, Inc., and regarding Consolidated Publishers, Inc., both of which I believe came out in the New York Sun and in the New York Times. Are those the ones you have reference to?

The CHAIRMAN. Yes. Do you have anything to say relative to those statements? Usually we do not notice statements of that kind, but I thought those perhaps were worthy of notice.

Under Secretary MAGILL. I shall be glad to put that in the record if you want it. As soon as we saw the statements, I asked the Commissioner and the men who have been working on this to check them for accuracy, to see what the facts are to be.

The facts are, as far as we can ascertain, precisely as we presented them to you here last week; that is, that in the case of the New York Sun and also of the Consolidated Publishers, both companies file personal holding company returns under section 351. Of course we do not know what the motive may have been of the persons that organized those two companies, and they can tell you about that better than anyone else, but anyway both companies did file personal holding company returns.

In both cases they were used by the Commissioner for the purpose of showing that by means of these various allowances which the companies took they avoided any substantial tax under section 351, although both companies had large earnings, and the tax would have been much greater had the earnings been taxable to the persons who had the beneficial interest in the two companies.

Further, I noticed in the Sun's statement the Sun made a good deal of the fact that the preferred or "A" stock, the first preferred, was owned by various employees. No statement was made with respect to the common or the second preferred. The information we have is that the common is owned by the Dewart family and not by these

employees about which the statement enlarged upon. So that the summaries of the facts are so far as we can see precisely as we stated them last week, and the two companies, though doubtless perfectly legally organized, were availed of for the purpose of reducing taxes which otherwise would have been imposed.

The CHAIRMAN. As to the motive, that is a matter for them to explain to the public?

Under Secretary MAGILL. I do not question their motive in the matter. I do not know what their motive was, but I do know that both of them had personal holding companies, and both of them did effect tax savings.

The CHAIRMAN. You know the action taken by them, and as to the motive and as to the interpretation the public may place upon that action, that is not a matter with which you have anything to do, is it?

Under Secretary MAGILL. Yes, sir. You will recall that we said at the very beginning, which of course is rather obviously true, that we cannot tell about a taxpayer's motive. We do not know why they did what they did. All we know is what they did and what the effect on the revenues was, and we are presenting these cases in that way.

The CHAIRMAN. Who is your next witness, Dr. Magill? Did Commissioner Helvering finish with his statement? The chairman was not present when he concluded.

Under Secretary MAGILL. I think the Commissioner has concluded. It was our purpose this morning with your approval to proceed to a somewhat more detailed discussion of some others of these personal holding companies, as showing how they are used for purposes of large tax savings; that is, to elaborate in more detail upon what the Commissioner mentioned last week. Then, tomorrow, it is our purpose to go ahead with a discussion of the incorporated yacht, the incorporated farm, and artificial deductions among members of the family.

Mr. Fortas will present the material this morning. Mr. Fortas is an attorney with the Securities and Exchange Commission, who has been working particularly on corporate organization, and we borrowed him for the purposes of this investigation, because of his special familiarity with this field. Mr. Fortas has worked up this material with respect to personal holding companies, and will present it now.

STATEMENT OF ABE FORTAS, ASSISTANT DIRECTOR OF THE PROTECTIVE COMMITTEE STUDY, SECURITIES AND EXCHANGE COMMISSION

The CHAIRMAN. Mr. Fortas, will you please give your full name and address, your official position, and the capacity in which you appear, for the purpose of the record?

Mr. FORTAS. My name is Abe Fortas. My address is Washington. I am assistant director of the Protective Committee Study at the Securities and Exchange Commission.

Mr. Chairman, before I start my statement, I would like to offer for the record a document which I have headed table III. This document is offered in response to a suggestion made by Senator Harrison at the last session of the committee. This table III lists the names of personal holding companies and their owners as shown on table II, which is already in the record. It further supplies information with

respect to the address of these individuals and their personal holding companies, and it gives the place of incorporation of the personal holding companies. I offer this for the record.

The CHAIRMAN. Without objection, it will be inserted in the record.

(The table referred to is as follows:)

TABLE III.—*Personal holding companies and owners*

Personal holding company and address	Principal owner	Place of incorporation
Acmaro Securities Corporation, Atlanta, Ga.	R. W. Woodruff, Wilmington, Del.	Delaware.
Baltic Securities Corporation, Jersey City, N. J.	Charles E. Merrill, New York City; Edmund C. Lynch, New York City	Do.
Beech Corporation, Newark, N. Y.	Thomas W. Lamont, New York City.	New Jersey.
Burton Securities Co., Florida	W. L. Burton	Florida.
Cherokee Securities Corporation, Delaware	W. R. Coe	Delaware.
Chesapeake Securities Corporation, New York City.	Virginia Campbell	Do.
Claytona Co., Ltd., Canada and New York City.	Isabel Willys, New York City	Canada.
Coalesced Co	A. W. Mellon, Paul Mellon, Ailsa Mellon, Pittsburgh, Pa.	Delaware.
Dayton Investment Co	George D. Dayton, Minneapolis, Minn.	Minnesota.
Delaware Realty and Investment Co., Delaware.	C. C. du Pont	Delaware.
Col. H. A. du Pont Co., Wilmington, Del.	Estate of H. A. du Pont, H. F. du Pont, trustee, Delaware.	Do.
Elalfrel Co., Delaware	F. V. du Pont	Do.
Elton Investment Co., Inc., Wilmington, Del.	R. C. du Pont	Do.
D. R. Fisher Co., Washington	D. R. Fisher	Washington.
The O. W. Fisher Co., Washington	O. W. Fisher	Do.
O. D. Fisher Investment Co., Seattle, Wash.	O. D. Fisher, Seattle, Wash	Do.
Habalu Trading Corporation, New York City.	Harry A. Hatry	New York.
Hannan Securities Corporation, Delaware	Henry T. Hannan	Delaware.
W. W. Hawkings Co., New York City	Mr. and Mrs. W. W. Hawkins	Do.
Roy W. Howard Co., New York City	Roy W. Howard and wife	Do.
Hudson Co., Delaware	Valentine E. Macy, Jr	Do.
Jaxon Corporation, Jersey City, N. J	Mrs. Irene Jackson Sloan, Great Neck, N. Y.	Do.
Jernlyn Securities Corporation, Jersey City, N. J.	Edmund C. Lynch, New York City	Maryland.
M-K, Inc., Detroit, Mich	Wm. A. Kent	Michigan.
Marquette Corporation, Jersey City, N. J	Alfred P. Sloan, New York City	Delaware.
Midland Investment Co., Delaware	Robert Nixon	Missouri.
Nemours Corporation, Wilmington, Del	Paulina de Pont Dean, Delaware	Delaware.
New Castle Corporation, Jersey City, N. J.	Alfred P. Sloan, New York City	Do.
New York Sun, Inc., New York City	William A. Dewart and wife, New York City.	New York.
Northern Exploration Corporation, Jersey City, N. J.	Charles Hayden (deceased)	Delaware.
Orchard Corporation, Jersey City, N. J	Charles E. Merrill, New York City	Do.
Park Corporation, New York City	W. S. Paley, New York City	Do.
Phillips Properties, Inc., Washington, D. C.	Mr. and Mrs. Duncan Phillips, Washington, D. C.	Do.
Regent Corporation, Wilmington, Del	Pierre du Pont, Wilmington, Del	Do.
Renappi Corporation, Wilmington, Del	Mrs. W. du Pont Ross, Montchanin, Del.	Do.
Rene Corporation, Jersey City, N. J	Alfred P. Sloan, New York City	Do.
Rockland Corporation, Newark, N. J	Mrs. F. Corliss Lamont	Do.
Ruppert Holding Corporation, New York City.	Jacob Ruppert, New York City	New York.
E. W. Scripps Co	E. W. Scripps	
Robert P. Scripps Co	Robert P. Scripps, California	
Senior Investment Corporation, Detroit, Mich.	Fred Fisher, Detroit, Mich	Michigan.
Thomas L. Sidlo Co., Ohio	Thomas L. Sidlo	Delaware.
Staple Products, Ltd	Charles E. Merrill, New York City	Canada.
Still Pond Co., Wilmington, Del	Paulina Du Pont Dean, Delaware	Delaware.
Transit Corporation, New York City	Jeremiah Milbank, New York City	Do.
United Telegram Co., Jersey City, N. J	Charles Haydon (deceased)	New Jersey.
Western Merchandise Corporation, Jersey City, N. J.	Charles E. Merrill, New York City; Edmund C. Lynch, New York City	Delaware.
Worth Bros. Corporation, Claymont, Del	E. H. Worth	Do.

Mr. FORTAS. Mr. Chairman, and gentlemen of the committee, as Mr. Magill said, I propose today to continue a discussion of the use of corporations subject to section 351 of the revenue act; that is, the personal holding companies. You will recall that this matter was discussed in a general way by Commissioner Helvering, at your last session. The Commissioner showed the loss of revenue resulting from the use of personal holding companies by certain wealthy individuals. He described the operation and effect of the structure of section 351 and of its provisions allowing certain deductions in order to arrive at the taxable income figure (the undistributed adjusted net income), as it is called in the act.

Allow me to restate the problem before proceeding to my discussion. From the time of the first income-tax law in 1913 to the present, Congress has been concerned with the use of corporations by individuals for the purpose of avoiding the full incidence of the surtax upon them. In the first revenue act passed in 1913, and in every revenue act thereafter, Congress included a provision imposing a surtax on corporations which unreasonably accumulated income for the purpose of avoiding surtax levies which their owners would otherwise have to pay.

As the committee discussed at its last session, this provision (now known as sec. 102) was supplemented in the 1934 act by section 351. This section defined as "personal holding companies" a certain type of closely held corporation which received at least 80 percent of its income from sources which normally represent not operating profits, but returns upon accumulated capital.

The purpose of this provision was clear, and it was stated as definitely and clearly as possible in the reports of the various committees of Congress which considered the provision. They recognized that perhaps the most prevalent form of tax avoidance practiced by individuals with large incomes was the use of "incorporated pocketbooks." The tax was therefore fixed so as to induce distribution of the income of the corporation, or to permit accumulation only at an additional cost in taxes.

Without question, in terms of revenue derived by the Government, section 351 was an improvement over the prior system. But as Commissioner Helvering stated, and as I wish further to show, the matter demands further congressional attention. Individuals, with the help of resourceful tax lawyers and consultants, are still escaping payment of their fair share of taxes by use of the "incorporated pocketbook."

I propose to describe in detail certain cases in which corporations have been used for tax avoidance by their owners, even though those corporations are subject to section 351 of the revenue act as personal holding companies. We shall later present to the committee a study of cases in which corporations which are not classified as personal holding companies are used for the same purpose.

The cases which I shall discuss cover variously the tax years 1934, 1935, and 1936. They are all the cases, relevant to my present purposes, which could be completed for presentation at this time. Some of them are presently under consideration by the Bureau, deficiencies of various sorts having been asserted. In some, claims under section 102 for unreasonable accumulation in years prior to 1934 have been asserted. In others, deductions and credits taken on the returns have been challenged. Because these matters are stilll pending, I shall not refer to these controversies in connection with individual cases.

I wish to describe to the committee in some detail by discussion of typical cases, the nature of these personal holding companies—their assets, liabilities, the sources of their income, and the extent of their accumulation of income. I shall also show how these companies enabled their owners to avoid taxes, and the actual amount of taxes so avoided.

In addition, I shall address myself to specific problems which have become apparent in the administration of section 351. This discussion will further illuminate the means adopted by individuals to take maximum advantage of technical loopholes in the statute, in order to obtain the greatest possible reduction in taxes.

I shall discuss the subject under separate headings. First, I think I should explain the difficulty of classification in connection with cases of this kind. There is bound to be overlapping, but cases usually have predominant aspects which serve as a basis for division of the subject into the following headings:

1. The saving in the ordinary case through the use of the personal holding company as a tax-saving device.

2. The use and abuse of the deduction provisions of the statute, including (*a*) the ordinary deduction provisions contained in section 23, and (*b*) the special deduction provisions contained in section 351.

Mr. Chairman, before I go into these individual cases, may I ask a favor of the committee? I shall be reciting rather complicated figures from time to time, and I should like to be able to recite them in round numbers with the understanding that the reporter will copy the exact figures in the record.

The CHAIRMAN. I am sure there will be no objection to that.

Mr. FORTAS. Let me first describe to you a fairly typical, large personal holding company, to show the nature of its assets and its use to avoid payment of taxes which its owner would have to pay, if it had not been utilized. The Central Shares Corporation was incorporated in the State of Delaware. Its officers are in Chattanooga, Tenn. It is owned by Mr. Cartter Lupton, a resident of Chattanooga. Mr. Lupton formed this corporation in February 1932, and transferred to it his extensive holdings of stock in about 30 commercial corporations engaged in bottling Coca-Cola. These, together with certain nontaxable securities, constitute the principal assets of the corporation.

The immense value of these stocks is shown by the dividends received therefrom, about $500,000 in 1934, $650,000 in 1935, and $900,000 in 1936.

These are the dividends received from the stocks. It does not appear that this corporation performs any substantial operating activities. Its only business function is to hold these securities, beneficially owned by Mr. Lupton. The record shows that Central Shares, the personal holding company, once possessed certain tin signs advertising bottled Coca-Cola, carried on its balance sheet at a figure of $12,000 in 1934. But it would be unreasonable to suppose that the corporation was organized to acquire or sell these signs in order to whet the public appetite for bottled Coca-Cola.

A more reliable guide to the primary purpose served by the corporation can be obtained by noting certain significant facts. In the first place, the company was formed in February 1932. On June 6, 1932, the Revenue Act of 1932 was approved, greatly increasing the surtax on individual incomes.

In the second place, although the holding company has realized income, after expenses, ranging from over $500,000 in 1934, to $900,000 in 1936, it has paid no dividends to Mr. Lupton, its owner.

In the third place, the creation and operation of the company resulted in a huge tax savings for Mr. Lupton. Even though the company filed a return and paid a tax under section 351, in addition to other corporate taxes, its owner, Mr. Lupton, avoided a large amount of taxes by its use. For the year 1934, he saved $131,045; for 1935, $181,788; and for 1936, $335,690, by the use of this personal holding company.

Senator GEORGE. Would you mind saying how much taxes he actually paid?

Mr. FORTAS. I think I can give you the figures, sir. Yes, I have that. I am coming to that in just a moment.

During these years, the combined net income of Mr. Lupton, individually, and the undistributed net income of his personal holding company after deductions, credits, and exemptions allowed in the revenue acts, amounted to $716,952 for 1934, $930,864 for 1935, and $1,384,694 for 1936. Those are net income figures combining Mr. Lupton, individually, and his personal holding company. He and his corporation together paid on this net income, taxes of $235,508.73 for 1934; $308,966.81 for 1935, and $600,057.31 for 1936.

Mr. VINSON. What part of it was paid for the corporation?

Mr. FORTAS. I am coming to that in just a moment, sir. Most of the corporate taxes for 1934 and 1935 were paid under section 351—$153,362 and $195,543, respectively. In 1936, the company paid $11,992 as normal tax; $157,245 as tax under 351, and an undistributed profits tax of $179,494.05.

Mr. VINSON. Mr. Chairman.

The CHAIRMAN. Mr. Vinson.

Mr. VINSON. Then because of section 351 having been enacted, the additional taxes paid by the personal holding company, which would not have been paid except for 351, was $153,362 in 1934, and $195,543 in 1935?

Mr. FORTAS. That is correct.

Mr. VINSON. And in 1936, $157,245, or a total of $506,150 taxes, additional to what would have been paid except for section 351?

Mr. FORTAS. That is correct, Mr. Vinson, on the assumption that if 351 had not been in existence section 102 would not have been applicable, or would not have been applied.

Mr. VINSON. Of course, we all know that nothing was collected under section 102.

Mr. FORTAS. I think that statement is correct, sir.

Mr. VINSON. In other words, he could have formed a corporation just as he did, and with section 102 being the only weapon, there would not have been any taxes paid?

Mr. FORTAS. I think that is correct, sir.

If this personal holding company had not been created, that is, if Mr. Lupton had not placed his stock and certain other assets in an incorporated pocketbook, he would have had to pay an additional tax for the 3 years in the amount of $648,523.89. That is on the assumption that all of the income from these assets went directly to Mr. Lupton, instead of going to his personal holding company, which they stopped.

There are many other cases in which it can be definitely shown that a substantial tax savings resulted from this procedure. I shall describe some additional cases in the course of this statement. Cases which involve the pyramiding of these incorporated pocketbooks can also be cited.

Mr. VINSON. Before you get away from that——

The CHAIRMAN. Mr. Vinson.

Mr. VINSON. Could you tell us the total of the deductions taken by the personal holding company for the years 1934, 1935, and 1936?

Mr. FORTAS. The deductions taken by Mr. Lupton's company?

Mr. VINSON. Yes.

Mr. FORTAS. I am sorry, Mr. Vinson, I do not have those figures readily available. I will be glad to supply them for the record.

The CHAIRMAN. Can you not rearrange those figures so as to bring them out a little more comprehensively, the amount of taxes they paid, the amount they avoided by the organization of holding companies, and also the amounts of additional taxes paid, as brought out by Mr. Vinson, by reason of section 351? I think you might arrange those so it would be a little more impressive. As you have them now, they are somewhat scattered.

Mr. FORTAS. I have those figures here, sir, and I shall be glad to read them into the record right now.

The CHAIRMAN. Put them into the record so they will be a little more readily understood. I think it will be helpful.

Mr. FORTAS. All right, sir. I will present a summary then of the figures with respect to Mr. Cartter Lupton and his Central Shares Corporation.

For the year 1934, on a personal and a corporate net income of $716,952, the total taxes paid by the personal holding company, including the normal tax and the section 351 tax, amounted to $153,684 plus an individual tax paid by Mr. Lupton in the amount of $81,824.30.

I might point out that for the year 1934 this corporation paid a normal tax of $322.07, so that virtually the entire tax paid during that time, Mr. Vinson, was the figure that I have stated, and it was paid under section 351.

The total corporate and individual taxes paid for 1934 amounted to $235,508.73, the total tax paid on combined income of $716,000, as I have stated, and, as I have said, if this personal holding company had not been created there would have been an additional tax to be paid by Mr. Lupton in the amount of $131,000. Is that clear, sir?

Now, Mr. Chairman, I can furnish the same sort of figures for 1935 and 1936 for the record, and it might save time if I did that instead of reading them.

The CHAIRMAN. You may just insert that in the record.

Mr. FORTAS. May I offer them for the record at the present time?

The CHAIRMAN. Without objection, that will be placed in the record.

(The data presented for the record by Mr. Fortas is entitled "Table I, Cartter Lupton, Chattanooga, Tenn.", and is as follows:)

TABLE 1

[Personal holding company,[1] Central Shares Corporation; incorporated, Delaware; date, February 1932; percent of stock ownership, 100 percent]

Year	Personal and attributable undistributed corporate net income	Individual taxes paid	Taxes paid by all of above holding companies				Total attributal corporation and individual taxes	Taxes if no personal companies	Tax saved by use of companies
			Normal (sec. 13)	Profits (sec. 14)	Personal holding company (sec. 351)	Total			
1934	$716,952.56	$81,824.30	$322.07	None	$153,362.26	$153,684.43	$235,508.73	$366,553.96	$131,045.23
1935	930,864.54	113,422.85	None	None	195,543.96	195,543.96	308,966.81	590,765.43	181,788.62
1936	1,334,694.24	251,325.16	11,092.85	$179,494.05	157,245.25	348,732.15	600,057.31	935,747.35	335,690.04

[1] To interpret this table, see text of statement.

Mr. CROWTHER. Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. It would appear that the amount paid in taxes was about 35 percent of the income. That is, $235,000 would be around 35 percent of $716,000.

Mr. FORTAS. I accept your computation, sir. I have not made it myself.

Mr. CROWTHER. I think that is near enough.

Mr. FORTAS. I think so, yes.

Mr. CROWTHER. That is a very fair rate on the whole, is it not?

Mr. FORTAS. I am not prepared to discuss that question, sir.

The CHAIRMAN. It might not be a fair rate when compared to the taxes paid by other people under similar conditions, on a similar income.

Mr. FORTAS. That seems to be a reasonable statement.

The CHAIRMAN. The question of fairness may depend upon a comparison with what other people paid on their incomes under similar conditions. That would determine the fairness, it seems to me.

You may proceed.

Senator WALSH. Is there any provision in the present law permitting the Secretary of the Treasury or the Commissioner of Internal Revenue to determine whether a personal holding company exists for the purpose of tax evasion or not?

Mr. FORTAS. As I understand the procedure, Senator, the corporation will determine in the first instance whether it is subject to section 351 or not, and if it determines that it is subject to section 351, it will file a return on form 1120–H of the Bureau. If a corporation does not file that return, and the Bureau determines that it is a personal holding company, then the Bureau would take up that question with the taxpayer.

Senator WALSH. Are there any cases in the Internal Revenue Bureau where there has been an adjudication that so-called personal holding companies were existing and operating for the purpose of avoiding the payment of taxes?

Mr. FORTAS. I do not know what the purpose of such a determination would be, under the revenue act as it is presently drafted, Senator Walsh.

Senator WALSH. This matter of tax avoidance through the instrumentality of a personal holding company might be eliminated by giving power to the Internal Revenue Department to adjudicate a

corporation as fictitious and existing only for the purpose of tax avoidance or evasion.

Under Secretary MAGILL. Senator Walsh, perhaps I can answer that.

Senator WALSH. If that were so, we would not need any more legislation, provided that law were enforced.

Under Secretary MAGILL. We have been thinking along those lines; that is, as to whether or not it would be possible as a part of this legislation to give some powers to the Commissioner to make a determination, for instance, that a company of this kind is being used simply for tax avoidance, and authorizing him to disregard it.

Senator WALSH. I do not understand what power he now has.

Under Secretary MAGILL. The powers that he now has, as I understand it, are twofold: You have first section 351, which we have been speaking of, which defines quite definitely the corporations which fall within its terms. There is no option to the Commissioner one way or the other; if a company comes under that section, it is taxed in that way.

Then in addition we have the section which has been in the law in one form or another since the beginning, and which I believe is now section 102, to the effect that if a corporation is formed or availed of for the purpose of defeating the imposition of surtaxes upon its shareholders, then an additional tax of so much shall be imposed.

Now, so far as that is concerned, the determination as to whether a company is so formed or availed of would rest with the Commissioner in the first instance, and it would then, if the matter were contested, be a question for the courts, as to whether the Commissioner's determination was sound. There have been some few cases involving that question, which have gone to the courts. On the whole, the experience with that section has not been vary satisfactory, because of the vague terminology.

Mr. VINSON. Mr. Chairman.

The CHAIRMAN. Mr. Vinson.

Mr. VINSON. The *DeMille case* was one of those, was it not?

Under Secretary MAGILL. Yes, sir.

Mr. VINSON. And the Commissioner evidently held that it was a corporation falling under section 102.

Under Secretary MAGILL. That is right.

Mr. VINSON. Subject to either the 50 percent penalty or the 25 percent penalty, whichever was applicable at that time; but the courts said "No"?

Under Secretary MAGILL. Now, there is one further remark I should make. As I recall the provisions of the law, section 102 is the provision giving the Commissioner the power to determine how a corporation is being used. It specifically exempts companies that come under section 351, so that if a company is a personal holding company within the definition in section 351 the Commissioner, as I understand has no power one way or the other.

Mr. CROWTHER. I don't want to disturb the continuity of the statement that is being made by Mr. Magill, but while he is on his feet I want to ask if there is any similarity between the type of the personal holding companies and their activities we are discussing and the one where a decision was given by Justin Miller in the Board of Tax Appeals in the *Lammot du Pont case*.

Under SECRETARY MAGILL. I am only familiar with that as it appeared in the newspapers.

Mr. CROWTHER. That is all the information I have. I have read some quotations from the decision.

Under SECRETARY MAGILL. Perhaps Mr. Kent can answer more accurately than I can.

Mr. KENT. I think I can answer that. In that case it is fair to say that the personal holding company was formed by the taxpayer in 1923 for the purpose of avoiding death duties in respect of stocks and securities issued by a corporation foreign to Delaware, the State of his residence, and also to avoid possible legal difficulties for his executors in effecting the transfer of such intangible property at his death.

Nevertheless, Mr. du Pont did have this corporation. It was in existence in the years 1929 and 1930, when the transactions which gave rise to the controversy between him and the Bureau took place. Mr. du Pont found that he was going to have a very large taxable income in 1931, amounting to nearly $2,500,000. To reduce his prospective tax obligation he apparently—let me go back a step, I have gone forward a little too far. The taxpayer had transferred a very large volume of securities to this corporation over a period of several years, but he still had a substantial volume of securities in his portfolio. In 1930, in order to reduce his taxes for that year, he sold a considerable amount of the securities which he still held personally and which had depreciated in value to this personal holding company. That company used as the money to pay for these securities sums which Mr. du Pont had previously loaned to the corporation.

The Commissioner took the position that the taxpayer dealt with no one but himself, and therefore that the alleged sales were not bona fide and that the losses resulting therefrom were not deductible for income-tax purposes.

In this recent decision the Board of Tax Appeals, following what it found to be a consistent line of holdings to the contrary, held that there was no sufficient reason for disregarding the corporate entity in this case, and that the losses on the sale of these securities to the personal holding corporation were deductible.

That same result had been reached by the Circuit Court of Appeals for the Ninth Circuit Court in the prior case of *Commissioner* v. *Eldridge* (79 Fed. 629), and in that case the Solicitor General refused to follow the recommendations of this office that a petition for certiorari be sought from the Supreme Court of the United States. In other words, it was the view of his office that there was not a sufficient basis for disregarding the corporate entity in the case. The decision in the case quite definitely, I think, indicates that it is only in rather extraordinary cases that the courts will disregard the corporate entity unless there is some express authority or mandate in the statute that it has to do so.

Mr. CROWTHER. It seems to me that if this subject is germane it would not be a bad idea—and I yield to the judgment of the committee on that, of course—to have that opinion of the Board of Tax Appeals in our minutes somewhere along here where we are discussing these cases, if there is enough similarity to be of any value.

Mr. COOPER. Will you yield?

Mr. CROWTHER. I yield.

Mr. COOPER. Let me ask this question. This case arose under the prior revenue act?

Mr. KENT. That is true.

Mr. COOPER. And if the distinction between that and the present situation that in 1934 we sought to meet a situation just of that type?

Mr. KENT. That is correct.

Mr. COOPER. And that provision of the 1934 act was carried forward in the 1936 act?

Mr. KENT. That is correct. I should have stated, as I intended to do, that so far as the particular situation presented in this recent case is concerned, it had been taken care of by the Congress in the amendment contained in section 24-A (6), Revenue Acts of 1934 and 1936, which denied to an individual a deduction for losses on shares sold or exchanged by him with a corporation in which he holds directly or indirectly the controlling interest.

Mr. COOPER. And while this particular case arose under prior acts, the effort has already been made by Congress to correct that situation?

Mr. KENT. That is true.

Mr. COOPER. And the situation that arose in the *Du Pont case* cited by you could not now arise under the law as it now stands?

Mr. KENT. That is true.

The CHAIRMAN. Dr. Crowther, do you request that that opinion be inserted?

Mr. CROWTHER. If it is not germane and there is no similarity between this and the present discussed case, I withdraw the request.

Mr. COOPER. The reason I had you to yield was to point out the fact that the law has already been changed. While this decision arose under prior acts it could not arise under existing law.

Mr. CROWTHER. And under existing law the decision was against the Treasury Department.

Mr. COOPER. Under the law it was applicable at the time the tax was to be paid.

Mr. VINSON. You referred to a circuit court of appeals case, Mr. Kent?

Mr. KENT. Yes.

Mr. VINSON. When was that decided?

Mr. KENT. That case was decided by the circuit court of appeals in 1935, Mr. Vinson.

Mr. VINSON. Of course, that decision was on the old statute?

Mr. KENT. That is true, that was on the law, under the law as it existed prior to 1934.

Mr. VINSON. Was that circuit court of appeals decision rendered prior or subsequent to the Gregory decision in the Supreme Court, where the Supreme Court did look through a corporate entity and held where it had been instituted for the sole purpose of tax evasion they would disregard the corporate structure?

Mr. KENT. It was subsequent to that case, Mr. Vinson. *Gregory* v. *Helvering* was decided January 7, 1935; and *Commissioner* v. *Eldridge* was decided November 4, 1935.

Mr. FORTAS. May I proceed, Mr. Chairman?

Mr. VINSON. If you please, Mr. Chairman, the other day a request was made for a statement of revenues that had been collected under the old sections 220 and 102 up to 1927, and then the revenues that were collected subsequent to that time and up to the enactment of section 351, with the further request for an estimate as to the additional revenue that has come into the Treasury because of the passage

or the enactment of section 351. I would like to ask Dr. Magill if he has such a statement.

Under Secretary MAGILL. Yes, sir. Our Division of Research and Statistics has prepared these figures which you requested the other day and I have it here on this piece of paper. I am sorry it has not been mimeographed, because I just got it before I came here.

Mr. VINSON. I would like for you to read it into the record.

Under Secretary MAGILL. This is titled: Surtax on corporations improperly accumulating surplus: Section 220, Revenue Acts of 1918, 1921, 1924, and 1926; section 104, Revenue Acts of 1928 and 1932; section 102, Revenue Acts of 1934 and 1936.

As of January 11, 1927, collections of tax under these provisions amounted to $183,833.59.

As of January 11, 1930, collections, and reasonably certain collections under cases disposed of by the General Counsel's office, amounted to $5,679,475.22.

Collections for the following fiscal years amounted to—

June 30, 1930	$5, 865, 701. 24
June 30, 1931	2, 196, 516. 34
June 30, 1932	582, 113. 13
June 30, 1933	1, 200, 807. 27
June 30, 1934	1, 230, 315. 96
June 30, 1935	2, 333, 993. 15
June 30, 1936	4, 910, 410. 44
April 30, 1937	3, 384, 716. 51

Estimated yield from surtax on personal holding companies, section 351, Revenue Acts of 1934 and 1936.

The yield in Federal revenue of section 351 is made up of two parts, (1) the surtax on personal holding companies and (2) the estimated yield from the extra dividends distributed by personal holding companies due to the operation of section 351. There is no statistical evidence to indicate what proportion of the total dividends paid by personal holding companies in each of the years tabulated is due to section 351. Due to the nature of the personal holding company vehicle, we feel that it is reasonable to assume that 75 percent of the dividends now distributed would not have been distributed except under the operation of section 351. On that basis the following tabulation indicates the yield from section 351:

Estimated revenue due to sec. 351 of the revenue laws

[In millions of dollars]

	Calendar year liabilities	
	1934	1935
Personal holding company surtax	1.8	3.0
Estimated individual income tax liability from extra dividends paid by personal holding companies	33.9	46.1
Total estimated tax due to sec. 351	35.7	49.1

The CHAIRMAN. You may proceed, Mr. Fortas.

Mr. FORTAS. Mr. Chairman, I was about to discuss the few cases involving the pyramiding of the personal holding companies, the incorporated pocketbooks which resulted in a saving of taxes.

I wish first to describe the personal holding companies belonging to Mr. Henry L. Doherty.

Mr. COOPER. I wish you would spell out those names so we can get them distinctly.

Mr. FORTAS. Yes, sir; Henry L. Doherty, D-o-h-e-r-t-y, president, Cities Service Co. and president or director of 63 other companies. Mr. Doherty owns a number of corporations which are personal holding companies under section 351 of the revenue act; the top personal holding company is Henry L. Doherty & Co., Inc., a Delaware corporation organized in November 1928, with offices in Jersey City. The principal assets of this company are securities.

It appears that the Doherty Co. is the agency through which Mr. Doherty controls many of his vast interests. We have also complete information, so far as relevant to present purposes, on the Doherty Research Co., the Improved Equipment Co., and Gas Securities Co. Those three are the Doherty Research Co., the Improved Equipment Co., and Gas Securities Co.

All of these are also personal holding companies owned directly or indirectly by Mr. Doherty.

Whatever the motives for the formation of these companies and other personal holding companies owned by Mr. Doherty, it is clear that they are merely parts of Mr. Doherty's personality. In other words, they are his creatures and his instruments. Any employees or officers which they may have are, in effect, working for Mr. Doherty.

It is also clear that the effect of these personal holding companies has been to avoid payment of a large amount of taxes which Mr. Doherty would have had to pay had they not existed. The four personal holding companies paid a surtax under section 351 of only $479.44 for 1934. Our computation shows that for the year 1934 alone, by use of the four personal holding companies' names, Mr. Doherty saved about $160,000 in tax on a combined corporate and indvidual net income of about $620,000.

Another instance of this sort involves Charles E. Merrill and Edmund C. Lynch.

Senator HARRISON. What is their address?

Mr. FORTAS. Their address is New York City. I think that is already in the record, Senator.

These two gentlemen control 23 corporations and 40 trust funds; 12 of the 23 corporations are personal holding companies under section 351 of the revenue act. These companies and the other interests owned and controlled by Mr. Merrill and Mr. Lynch are pyramided, so that they run the show by actual, individual stock ownership in only a few companies.

Some of the personal holding companies are owned solely by Mr. Merrill some by Mr. Lynch, and some jointly.

I have here a table headed exhibit A, showing the names of these personal holding companies owned by Mr. Merrill and Mr. Lynch, their respective ownership, the place of incorporation, the date of incorporation, and I wish it inserted in the record, if it is in accordance with the wishes of the committee.

The CHAIRMAN. Without objection it will be inserted in the record.

(The statement referred to is as follows:)

EXHIBIT A

PERSONAL HOLDING CORPORATIONS OF CHARLES E. MERRILL AND EDMUND C. LYNCH

Companies in control of Charles E. Merrill and Edmund C. Lynch, jointly:
- Baltic Securities Corporation, Jersey City, N. J., incorporated in Delaware, August 1, 1927.
- Western Merchandise Corporation, Jersey City, N. J., incorporated in Delaware, December 15, 1928.
- Chain Merchandising, Ltd., Charlottetown, Prince Edward Island, Canada, incorporated in Canada, 1929.
- Chain Stores Corporation, Montreal, Canada, incorporated in Canada (address on return), 1924.
- Common Commodities Corporation, Montreal, Canada, incorporated in Canada (address on return), 1924.

Companies in control of Charles E. Merrill:
- Cemstate Corporation, Jersey City, N. J., incorporated in Delaware, November 25, 1930.
- Orchard Corporation, Jersey City, N. J., incorporated in Delaware, June 1932.

Companies in control of Edmund C. Lynch:
- Jayel Corporation, Jersey City, N. J., incorporated in Delaware, June 23, 1930.
- Jernlyn Securities Corporation, Jersey City, N. J., incorporated in Maryland, June 1930.
- Truflyn Securities Corporation, Jersey City, N. J., incorporated in Maryland, June 1930.
- Truhlyn Corporation, Jersey City, N. J., incorporated in Maryland, June 1930.
- Yeoman Corporation, Jersey City, N. J., incorporated in Delaware, June 1932.

REALTY CORPORATIONS

Company in control of Charles E. Merrill: Retail Realty Corporation, Jersey City, N. J., incorporated December 20, 1926.

Company in control of Edmund C. Lynch: Edlyn Realty Corporation, Jersey City, N. J., incorporated December 20, 1926.

Mr. FORTAS (continuing). Mr. Merrill and Mr. Lynch would undoubtedly have saved taxes if they had created only 1 personal holding company; but they set up 12 of these outfits. These 12 companies served, in part at least, to enable the accomplishment of transactions such as I shall later describe in this statement.

Senator HARRISON. They would still be subject to tax?

Mr. FORTAS. As I understand it they would still be subject to section 351 as personal holding companies.

The minimum result of the simple division of income between these men and their personal holding companies was an approximate savings to each of them in excess of $60,000 for each year 1934, 1935, and 1936. We have arrived at this figure by adding to the personal net income of each man, first the net income of the companies which he owned, and second, his approximate share of the net income of the personal holding companies jointly owned. We have computed the tax which each man would have had to pay on his income and have deducted from it the tax actually paid by him and his corporations, and in that way we arrive at the tax saving which I have just stated.

As I said, gentlemen, these figures as to the amount of tax avoided take no account of deductions for capital losses taken in the returns of these personal holding companies. These deductions might not have been available to Mr. Merrill and Mr. Lynch if their companies had

not existed. I shall discuss this in detail in a later part of the statement.

It is perhaps advisable to complete the picture at this point to indicate that the tax savings effected by subdividing income between an individual and personal holding companies may be multiplied by use of the holding company in combination with other devices. For example, an individual may not retain all of the stock of his personal holding companies. He may divide their stock among a number of persons in his family or among a number of irrevocable trusts, created to benefit persons in whom he has an interest. This may result in a reduction of the aggregate tax levied upon distributions by the personal holding companies. This lower aggregate tax may result, as you know, because of the operation of the graduated surtax. Persons receiving the principal part of the holding company's distributions may be in lower surtax brackets than is the creator of the company, and the tax therefore leviable upon the company's dividend distributions will be less than if all dividends were paid to one individual. I call this to the committee's attention merely in order that it may have before it a fairly complete picture of the possibilities of loss of revenue through subdivisions of income in combination with the use of personal holding companies.

Gentlemen, I have thus far been talking of methods by which taxpayers have taken advantage of statutory provisions so as to subdivide their profits and thereby avoid the incidence of the graduated surtax on individual and personal holding company incomes. I now wish to point out certain typical schemes by which taxpayers have done more than merely subdivide their income. In these cases they have so arranged their assets and so engineered transactions as to get deductions which would not otherwise be available. They have not been content with the substantial saving resulting from the simple subdivision of income between the real owner and one or more personal holding companies. They have used their personal holding companies, and arranged their affairs so as to avoid even further their obligation to pay a full and fair measure of taxes to their Government.

In the first place, some of these individuals have incorporated their homes—the places in which they live. Others have incorporated their yachts, airplanes, cruisers, automobiles, country estates, and other possessions. Not all of these corporations are subject to the surtax under section 351. Some of them, for reasons which I shall hereafter state, have been taken out of this classification and are subject only to the normal corporate tax. But even though the corporations are personal holding companies subject to the surtax under section 351, their owners have deprived the Government of revenue—have avoided their full share of taxes, by turning over to their corporations homes, estates, airplanes, automobiles, and the like.

Let me show you how this may be done. Mrs. Helena S. Raskob, wife of John J. Raskob, owns several personal holding companies. Mrs. Raskob's address is Wilmington, Del. Mr. Raskob is a director of General Motors Corporation.

Directly or through Pioneer Point Farms, Inc., which she owns, Mrs. Raskob owns Archmere, Inc., a Delaware company formed in 1916. She also owns through Pioneer Point Farms the Pioneer Point Realty Corporation, which was organized in Delaware in December

1931. Mrs. Raskob also has a minority interest in Christiana Securities Corporation, apparently a large company in which certain other General Motors executives are interested.

Pioneer Point Farms, the top company, so to speak, is not classified as a personal holding company because, as I shall later explain in detail, it receives more than 20 percent of its income from operating a farm. Pioneer Point Realty Corporation, one of lower companies, owns the Raskob farm and estate in Maryland. This is a personal holding company. But Pioneer Farms apparently has all the rights of the farming operations on that farm and estate that is owned by the Realty Corporation, so one personal holding company owns the land and another company, not a personal holding company, has all rights to farm operations in and on that land. The farming operations that are done by the top company generally results in substantial net losses.

The reason for this multiplicity of corporations seems moderately clear. The Realty Corporation which owns the estate and the farm land and Archmere, Inc., another one of the personal holding companies, received most of their income from holdings of stock in Christiana Securities Corporation, another company. The Farms Corporations, the top company, receives most of its income from Archmere, which received its income from Christiana, and therefore the Farms receives most of its income from Christiana indirectly through Archmere.

Now, by dividing the income from her stock in Christiana, which is the profitable enterprise, the profitable investment, between the Realty Corporation which owns the farm land, Archmere, another holding company, and the Farms Corporation which operates the farm, instead of receiving it herself, by dividing it among these companies Mrs. Raskob saves taxes. Furthermore, by diverting some of this income to the Realty Corporation which owns the Raskob estate, and to the Farms which conducts the farming operations, Mrs. Raskob is enabled to get the benefit of certain statutory deductions against the income of the profitable corporation, Christiana. This is possible because losses on the farm and the estate are deducted on the returns of Mrs. Raskob's companies, which might not be deductible on her individual return. The Realty Corporation and the Farms deducted the losses of running the estate and the farming losses respectively, setting that off against income from Christiana. These losses might not be deductible on Mrs. Raskob's individual return, and therefore if Mrs. Raskob received this income directly she might not be able to set off against that as a deduction the losses on the estate and the Farms.

Mr. Crowther. You say they might not be deductible?

Mr. Fortas. If you will bear with me for a moment I will explain that, sir. Neither the estate nor the farming seems to be profitable to its corporate owner. The Realty Corporation in its returns for 1934 and 1935 offset its income by depreciation and miscellaneous expense of its country estate. The Farms, the top company, deducted from its income losses on the farming operations.

As you know, in accordance with section 24 of the Revenue Act an individual cannot deduct personal, living, or family expenses in arriving at net income. That is under section 24. Therefore, Mrs. Raskob would not have been able to deduct the expenses of her farm and estate unless she could show that they were, quoting the statutory language, "ordinary and necessary expenses" in carrying on a "trade or business."

I am not passing judgment on this point, as to whether Mrs. Raskob might have been able to deduct these expenses and losses in her individual returns, but it is important to note that by transferring the farming and estate to personal holding companies, Mrs. Raskob claimed the benefit of these expenses as a deduction under section 25 of the Revenue Act, applicable to corporations.

Thus, by the usual device of dividing the income between a number of companies and the additional device of having two of the companies engaged in operations which result in substantial losses and deductions, which are offset against that income, an increased reduction of tax liability is effected.

Mr. Kent, of the Treasury Department, as Mr. Magill said, will hereafter discuss the incorporated farms and kindred problems before this committee. I do not wish to dwell upon this except to show how it is used in connection with personal holding companies to increase the tax reduction which they effect. I can do this most clearly by brief reference to relevant facts in a few additional cases.

Mrs. Wilhelmina du Pont Ross, of Montchanin, Del., owns a personal holding company, the Renappi Corporation, organized in Delaware in July 1928. Mrs. Ross transferred to this company securities, natural-gas leases, and also a large farm and a racing stable.

The Renappi Corporation derives its substantial income from securities and gas leases. This income amounted in 1936 to $500,000. In the same year, all the corporations got out of the racing stable was $6,100, listed as receipts from purses won at various tracks, and expenses of over $30,000. The corporation also received no net income from the farm. It deducted from its gross income $33,302, as net farm losses. The gross income of the farm was only $5,945.

Mr. Kent will describe the Renappi Corporation in detail to you. My point is that, first, Mrs. Ross reduced her taxes on the income of her securities and gas leases, by $40,405 in 1936, by the use of this personal holding company; that is, before making any adjustment for these deductions; and, second, that she may have further reduced her taxes by deducting on the corporate return expenses of her racing stable and farm, and other items, which might not have been allowed as deductions on her individual return, because of the statutory provisions which I have discussed.

Let me also point out the same sort of situation in the C. E. M. Securities Corporation of Delaware, organized in February 1928. It is owned by Mr. Charles E. McManus, his wife, and his son. Mr. McManus is president of Crown Cork & Seal Co.

Mr. McManus himself reported 73.5 percent of the dividends paid by his personal holding company in 1936. Accepting this as a basis for figuring Mr. McManus' beneficial interest in the corporation, we have computed that by use of the personal holding company he avoided payment of an additional $130,059.34 in taxes; and this figure is arrived at merely as a result of subdividing income.

But the C. E. M. Securities Corporation holds in addition to securities of various sorts, a residential property. This property is rented to Mr. McManus for $8,500 a year, which is about 4 percent on its stated value of $198,990. The identifiable expenses allocated to this property, and deducted by the corporation, on its return, amount to $6,775 for the year 1936. These expenses might not have been deductible on Mr. McManus' individual return if they have been paid directly by him instead of by his holding company.

Now I cite one further case that was mentioned in another connection at the last session of this committee. Mrs. Irene Jackson Sloan of Great Neck, N. Y., wife of Alfred P. Sloan, owns the Jaxon Corporation, Snug Harbor Development Corporation, and one-half of New Castle Corporation. All of these are Delaware corporations except Snug Harbor, which was incorporated in New York. Mr. Alfred P. Sloan is president of General Motors, as the record shows, and a director of various companies, including E. I. du Pont de Nemours and the Pulllman Co. He owns Rene Corporation, Marquette Corporation, and one-half of New Castle Corporation, all Delaware companies.

All the named companies, five in number, owned by Mr. and Mrs. Sloan, are personal holding companies under section 351 of the Revenue Act. We compute that their use, allocating a proportionate part of their income to Mr. and Mrs. Sloan, respectively, resulted in the following amount of tax avoidance.

	1934	1935	1936
Mrs. Sloan	$211,707	$175,928	$413,412
Mr. Sloan	257,774	248,435	614,331

These savings were effected on a net income of the individuals and their corporations in the following amounts:

	1934	1935	1936
Mrs. Sloan	$513,271	$783,115	$1,445,363
Mr. Sloan	590,960	1,237,005	2,018,527

These savings are computed without any adjustment for deductions claimed by the personal holding companies which might not have been claimed by the individuals. The income of these corporations was derived almost wholly from securities which they own. But Rene Corporation, owned by Mr. Sloan, also owns other property valued at over $1,000,000. The corporation has claimed deductions under section 23 of the act for expenses of this property. Snug Harbor, another one of these personal holding companies, owns land adjoining the Sloan estate at Great Neck, N. Y. Expenses of developing this land have been claimed.

If adjustment were made for these expenses, if they were included in the taxable income of Mr. and Mrs. Sloan, the amount of tax they would have to pay would of course be considerably increased.

As I have said, these deductions are not peculiar to corporations under section 351. They may be claimed by other types of companies—not subject to that section. My point is that by the device which I have described, individuals seek to obtain for their personal holding companies, a deduction from gross income. Thereby they attempt to avoid taxes even further than is possible by the simple division of income between themselves as individuals and their alter ego—the personal holding company.

I wish to proceed to certain types of deductions peculiar to personal holding companies subject to section 351. Commissioner Helvering, at the committee's last session, commented upon the deduction pro-

visions of section 351 and showed how they resulted in huge loss of revenue and in avoidance of taxes. You will remember his discussion of the provisions allowing tax-free accumulation of 20 percent of the personal holding company's income (sec. 351 (b) (2) (A)); permitting deduction of "reasonable" sums paid or set aside to retire indebtedness incurred prior to January 1, 1934 (sec. 351 (b) (2) (B)); and allowing unlimited deduction of losses from sales or exchanges of capital assets (sec. 351 (b) (3) (C)).

Now, I ask your further attention to the last two provisions. These provisions unquestionably have been and are being used in a manner not contemplated when section 351 was enacted.

The report of the Finance Committee in 1934, respecting section 351, stated that the purpose of the debt retirement provision was to "relieve personally owned corporations which had outstanding bonds or indebtedness that must be met from current earnings before distributions can be made" (Finance Committee Rep. 558, 73d Cong., 2d sess., p. 15). This interpretation was substantially incorporated in the regulations issued by the Commissioner (Art. 351-3 of regulation 86 for Revenue Act of 1934).

As a matter of fact, however, the returns of the personal holding companies show that they have not confined themselves to this interpretation. Relying upon the language of the debt retirement provision, they have claimed deductions for retirement of debt incurred before January 1, 1934, regardless of the nature of the debt.

Furthermore, there are instances of deductions taken for retirement of debt owned by the personal holding company for its owner. One such case is Land's End Corporation, organized in Delaware in December 1931 by Owen B. Winters. Mr. Winters is interested in Erwin Wasey & Co., Inc., and other companies, which are engaged in the advertising business. Land's End owns Mr. Winters' farm, real estate, household effects, guns, horses, dogs, securities, mortgages, bank balances, yacht, automobiles, and other possessions. It also owns Southern Cross, Ltd., a Bahamas corporation organized by Mr. Winters.

Senator HARRISON. When was that corporation organized?

Mr. FORTAS. That was organized in the Bahamas, sir.

Senator HARRISON. What year?

Mr. FORTAS. It was organized in 1932, I am informed.

Through a complicated holding company set-up, Mr. Winters' principal income from advertising companies and from various other sources, is received by his personal holding companies.

For present purposes, I want to direct your attention to an aspect of the 1934 return of Land's End Corporation. This return showed no personal holding company surtax. Any income that might have been taxable was offset by a reported retirement of $55,000. This was part of a debt in the amount of $81,309 owed by the corporation to Mr. Winters, himself, and stated to be incurred prior to January 1, 1934. In other words, according to his return, Mr. Winters avoided personal holding company surtaxes on his corporation by paying himself a debt owed to himself. Such a result could hardly have been contemplated by the Congress which enacted the Revenue Act of 1934. Furthermore, the payment of this debt to Mr. Winters by the corporation will no doubt be claimed to be nontaxable on his individual return even though it constitutes a distribution by the corporation to its sole owner.

I also note on the 1934 balance sheet of Land's End, a debt of $188,867, incurred prior to January 1, 1934. This debt is stated to be due the Southern Cross, Ltd., which is owned by Land's End itself. This item was apparently available for another attempt to avoid taxes by paying or setting aside money in one of Mr. Winters' pocketbooks to pay a debt to the other.

This is not the only type of case in which a somewhat unreal transaction is used to effect a reduction of surtax paid by the personal holding company.

The personal-holding-company device is sometimes used to effect a double-headed advantage, that is, the sale of capital assets (generally securities) in order to take a loss, coupled with continued control over those assets as a practical matter. Under section 117 (d), of the revenue act, ordinary taxpayers, individual and corporate, may deduct losses on sales of capital assets only to the extent of $2,000 plus whatever gains are made from the sales of such assets. But in determining the personal holding company surtax under section 351, 100 percent of the capital losses is allowed as a deduction in section 351 (b) (3) (C).

This provision has been employed effectively by Charles E. Merrill and Edmund C. Lynch, to whom I have already referred.

As I have already stated, Mr. Merrill and Mr. Lynch own, among other interests, 12 personal holding companies. They also own two realty companies. The two realty companies are owned, one by Merrill and one by Lynch. These companies receive considerable income as distribution from the personal holding companies, but their own income from rentals is sufficient to take them out of the category of personal holding companies, and therefore, they are not subject to the surtax under section 351.

During the year 1935 the personal holding companies owned and controlled by Charles E. Merrill and Edmund C. Lynch claimed losses aggregating $522,087.86, resulting from sales of securities between these corporations. Since 100 percent of these losses are allowed as deductions, very large savings in tax were effected through these sales. Not only was tax avoided by Mr. Merrill and Mr. Lynch through the use of the personal holding companies as buffers between them and the high surtax rates, as we have discussed, but the companies were themselves relieved in considerable part from the surtax under section 351.

These sales from which the capital losses were derived, were effected in many ways. There were sales from one company owned by both individuals to another company owned by both individuals; there were sales from a company belonging to one individual's group to a company belonging to the other individual's group; there were sales within a group; and, most ingenious of all, there were sales that "completed the circuit", that is, securities were sold by a company owned by one of these individuals to a company owned by the other, and then a like number of shares of the same securities were sold back by two other controlled companies—the result being that each group of companies was back to where it had started, and losses were claimed on both sales.

In one transaction during 1935, Baltic Securities Corporation, which is owned equally by Merrill and Lynch, sold stock to Chain Merchandising, Ltd., at a loss of $330,254.14. Chain Merchandising, Ltd., is owned equally, though indirectly, by Lynch and Merrill. As a

result of this case and the 100-percent capital-loss allowance, there was no net balance of income subject to tax under section 351. As a matter of fact, a minus figure of $833.99 resulted.

On December 30, 1935, Jernlyn Securities Corporation, owned by Jennie V. Lynch and indirectly by Mr. Lynch, sold stock to Retail Realty Corporation, which is wholly owned by Merrill, at a loss of $26,883.89.

On various dates in 1935 Yeoman Corporation, wholly owned by Lynch, sold stock to Comstate Corporation and Retail Realty Corporation, both of which are Merrill companies, at an aggregate loss of $61,754.72.

During August and September 1935, Yeoman Corporation (owned by Lynch) sold 900 shares of Safeway Stores Corporation stock to Comstate (owned by Merrill trusts) at a loss of $21,323.60. On the same days, a like number of the same shares were sold by Orchard Corporation (owned by Merrill) to Edlyn Realty Corporation (owned by Lynch) at a loss of $19,568.60. That case is an illustration of completing the circuit.

On December 10, 1935, Yeoman Corporation (owned by Lynch) sold 888 shares of Safeway Stores Corporation stock to Retail Realty Corporation (owned by Merrill) at a loss of $23,980.92. On the same day Orchard Corporation (owned by Merrill) sold 575 shares of the same stock to Edlyn Realty Corporation (owned by Lynch) at a loss of $14,455.50—another illustration of completing the circuit.

On December 3, 1935, Yeoman Corporation (owned by Lynch) sold 650 shares of Lane Bryant Corporation stock to Retail Realty Corporation (owned by Merrill) at a loss of $1,339. On the same day a like number of shares of the same stock were sold by Comstate (owned by Merrill) to Edlyn Realty Corporation (owned by Lynch) at a loss of $27,339.

Gentleman, there seems to be no specific provision in the revenue act which in terms prevents the realization of unreal losses by intercorporate juggling such as has been described. A provision was inserted in the Revenue Act of 1934, which was mentioned at the outset of this session, which went a long way toward eliminating the establishment of capital losses by transfers involving no real change in ownership. This act and the 1936 act prevent the deduction of losses on sales between members of a family and between an individual and a corporation in which the individual, directly or indirectly, owns more than 50 percent of the stock. That provision is section 24 (a) (6) which Mr. Kent mentioned earlier.

An individual, for purposes of this provision, includes members of the same family in the same way as is provided in section 351. But this provision does not in terms apply to sales between one corporation and another corporation, even though both corporations may be owned by the same individual or by business associates. Unless the present provision is construed to forbid taking losses in such cases, therefore, the statute seems to furnish some individuals with this additional inventive to organize multiple holding companies. It is obvious that many of the losses described in the case of Merrill and Lynch companies are not real losses, and since they are not, they should be used to offset income which would otherwise be taxable.

Now, gentlemen, as my last topic I want to call your attention to various ways by which a corporation may escape from the personal holding company classification.

The CHAIRMAN. Do I understand you to say that under the law fictitious losses may be used to offset as credits for payment of taxes instead of real losses?

Mr. FORTAS. No, sir; I did not say that and I don't think that is the case. But in the Merrill and Lynch situations, which I described, Mr. Chairman, there were so-called losses, at any rate, paper losses that occur by reason of sales between one corporation owned by one of these individuals and another corporation which might have been owned by the same individual or by his business partner, and I pointed out that the present law, the provision which was inserted in the 1934 act, does not in terms prohibit the taking of losses as a result of that sort of transaction.

The CHAIRMAN. Wouldn't that be a lame place in the law, then?

Under Secretary MAGILL. Mr. Chairman, you recall that in 1934 we attempted to stop that particular loophole in two different ways, and to a large degree it was stopped, but there still seems to be an aperture through which you can wriggle if you try hard enough.

If you recall at that time, deductions or capital losses in excess of capital gains was reduced to $2,000, so that so far as sales between the individuals is concerned this type of juggling of losses could not occur any longer except to that limited extent.

Then you also put in the law this provision denying deductions for losses where there were sales between an individual and members of his family, and between him and his personal holding company.

What these two gentlemen did, as I understand Mr. Fortas' testimony, is to organize companies which sell to each other and, in terms, that situation is not cared for by the present law. The law in terms deals with sales between an individual and his own company, but does not deal with sales between one individual company and his partner's company, for example.

Mr. VINSON. The chairman used the term "fictitious", Mr. Fortas, and you said you didn't think it was a fictitious loss. If A has 10 shares of stock and sells to B at a loss, and then C which is A in effect, sells 10 shares of stock to A at the same price, you wind up with A having 10 shares of stock without a loss, why isn't that a fictitious loss?

Mr. FORTAS. Well, Mr. Vinson, I would say that it seems to me to be an unreal loss, that is, there is no loss there, it seems to me, but a lawyer who has been studying this field, not only in connection with taxes but this field generally in connection with the law of securities shudders a little at the word "fictitious", because in the law books as you know, I suppose that word has received so many and so varied interpretations that it is very difficult to say what the law means by "fictitious".

Mr. VINSON. You say it is not real?

Mr. FORTAS. It is perfectly clear to me that it is unreal; yes, sir.

Mr. VINSON. Well, then, at least it is purely a paper loss.

Mr. FORTAS. So it seems to me, sir. I just wanted to point out why I avoid that word, because it is a very ambiguous word to a lawyer.

Mr. VINSON. It is a common acceptation, it seems to me, that would lead me to the notion that it could be called a fictitious loss.

Mr. FORTAS. I quite agree, sir.

Senator HARRISON. At least it is an ingenious subterfuge, isn't it?

Mr. FORTAS. It seems to me clearly so.

Senator GEORGE. At this stage of the hearing might I ask—perhaps Dr. Magill would be able to answer this question—has there been a notable increase in the creation of personal holding companies since 1934, domestic holding companies?

Under Secretary MAGILL. I don't know that we can say that. I haven't reviewed the figures on that.

Senator GEORGE. Are they available, doctor?

Under Secretary MAGILL. I can try to get them. Do any of you have such figures?

Mr. FORTAS. My recollection, Senator, subject to check, is that there were more returns filed under the 1935 act, under section 351, the personal-holding-company section, than were filed under the 1934 act, and that the returns which were filed under the 1936 act, which have not yet all come in, will show a very substantial increase over preceding years.

Senator GEORGE. What I want to know is when these personal holding companies were formed, not when they came under the matter of returns but when they were formed.

Mr. FORTAS. I am sorry to say I can't answer that directly, but I might point this out, which will perhaps throw some light on the answer to your question, that a good many holding companies are used; the use of holding companies is changing constantly; that is to say, every time a man wants to do something else he does not go out and form a new corporation, he may use an old corporation and therefore the date of incorporation is not always very significant, as to the use being made of the corporation and the reasons for that use.

Mr. VINSON. Will the Senator yield at this point?

Senator GEORGE. I would like to have those figures if they can be gotten by reasonable effort.

Under Secretary MAGILL. Suppose we try to get them for you, Senator, and we will advise you what we can do. (Information furnished by Treasury subsequently, see p. 257.)

Senator GEORGE. Yes, sir.

Mr. VINSON. I might suggest that every one of the corporations to which reference has been made, the Merrill and Lynch Corporations were formed prior to the 1934 act—a number of them, I don't know whether all of them or not, but my recollection is that most of the corporations to which you have referred in your testimony, Mr. Fortas, were formed prior to 1934.

Mr. FORTAS. That is correct, sir, and I think you will notice, Mr. Vinson—I can't be sure of this without check—but my general impression is that there is somewhat of a concentration in 1932 of some of these companies.

Mr. VINSON. Take Archmere—is it Archmere?

Mr. FORTAS. Yes, sir.

Mr. VINSON. Formed in 1916, and the Pioneer Realty Corporation in 1931. When was Christiana formed?

Mr. FORTAS. I don't have that date.

Mr. VINSON. Then here is your Renappi Corporation, formed in 1928, and your C. E. M., formed in 1928.

Mr. FORTAS. Mr. Vinson, if I might try to explain a little more clearly my view of this particular point?

Mr. VINSON. Just a minute—Land's End was formed in 1931, and Southern Cross, Ltd., in 1932.

Mr. FORTAS. My point, sir, is merely that the date when these companies were formed is not of particular significance.

Mr. VINSON. Well, it is of this significance: They were in existence when the 1934 act was passed. They had the opportunity to file under section 102 and it demonstrates conclusively that the 1934 act is not a device under which these people came into existence. They were already in existence, saving more money than they saved subsequent to the 1934 act.

Mr. FORTAS. I quite agree with that, Mr. Vinson, and let me state it in this way. It seems to me nobody would form a corporation for the purpose of having it come under section 351 if he thought he could form and use a corporation which would come under section 351 and have a reasonable opportunity of escaping section 102.

Mr. VINSON. Senator George asked you, though, whether or not there had been any noticeable or apparent increase in corporations since 1934.

Senator GEORGE. That is right. I think it is a very pertinent inquiry. I can understand, of course, that they now make different uses of corporations formed prior to the effective date of the act, but the point is whether there was any pronounced increase in the domestic holding companies since 1934.

Mr. FORTAS. Senator, I am sorry I did not get that question clearly before. Let me try to explain it in this way. All these corporations—there were a lot of corporations prior to 1934. Some of them did precisely the sort of thing that is described in section 351. In other words, they were owned by a few individuals and they received 80 percent or more of their revenue from interest and dividends and so on. That sort of corporation did not arise because of section 351. It is a known phenomenon in corporate history for lawyers, it has existed ever since we had corporations—corporations formed for that particular purpose.

Congress felt that there should be a surtax upon certain types of corporations, and that type of corporation was described in section 351. Some of these corporations which had existed, some of them as far back as the early 1900's came within that classification and was subject to the surtax because they were personal holding companies as Congress described them. May I continue, sir?

The CHAIRMAN. Go ahead.

Mr. FORTAS. In the foregoing, I have described how individuals have used corporations to avoid surtax provisions of section 351. I believe it is also advisable to point out, for the sake of completeness, certain limitations on the definition of personal holding companies subject to the surtax under section 351.

It is possible for corporations to be set up, which are in substance and in fact personal holding companies, owned by one individual or a small family group. The companies may hold assets belonging to their owners and collect the income therefrom. But they may be so constituted as to be subject only to the taxes levied upon operating companies. They will not then be subject to the surtax under section 351, levied on personal holding companies as they are defined.

This can come about in several ways. One method of escape is furnished by the exemption of real-estate corporations from the provision, an exemption which was made for good reason in 1934 and carried over in 1936. The report of the Finance Committee of the Senate and the Conference Report on the 1934 Revenue Act show that the com-

mittees of Congress did not wish to impose the surtax upon small family corporations engaged in the real-estate business. They felt that a great part of the real-estate business of the country is done by small family companies, partaking more of the nature of operating companies than of mere holding companies.

If, therefore, as individual has set up a corporation to hold his securities and also his farm and residence properties, he may be able to escape the surtax under section 351. He could do this, if he so desired and if the circumstances allowed, merely by making certain that the rent which he pays from his unincorporated to his incorporated pocketbook for these properties is at least 21 percent of the total income received by the company. That would take the case out of the statutory definition.

Mr. VINSON. One point—in the development of that 1934 act rents were included?

Mr. FORTAS. That is right, that was in the House bill and then it was stricken.

This matter and other aspects of the definition of companies subject to section 351, upon which I shall not comment, deserve consideration in connection with any legislative program relating to personal holding companies.

In conclusion, let me summarize the situation which has been presented to the committee in a few words: It is clear from our study of personal holding companies that certain individuals have avoided paying their full share of the expenses of government, as contemplated by Congress. In most instances, this has been done by use of various loopholes in the law, through which the alert taxpayer of sufficient wealth, who is willing to do so, can escape a portion of his burden. In some instances, taxes have been avoided by the use of unreal transactions and intercorporate juggling which reflect not so much imperfections in the law or its enforcement, as a deficient sense of responsibility in the taxpayer. That concludes my statement.

The CHAIRMAN. We thank you very much for your appearance and the testimony you have given the committee.

Mr. COOPER. I move we recess until 10 o'clock tomorrow morning.

(The motion was seconded and carried.)

(Whereupon, at 11:50 a. m., June 29, 1937, the hearing was recessed to 10 a. m., Wednesday, June 30, 1937.)

TAX EVASION AND AVOIDANCE

WEDNESDAY, JUNE 30, 1937

Joint Committee on Tax Evasion and Avoidance,
Washington, D. C.

The joint committee met in the hearing room of the Committee on Ways and Means in the New House Office Building, at 10 a. m., Hon. Robert L. Doughton presiding.

The Chairman. The committee will be in order. Dr. Magill, are you ready to proceed?

Under Secretary Magill. Yes, Mr. Chairman. I have a document here to put in for the record, with respect to the testimony yesterday as to one of these personal holding companies.

The Chairman. Without objection, it may be included in the record.

(The tabular statement submitted for the record by Under Secretary Magill is entitled "Deductions Shown on Personal Holding Company Surtax Return of Central Shares Corporation", and so forth, is as follows:)

Deductions shown on personal holding company surtax return of Central Shares Corporation, personal holding company of Cartier Lupton, 1934–36

	1934	1935	1936
Net income, sec. 21	$2,342.32	[1]$30,722.77	$906,767.33
Plus dividends deducted	508,457.84	696,919.07	....
Total	510,800.16	666,196.30	906,767.33
Less:			
Taxes, sec. 351 (b) (3) (A)	292.79	621.42	191,486.90
Charitable contributions or gifts, sec. 351 (b) (3) (B)	....	23,250.00	....
Capital losses, sec. 351 (b) (3) (C)	....	....	....
Total adjusted net income deductions	292.79	23,871.42	191,486.90
Adjusted net income	510,507.37	642,324.88	715,280.43
Less:			
20 percent deduction, sec. 351 (b) (2) (A)	102,101.47	128,464.98	143,056.09
Debt retirement, sec. 351 (b) (2) (B)	....	....	....
Dividend paid credit, sec. 351 (b) (2) (C)	....	....	....
Total undistributed adjusted net income deductions	102,101.47	128,464.98	143,056.09
Undistributed adjusted net income	408,405.90	513,859.90	572,224.34

[1] Indicates a minus figure.

Under Secretary Magill. This morning the purpose is to have Mr. Arthur Kent, who is Assistant General Counsel in the Department discuss the subject of the reduction of taxes by means of incorporated yachts and country places, and the like. Mr. Kent.

The Chairman. All right.

STATEMENT OF ARTHUR H. KENT, ASSISTANT GENERAL COUNSEL, TREASURY DEPARTMENT

The CHAIRMAN. Mr. Kent. Please give the usual information to the stenographer for the record. Of course, we all know who you are.

Mr. KENT. I am Arthur H. Kent, Assistant General Counsel, Treasury Department.

Mr. Chairman, and members of the committee, with the indulgence of the committee I should like to follow the same practice as Mr. Fortas followed yesterday in the handling of figures, and to use round numbers in the interests of economy of time, rather than reading them out to the last cent.

The CHAIRMAN. I am sure that will be agreeable to the committee. You may proceed.

Mr. KENT. Moreover, when I come to the explanatory tables in connection with some of these cases, instead of reading all the detailed figures, I shall simply read summaries of them. That is also in order to save time.

Mr. CROWTHER. Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. May I ask Mr. Kent before he commences if what he is to present to us this morning is in the category of legal avoidance rather than illegal evasion? Is there anything wrong about this? Is there any criminal or illegal action on the part of these people that you are going to talk about?

Mr. KENT. I could not answer that categorically. The cases differ in that respect.

Mr. CROWTHER. Do you think that some of them are of that description?

Mr. KENT. Some of them are, clearly, and some may be on the borderline.

Mr. CROWTHER. Will you differentiate as you come to them, as to which ones you think are?

Mr. KENT. I am going to present the facts, and I shall be glad to answer any questions that you may desire to ask in connection with the cases.

Mr. CROWTHER. Mr. Chairman, my purpose in asking that question is this, that so far we appear to have had no evidence submitted to us except as to legal avoidance. There have been no charges against anybody that what was done was illegal or wrong. In fact, it has been testified that there was no illegal action, and are we going to have later on some clear examples of tax evasion, of illegal evasion?

Mr. COOPER. Will the gentleman yield?

Mr. CROWTHER. Yes.

Mr. COOPER. I think that is a little too broad a statement. I think we have had some cases.

Mr. CROWTHER. I think we have had one case, the De Ronde case, which is the only one.

Mr. COOPER. Yes; we have had some cases on these foreign insurance companies that for my part at least showed me very clearly that they were cases of fraud. Whether a case presents a matter of fraud and the basis for criminal prosecution, or whether it simply points out evasion or avoidance of the present law, the same thing still appears, that it is the duty of this committee to try to amend the law so as to prevent tax avoidance; and of course any cases that are

developed, that show a clear case of fraud, they will be handled through the Department of Justice in the regular course of business.

Mr. CROWTHER. Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. I have no quarrel with the gentleman from Tennessee as to his personal deduction after the evidence is in on these matters, none whatever. I simply asked for information as to whether later on we were going to have some cases that clearly involved illegal evasion.

The CHAIRMAN. The Chair thinks both observations are pertinent and helpful.

You may proceed.

Mr. KENT. In his statement before the joint committee, Secretary Morgenthau pointed out that a common characteristic running through the various devices more or less frequently employed by taxpayers to reduce their taxable incomes is the creation of a multiple personality, by which the taxpayer "ceases to be a single individual and becomes a whole group of people, some of whom are earning while others are losing it." Sometimes the device of incorporation is resorted to in order to split a single individual into a number of personalities; in other cases similar tax-saving results are accomplished without the necessity of recourse to the corporate fiction. I shall endeavor in the course of my statement to elaborate upon and provide a number of concrete examples of both the corporate and noncorporate devices which have been and are being more or less successfully employed to reduce taxes.

The use of the corporate device is a variation from the ordinary holding company technique and is based upon the same general idea of an individual dividing himself into more than one taxable entity. A study of the illustrative cases which follow clearly suggests that the principal purpose of incorporation is to either avoid taxation of income at the rates prescribed in the higher individual surtax brackets in the statute or to obtain the benefit of deducting as a corporation, expenditures not allowed to be deducted by individuals, or both. It has not been possible in the limited time available to secure complete data in all cases necessary for an exact computation of the tax saving effected; however, where possible, estimates have been made of the amount of tax which would have been payable by the incorporations or by the individuals concerned if the particular tax-saving devices which are being explained had not been used, as compared with taxes actually paid. Mathematical exactitude is not feasible in most cases, due to the presence of many variable factors or of several tax-saving devices not all of which fall within the purview of this statement.

The plan of reduction of tax by the corporate device is very simple for an individual of large means. All that is necessary is that he form a corporation, the articles of incorporation of which are made sufficiently broad to permit it, in addition to investing in securities, to own and operate real estate, and to own and operate, lease or rent yachts or other property which he uses for personal enjoyment. The yacht or the real property or both are than conveyed to the corporation in exchange for its stock or as paid-in surplus, or are purchased by the corporation with cash previously advanced by the stockholder. Income-producing securities are then turned over to the corporation (usually a domestic one) for stock or as paid-in surplus so as to provide

it with a substantial income with which to defray alleged operating expenses. In most instances possibly in order to lend some color to its alleged business activities, the corporation will charge its sole or principal stockholder charter fees for the use of the yacht or rent for occupying the residence or other estate. Such charges for fees or rents are typically far below the actual costs of the operation and maintenance or depreciation of the property, and usually much below the amount which would have to be charged in an arm's length transaction to yield a fair return upon the value of the property regarded as an investment.

The corporation claims to be carrying on a business as permitted by its articles of incorporation and defends its claim to a deduction of the expenses on the ground that section 23 (a) of the Revenue Act of 1936 and the corresponding provision of prior acts permits a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

It has been very generally assumed that the business of a corporation comprehends all its actual activities which it is empowered by its charter to carry on and which are therein declared to be the objects of its incorporation. In the cases of a great majority of corporations formed bona fide to carry on commercial enterprises for profit, this assumption no doubt accords with the realities. It is difficult to believe, however, that the Congress ever contemplated or expected that the device of incorporation would be abused by individuals in order to obtain tax-saving deductions for expenditures which would be disallowable, if claimed by them as individuals, under the clear language of section 24 (a) (1), which provides that "no deduction shall in any case be allowed in respect of (1) personal, living, or family expenses."

The investigation so far made, which is far from complete, indicates that this device of creating corporations for the purposes of holding, maintaining, and operating yachts, city mansions, country estates, and racing stables in such manner as possibly to nullify the effect of the express provisions of the statute, which deny or limit the deduction of personal expenses, is now being employed by many wealthy taxpayers and that there is a tendency toward increased use of it. The potential menace to the integrity of the revenues which it contains is very great for it is capable of profitable use by any taxpayer who owns property requiring large personal expenditures and who also owns a substantial amount of income-producing property.

The Rene Corporation, 26 Journal Square, Jersey City, N. J., is a corporation organized in 1929 under the laws of the State of Delaware for the purpose of holding title to the yacht *Rene*, which was then under construction for Mr. Alfred P. Sloan, Jr. He is president of the General Motors Corporation, and he resides in Great Neck, N. Y. The corporation assumed the obligations of Mr. Sloan under the contract for the yacht's construction. The capital stock outstanding December 31, 1935, consisted of $1,000,000 par value preferred and $3,000,000 par value common. All the common stock, 30,000 shares, and 9,545 shares of the preferred, according to our latest information, are owned by Mr. Sloan. The total cost of the yacht upon completion in 1930 was in excess of $1,100,000, of which sum about a million appears to have been paid from the proceeds of the sale of preferred stock to Mr. Sloan. The common stock in the amount of $3,000,000 was

issued to him in payment for securities in the same amount which he turned over to the corporation.

The return of the Reno Corporation for 1934 showed a gross income of $153,863.73, of which $63,750 represented dividends received on capital stock of domestic corporations and $90,113.73 charter fees paid to the corporation for the use of the yacht. The total deductions taken on this return amounted to $223,219.10, resulting in the corporation reporting a net loss of $69,353.37. In its return for 1936 the corporation reported $191,250 income from domestic dividends and $119,608.78 from charter of the yacht, making a gross income of $310,858.78 from which it deducted total expenses of $185,670.32, leaving a net income of $122,843.35. The corporate return for 1936 shows tax assessable of $25,182.88, representing chiefly surtax on undistributed profits, no dividends having been paid by the corporation.

This case presents an excellent illustration of tax reduction by securing through a corporation a deduction of a substantial portion of otherwise disallowable personal expenses, as well as the saving which may be effected through the diversion of a portion of investment income from the individual's pocket to the coffers of his personally owned corporation.

The following figures will serve to show the character of the operations of the Reno Corporation, so far as they relate to the yacht in question:

Year	Revenue from charter hire	Yacht expenses exclusive of taxes and interest	Loss on operation
1931	$108,000.00	$161,514.20	$53,514.20
1932	108,000.00	104,349.21	[1] 3,650.79
1933	None	34,423.45	34,423.45
1934	90,113.73	151,216.69	61,102.96
1935	116,986.89	134,009.93	67,023.04
1936	119,608.78	185,670.32	36,061.54
Total	542,709.40	821,183.80	278,474.40

[1] Net income.

It is apparent from the foregoing figures that the operation of the yacht has by no means been a profitable enterprise.

You will note that the total revenue from charter hire was $542,-709.40, all but a very small part of which at least was paid by Mr. Sloan.

Mr. Cooper. Mr. Chairman.

The Chairman. Mr. Cooper.

Mr. Cooper. Would it disturb you to ask you a question at that point?

Mr. Kent. Not at all.

Mr. Cooper. My interest has been somewhat aroused with reference to this item appearing on page 5 of your statement, which shows $90,113.73 "charter fees". What does that mean?

Mr. Kent. That means that during each year that this corporation has been in existence Mr. Sloan has paid substantial sums to the corporation under the form of charter fees for the use of this yacht by himself and his family.

Mr. COOPER. All right. Mr. Sloan had the yacht built at an expense of $1,200,000?

Mr. KENT. Yes.

Mr. COOPER. And he incorporated it?

Mr. KENT. Yes.

Mr. COOPER. And now he charges himself charter fees for the use of the yacht that he built and paid for?

Mr. KENT. Yes.

Mr. COOPER. In effect, that is what it amounts to?

Mr. KENT. That is what it amounts to. And the amount paid as "charter fees" is not equal to the cost to the corporation of maintaining and operating the yacht. As this table shows, there is a substantial deficit every year on that account.

Mr. COOPER. Your table appearing on page 6 shows, under the heading "Revenue from charter hire", a total of $542,709.40. In other words, is that what Mr. Sloan is supposed to have paid as hire for his own yacht?

Mr. KENT. Substantially so; although I think I should say that the figures on 1935 and 1936 indicate the possibility that there may have been some small amount received from outsiders. We have not been able to determine that fact definitely.

The original arrangement apparently was that Mr. Sloan was to pay the corporation $108,000 a year, and that was done in 1931 and 1932. In 1933 nothing was paid, and in 1934, less than that amount. Now, it may be that in 1935 and 1936 more was paid than the $108,000, or it may be that excess came from some other source. That, we have not been able to determine.

Mr. COOPER. Would it be possible for him to charge himself charter fees for the use of his own yacht in such amount as may be found to be necessary to show a loss, and result in the payment of no tax?

Mr. KENT. That is correct.

Mr. VINSON. Mr. Chairman.

The CHAIRMAN. Mr. Vinson.

Mr. VINSON. Of course, it is always less than the income from the securities that had formerly been owned by Mr. Sloan, and which had been purchased from him by the corporation?

Mr. KENT. That is generally true.

Mr. VINSON. That is true, according to these figures?

Mr. KENT. Yes.

Mr. CROWTHER. Just one question, Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. This has been going on since 1931. Has the Bureau of Internal Revenue ever passed upon this validity, or the legality of this kind of operation?

Mr. KENT. The Bureau of Internal Revenue has apparently questioned some of these items on one or two occasions, but we are up against the recognition given to the corporate entity under the present law in all of these cases.

Mr. VINSON. And by the courts?

Mr. KENT. By the courts.

Mr. CROWTHER. The evasion, however, in many cases is close to a fiction?

Mr. KENT. That is correct.

The CHAIRMAN. When did the Bureau discover this method of escaping taxes? When did the Bureau first find out that this tax-

payer was avoiding, by this method or in this manner, the payment of taxes as intended by law?

Mr. KENT. That I could not state exactly, Mr. Chairman. If you will permit me to go on for a moment or two and put the whole picture before you, the next table may throw some light on that question.

The reduction in Mr. Sloan's income taxes resulting from the formation and use of this corporation has been very substantial, as is reflected in the following figures. These figures are based upon adding to the income of Mr. Sloan the excess of the yacht expenses deducted by the corporation over the amount of the charter fees received by the corporation. In the instant case and similar cases which follow, however, in order that the estimate of tax benefit may be conservative, and as fair to the individuals involved as possible, we have endeavored to limit the excess so transferred to an amount which does not exceed the corporate income from all sources other than the operation of the yacht, residence, or similar property after deducting taxes, interest, and other legitimate expenses, not including of course those relating to the yacht, residence, or racing stable, as the case may be, which the corporation is operating for its owner's personal use and benefit.

To restate in simple terms what I have just said, Mr. Chairman, I may say that it is just one of these problems of trying to explain in simple language an arithmetical formula, in order to be as conservative in our estimates of tax saving and as fair to the taxpayer as possible. We have done this. Where the income of the corporation from its investments or from other sources, other than the operation of this type of property that we are talking about, less the amount of the legitimate deductions such as taxes and interest, which would be allowed if there were no corporation, is less than the excess of the operating expenses of the yacht or the country residence, over the income derived therefrom, we have carried over the lesser of the two amounts into the taxpayer's return, simply on the theory that in that case the corporation had run a net deficit for the year, which might have been made up by some voluntary contribution or taken out of its capital.

We could have figured it on a somewhat different basis, but it seemed to us that that was the basis which was the most conservative and the fairest possible basis for figuring the tax saving, and that is what we have done.

Mr. VINSON. That is, giving the taxpayer the benefit?

Mr. KENT. Giving the taxpayer the benefit.

Mr. VINSON. Because, if you do not have the corporate entity, items for the operation of the yacht for his personal use would not be deductible?

Mr. KENT. That is correct.

The table which follows shows the income reported by Mr. Sloan on his returns for the years in question, the tax which was paid thereon, the operating expenses of the corporation or its income from outside sources, whichever is less, and the additional tax if such amount were added to Mr. Sloan's income.

On the basis of computation which we have adopted, there was no actual tax saving to the individual in that case until the year 1933, and since that time the saving has been greater each year, showing a total saving for these years of $128,528.31.

Year	Income reported by Mr. Sloan	Tax thereon	Operating expenses of corporation or its income from outside sources, whichever is less	Additional tax if such amount added to Mr. Sloan's income
1931	$569,149.17	[1] None	$53,514.20	....
1932	210,887.70	[2] $10,378.56	....	....
1933	111,108.35	[3] 216,069.36	31,423.45	$10,277.18
1934	36,235.39	3,741.13	56,497.59	19,448.55
1935	310,235.39	161,482.16	67,023.04	39,595.80
1936	872,486.31	582,133.61	66,061.54	50,206.78
Total	2,140,563.83	973,408.82	277,510.82	128,538.31

Alfred P. Sloan, Jr.—Additional tax if corporate entity of Rene Corporation is ignored

Year	Income reported by Mr. Sloan	Tax thereon, including tax reported by Rene Corporation	Income of Rene Corporation from sources other than charter fees, less taxes and interest paid	Additional tax if such amount is added to Mr. Sloan's income
1931	$569,149.17	[1] None	$112,908.75	None
1932	210,887.70	[2] $10,378.56	45,248.07	22,624.04
1933	111,108.35	[3] 216,069.39	43,288.23	20,035.37
1934	36,235.39	3,741.13	55,497.59	18,913.71
1935	310,696.88	181,116.91	130,647.00	55,963.42
1936	872,486.34	621,179.60	188,904.89	105,110.65
Total	2,140,563.83	1,032,485.59	582,491.53	222,647.19

[1] Due to capital net loss $1,130,729.27.
[2] Due to capital net loss $528,202.30.
[3] Due to capital net gain $1,466,747.60.

Mr. VINSON. Mr. Chairman.

The CHAIRMAN. Mr. Vinson.

Mr. VINSON. I would like to have inserted in the record another table showing what the tax saving would have been if the corporate entitiy had been disregarded; because that would be a much larger tax saving.

Mr. KENT. That is true.

The CHAIRMAN. Can you furnish that table?

Mr. KENT. Since I have been dealing in this paper only with this particular device, I have sought to abstract the tax factor of the use of this particular device out of a situation which involves other tax-saving factors; but I think that such a table could be prepared on these cases and supplied without great difficulty.

The CHAIRMAN. Will you please do that, and include it with your remarks?

Mr. KENT. Yes.

Mr. VINSON. In each instance, after the table that you have presented here?

Mr. KENT. All right.

Mr. CROWTHER. Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. In Mr. Sloan's personal return he did not attempt to deduct from that the amount he paid for the use of the yacht?

Mr. KENT. No; he did not.

Another case clearly illustrating the use of incorporation to obtain deductions for expense of operating a yacht for personal pleasure purposes is the Savarona Ship Corporation controlled by Mrs. Emily R. Cadwalader of Fort Washington, Pa. Mrs. Cadwalader is prominent in Philadelphia and is a daughter of the late Richard Roebling of John A. Roebling Sons Co., large manufacturer of wire rope and cable. Her husband, Richard M. Cadwalader, is a man of large means.

The Savarona Ship Corporation was organized under the laws of New York in 1928 with its entire capital stock of 1,000 shares owned by Mrs. Cadwalader. In 1932 she transferred 400 shares of the stock to her attorney, Thomas Campbell, at a price far below its book value for the purpose of establishing a loss, which was later disallowed by the Bureau. The corporation has been used to own Mr. Cadwalader's private yachts. The first yacht owned by the corporation was named the *Savarona*, but it was sold in 1929 for $1,800,000 cash. Its successor, given the same name, was completed in Germany in 1931 at a cost of $2,130,812.13 and is reputed to be the largest privately owned yacht in the world. It is 410 feet long. It is interesting to note that this yacht has never been brought into American waters and thus subjected to the import duty on foreign-built yachts, imposed by the Tariff Act of 1930 (par. 370, 19 U. S. C. A., sec. 1001).

Senator HARRISON. Was that when we increased the rate on imported yachts?

Mr. KENT. Yes; in the paragraph just cited, which imposed an ad valorem duty of 30 percent on foreign-built yachts brought into territorial waters for purposes of chartering, and for certain other purposes.

Senator HARRISON. What was the tariff prior to that?

Mr. KENT. I do not know about that, Senator Harrison; I can find out.

Senator HARRISON. But it was less than now provided?

Mr. KENT. That is my impression.

It appears that some effort has been made to operate this yacht to obtain some income, for it has been chartered on two occasions to a friend of Mrs. Cadwalader and once to Ufa Film Co. Except for these instances, however, the yacht has been chartered or used by the Cadwaladers exclusively. The true reason for these charters to other persons is clearly revealed by the following excerpt from testimony given by Mrs. Cadwalader at a hearing before Mr. Sorrell, conferee in the Bureau of Internal Revenue on December 6, 1934. This testimony, given in answer to questions by Mr. Sorrell, was as follows:

Question. But it always was to some extent a pleasure boat for you?

Answer. Yes; but I mean when we first made this contract—I mean—it was in 1928 I think—and I mean the market was up and everything was going strong and I thought it was pretty nice and comfortable, but in 1929 I mean we even went so far as to think we could stop the building of the ship but we had signed the contract and couldn't do anything and some of these sales were made, I mean, to help build the boat. I mean we had to meet our obligations—it was trouble constantly—and that was one reason why Mr. Cadwalader's health just went to pot.

Question. I think Mr. Luce asked you at the time the boat was built whether you had in mind making any profit from it, and I think your answer was "no."

Answer. Not when it was started. It was just to take the place of the other boat.

Question. Just for your personal pleasure?

Answer. Yes.

Question. Then he asked you whether later on, as the result of certain developments, the situation had not changed and you answered that it had, I think, or words to that effect. Is that right?

Answer. Yes.

Question. Did you at any time, after this changed situation—did you believe you could make a profit with that boat?

Answer. No. I had hoped that we would get some charters.

Question. Yes.

Answer. But I soon discovered that we could only get one charter.

Question. But you hoped to get some charters.

Answer. It was through a friend of Mr. Campbell's that we got the charter.

Question. You hoped the charters would merely reduce your operating expense of the boat; you never figured to make a net profit?

Answer. I kind of thought maybe—no; I don't think I did really—on account of the depression I didn't see possibly how we could, but we wanted to get along the best way we could.

Question. The only thing you saw was the possibility of getting back some of your expense money in connection with the expenses of the boat?

Answer. Yes.

The expenses of operation of the yacht have greatly exceeded the revenue from charter hire. The deficit has been made up from income of securities transferred to the corporation by Mrs. Cadwalader and from profits on sales of securities, the corporation having engaged in very substantial trading activities.

Mr. VINSON. Mr. Chairman.

The CHAIRMAN. Mr. Vinson.

Mr. VINSON. When were the securities transferred to the corporation?

Mr. KENT. Apparently transfers were made from time to time, all along. It was not a case where the whole bundle was put into the corporation at a single time.

Mr. VINSON. How was the initial cost of the yacht met?

Mr. KENT. It was out of the proceeds of the sale of the prior yacht, which was sold for $1,800,000 cash, and out of income and out of securities which were transferred to the corporation.

Mr. VINSON. How was the first yacht bought? Was it bought individually, or had securities been transferred to the corporation?

Mr. KENT. So far as our information shows, that yacht was apparently owned by her at one time individually, and was then placed in the ownership of the corporation.

Mr. VINSON. For the capital stock of the corporation?

Mr. KENT. Yes; that is correct.

The following figures clearly show the character of the operations of this corporation:

Year	Revenue from charter hire	Expense of operating yacht	Loss on operation
1931	$75,000.00	$145,340.36	$70,340.36
1932	137,022.35	152,408.15	14,485.80
1933	28,613.47	208,585.03	179,971.56
1934		168,891.33	168,891.33
1935		170,784.51	170,784.51
1936		191,007.03	191,007.03
Total	241,535.82	1,037,022.41	795,480.59

The tax saving to Mrs. Cadwalader by use of the corporation has, of course, been very great. As in the Reno case, the approximate tax saving to Mrs. Cadwalader through the use of the corporate device has been reached by computing the additional tax payable upon adding to

her net income the operating expenses of the yacht, or the net income of the corporation from outside sources, whichever sum is less. The approximate tax savings upon this basis are as follows:

Year	Income reported by Mrs. Cadwalader	Tax thereon	Operating expenses of corporation or income from outside sources, whichever is less	Additional tax if such amounts added to Cadwalader's income
1931	[1] $272,583.81	$38,158.73	None.	None.
1932	[1] 256,197.43	None.	$14,485.80	None.
1933	78,807.56	13,603.90	142,617.85	$79,505.44
1934	17,618.39	667.16	111,904.15	41,351.06
1935	180,714.51	68,997.35	170,784.51	99,327.15
1936	....	....	191,007.03	....
Total	805,921.70	11,427.14	630,799.34	220,183.65

[1] Capital net losses reflected in tax computation.

Mrs. Emily R. Cadwalader (Savarona Ship Corporation)—Additional tax if corporate entity of Savarona Ship Corporation is ignored

Year	Income reported by Mrs. Cadwalader	Tax thereon including tax reported by Savarona Ship Corporation	Income of Savarona Ship Corporation from sources other than charter fees, less taxes and interest paid	Additional tax if such amount is added to Mrs. Cadwalader's income
1931	$272,583.81	[1] $28,158.73	[2] $2,815.93	[2] $563.18
1932	256,197.43	[1] None	24,644.50	None
1933	78,807.56	13,603.90	142,617.85	77,154.02
1934	17,618.39	667.16	111,904.13	41,351.05
1935	180,714.51	102,799.52	422,478.03	214,787.17
1936	....	....	322,914.15	....
Total	805,921.70	145,229.31	1,021,742.73	332,729.06

[1] Tax on capital losses reflected in tax computation.
[2] Loss.

I may say that for the year 1936 the individual's return is not available, and the only figure that we have for that year is the operating expenses.

Mr. VINSON. Mr. Chairman.

The CHAIRMAN. Mr. Vinson.

Mr. VINSON. Why is not the 1936 return available?

Mr. KENT. It is somewhere in the field, Mr. Vinson, and attempts have been made to locate it, but we simply have not been able to uncover it up to this time.

Mr. VINSON. You understand that one has been made?

Mr. KENT. Yes; I so understand.

The magnitude of the sums involved in this case serves to emphasize the tax savings made possible by the use of this device.

Mr. CROWTHER. Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. Is that the end of the yacht cases?

Mr. KENT. That is the end of the yacht cases.

Mr. CROWTHER. The *Nourmahal* was not incorporated, was it?

Mr. KENT. I have no information to that effect, Mr. Crowther.

Mr. CROWTHER. You do not know anything about that?

Mr. KENT. We have the names of some other yachts that are supposed to be incorportaed, and efforts are being made to obtain information with regard to them, but the information is still too incomplete to warrant any inferences as to their use for tax-saving purposes.

Mr. VINSON. You can check that and see if it was incorporated, can you not?

Mr. KENT. Yes. (See p. 289.)

Nemours, Inc., was organized in 1925 as a personal holding corporation of Alfred I. du Pont, who at one time substantially controlled E. I. du Pont de Nemours Co., and who was a very wealthy man. He died in 1935. At the time of its creation he transferred to this corporation real property worth over $1,000,000 consisting primarily of a palatial residence at Wilmington, Del. He also transferred to it $2,000,000 par value of 5 percent preferred stock of Almours Securities, Inc. A nominal lease of the residence was executed with a rental of $1 and an agreement on the part of Nemours, Inc., to pay all taxes, expenses, and charges for upkeep.

The gross income of the corporation has been the sum of $100,000 for each year of its existence, derived from dividends on the Almours Securities stock. This income has been employed to meet the expenses of the mansion in Wilmington previously referred to and these expenses have been taken as deductions by the company.

Since the operating expenses of maintaining the residence have practically equalled the gross income of the corporation, and have been taken as deductions, the corporation has had little net income and paid practically no tax. This procedure has continued from the formation of the corporation down to the present time. Since the income of Alfred I. du Pont, and of his estate since his death, has been very large, the tax saving has been great. This is demonstrated by the following figures:

Year	Income Alfred I. du Pont or his estate	Tax thereon	Expenses deducted by corporation	Additional tax if amount deducted as expenses added to individual income
1931	$574,650.37	$106,417.96	$95,546.48	$23,800.19
1932	566,716.44	259,310.71	74,536.07	45,305.36
1933	839,792.01	412,962.20	74,055.40	45,914.34
1934	1,172,511.84	633,306.09	79,655.82	48,701.01
1935 [1]	275,260.00	120,915.40	24,384.39	13,744.34
1935 [2]	1,244,782.19	682,928.16	48,768.78	22,873.58
Total	4,673,712.85	2,215,850.51	396,946.94	200,437.82

[1] Period Jan. 1 to Apr. 29.
[2] Period Apr. 30 to Dec. 31, estate of Alfred I. du Pont.

Alfred I. du Pont (Nemours, Inc.)—Additional tax if corporate entity of Nemours, Inc., is ignored

Year	Income reported by Alfred I. du Pont or his estate	Tax thereon (no tax paid by corporation)	Income of Nemours, Inc., from other sources, less taxes and interest paid	Additional tax if such amount is added to income of Alfred I. du Pont or his estate
1931	$574,650.37	$106,417.06	$95,540.48	$19,045.45
1932	566,716.44	259,319.71	74,536.07	39,504.12
1933	830,792.01	412,062.29	74,055.40	37,014.34
1934	1,172,511.84	633,306.09	79,655.82	46,096.93
1935 [1]	275,260.00	120,915.40	27,272.88	14,748.52
1935 [2]	1,244,782.19	682 928.16	54,545.76	26,282.00
Total	4,073,712.85	2,215,850.51	405,612.41	184,491.36

[1] Period Jan. 1 to Apr. 29.
[2] Period Apr. 30 to Dec. 31, estate of Alfred I. du Pont.

In this case also, one of the 1936 returns has not thus far been obtained, although it has been requisitioned. We therefore could not show the total figures for that year.

Mr. CROWTHER. Mr. Chairman, may I ask a question?

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. This has been going on since 1931, too, has it not?

Mr. KENT. Yes; I believe it has.

Mr. CROWTHER. Has the Bureau of Internal Revenue in this case ever passed upon its validity or legality, or determined whether it is moral, unmoral, or immoral?

Mr. KENT. Of course, the Bureau is a tax-collecting agency, which has to collect taxes according to the law. The Bureau has attempted in some cases of this type to include the income of the corporation in the income of the shareholder, but when protests have been filed and the question has been examined from a legal point of view, the protests have been successful.

Mr. CROWTHER. Was that done in this case, or just in similar cases?

Mr. KENT. That was apparently done in this case. In 1913, the Guanargua Securities Corporation was organized in Delaware to hold the family residences and appurtenant properties of Mr. and Mrs. Myron C. Taylor, who reside in Locust Valley, N. Y. Mr. Taylor is chairman of the board and chief executive officer of the United States Steel Corporation. The stock of the Guanargua Co. is entirely owned by Mrs. Taylor.

The balance sheet of the company as of December 31, 1934, showed an investment in securities of $1,665,350 and in properties of $2,034,-409.91. It appears that for the use of the large residences occupied by the Taylors, rentals were paid which represented only a small proportion of the expenses of operation of the properties which were paid by the corporation and deducted in its income-tax returns. The expenses exceeding rentals received were in general paid, as far as possible, out of the income on the securities owned by the corporation. Over a period of a number of years the corporation has reported little net income.

For example the total rents received, including small sums received as rents from persons other than Mr. Taylor, compared to total expenses were as follows for the years stated:

Year	Rents received by corporation	Operation expenses paid by corporation, exclusive of taxes	Net loss on operations
1931	$26,491.66	$112,637.23	$86,145.57
1932	22,000.01	93,317.68	71,317.64
1933	18,575.00	83,342.97	64,767.97
1934	13,400.00	78,610.89	65,210.89
1935	19,200.05	85,841.82	66,641.77
Total	99,666.75	453,750.59	354,083.84

Myron C. Taylor (Ganargua Securities Corporation)—Additional tax if Corporate Entity of Ganargua Securities Corporation is ignored

Year	Income reported by Mr. Taylor	Tax thereon (no tax was paid by corporation)	Income of Ganargua Securities Corporation from sources other than rent, less taxes paid or losses	Additional tax if such amount is added to Mr. Taylor's income, or excess tax if loss is deducted
1931	$116,036.30	$14,647.26	$10,124.56	$2,024.91
1932	67,705.06	2,202.20	[1] 5,809.16	[1] 2,211.29
1933	206,563.52	80,297.07	[1] 19,174.04	[1] 10,994.84
1934	319,087.30	153,394.79	25,175.50	12,514.79
1935	260,147.03	119,415.47	[1] 305.47	[1] 1,077.17
Total	969,631.01	370,047.39	10,011.09	256.40

[1] Loss.

Anabel M. Taylor (Ganargua Securities Corporation)—Additional Tax if Corporate Entity of Ganargua Securities Corporation is Ignored

Year	Income reported by Mrs. Taylor	Tax thereon (no tax was paid by corporation)	Income of Ganargua Securities Corporation from sources other than rent, less taxes paid or losses	Additional tax if such amount is added to Mrs. Taylor's income, or excess tax if loss is deducted
1931	$7,682.00	None	$10,124.56	$380.63
1932	5,390.45	$37.42	[1] 5,809.46	[1] 37.43
1933	4,081.74	137.07	[1] 19,174.04	[1] 137.07
1934	5,350.57	175.25	25,175.50	2,924.70
1935	3,354.68	30.00	[1] 305.47	[1] 30.90
Total	26,759.44	380.73	10,011.00	3,099.85

[1] Losses.

The tax savings to the Taylors by the use of this corporation have been much smaller than in some of the other cases presented, due solely to the fact, however, that the large volume of investment securities transferred to the corporation were producing relatively little income in the years in question. The total savings for 5 years appear to have been between $4,400 and $16,800, depending upon whether the saving is computed in respect of Mrs. Taylor's or Mr. Taylor's return. It is obvious that if the income from securities

becomes larger, the saving will be greater. On the other hand, if the corporation continues to operate at a deficit, the corporation may be used by the stockholders to effect a substantial tax saving by liquidating the corporation at a time when the capital loss resulting therefrom may be used to offset a capital gain.

In 1932 Mr. John Hay Whitney formed, under the laws of New York, a corporation named Llangollen Stables, Inc. At the time of incorporation there were transferred to it securities valued at $1,623,385 and racing and breeding stock valued at $656,978. Mr. Whitney is a resident of New York. He is well known for his interest in horse racing and related activities.

It appears that prior to 1932, the horse-racing activities now conducted by Llangollen Stables, Inc., were carried on by Mr. Whitney personally and no effort was made by him to deduct the expenses of operation. The corporation was formed in 1932, however, and has since been utilized for securing deductions for the expenses of the stable which prior to that time had not been deducted by Mr. Whitney individually. To show the magnitude of the operations involved and the losses incurred in such operations, the following data should be considered.

Year	Gross income from stable operations	Expenses incurred and deducted for stable operations	Loss on operations
1932 (8 months)	$72,096.26	$323,356.46	$251,260.20
1933	116,398.00	410,301.44	293,903.44
1934	99,089.01	351,275.94	252,186.93
1935	40,381.13	337,750.02	297,368.89
1936	162,784.02	394,005.13	231,221.11
Total	490,748.42	1,816,688.99	1,325,940.57

The saving to Mr. Whitney accomplished by the taking of these deductions has been very great.

Year	Income reported by Mr. Whitney	Tax thereon	Operating expenses of corporation or its income from outside sources, whichever is less	Additional tax if such amount is added to Mr. Whitney's income
1932	$597,378.01	$210,113.94	$104,225.22	$55,239.36
1933	451,228.11	98,496.89	185,287.52	97,714.66
1934	817,510.72	299,544.92	220,387.58	133,943.87
1935	524,205.18	236,343.99	191,627.33	109,227.58
Total	2,390,322.02	944,499.74	701,527.65	390,125.47

John Hay Whitney (Llangollen Stable, Inc.)—Additional tax if corporate entity of Llangollen Stable, Inc., is ignored

Year	Income reported by Mr. Whitney	Tax thereon (no tax paid by corporation)	Income of Llangollen Stable, Inc., from sources other than racing, less taxes and interest paid	Additional tax if such amount is added to Mr. Whitney's income
1932	$597,378.01	$210,113.94	$104,225.22	$55,239.36
1933	451,228.11	98,496.89	185,287.52	97,714.66
1934	817,510.72	399,544.92	220,387.58	128,176.78
1935	524,205.18	236,343.99	191,627.33	109,227.58
Total	2,390,322.02	944,499.74	701,527.65	390,360.38

In 1929 Renappi Corporation was formed under the laws of Delaware by Mrs. Wilhelmina du Pont Ross. The corporation was a personal holding company and among other assets transferred to it were the following with the values furnished by the corporation in 1934:

Racing stable	$6, 750
Farms	421, 000
Gas leases	159, 000
Securities	1, 600, 000

The procedure used in other cases previously discussed was used to good advantage by Mrs. Ross and Renappi Corporation with respect to three classes of deductions taken by the corporation, representing expenses paid by the corporation out of income from securities and royalties. These classes of deductions will be separately discussed.

One of these groups of deductions relates to the racing stable. It appears that the stable has succeeded in earning only a nominal amount as compared to its operating expenses, the loss having been met out of the corporation's income from securities. The record of income and expenses of the stable is as follows:

Year	Gross income of stable	Operating expenses of stable	Loss on operations
1931	$3, 862. 50	$22, 373. 22	$18, 510. 72
1932	0	7, 541. 82	7, 541. 83
1933	0	6, 102. 60	6, 102. 60
1934	2, 850. 00	13, 253. 58	10, 403. 58
1935 [1]			
1936	6, 100. 00	30, 565. 23	24, 465. 23
Total	12, 812. 50	79, 836. 46	67, 023. 96

[1] No information available.

The situation with regard to the stable was duplicated in connection with the farms operated by the corporation. The record of income and expenses of the farms is as follows:

Year	Gross income of farms	Operating expenses of farms	Loss on operations
1931	$3, 330. 30	$73, 486. 32	$70, 140. 03
1932	3, 443. 06	57, 118. 52	53, 675. 46
1933	998. 81	33, 755. 99	32, 757. 18
1934	950. 78	31, 830. 83	30, 880. 05
1935 [1]			
1936	5, 946. 37	39, 248. 56	33, 302. 19
Total	14, 675. 41	235, 440. 22	220, 770. 81

[1] No information available.

Still a third group of deductions relates to the salary paid by Renappi Corporation to Mrs. Ross' husband, Donald P. Ross.

Senator HARRISON. How much was his salary?

Mr. KENT. That figure appears in just a moment.

For most of the years studied, Mr. Ross has had very little income in addition to this salary. Thus the tax upon this salary paid to him is very small compared to the tax which would have been payable if such income had been taxed to Mrs. Ross since she had a very large

income. The amounts paid to Mr. Ross and deducted by Renappi Corporation have been as follows:

Year:	*Amount of salary deducted*
1931	$9,000
1932	18,000
1933	12,000
1934	12,000
1935	[1]
1936	36,000
Total	87,000

[1] No information available.

The 1935 return is in the field, and efforts to obtain it have not been successful to date.

The savings to Mrs. Ross by avoiding the inclusion of these amounts deducted by the corporation in her personal net income have been very substantial, as shown in the following table. The method of computation is similar to that used in cases already described except that credit is given for the small sums of tax paid by Mr. Ross upon the salary received by him from the corporation.

Year	Income reported by Mrs. Ross	Tax thereon	Total expenses deducted by corporation, or income from outside sources, whichever is less	Additional tax if such amount added to Mrs. Ross' income less tax paid by Mr. Ross on salary
1931	$150,469.61	$21,624.05	$97,660.65	$23,668.07
1932	100,584.52	22,740.57	79,217.29	42,244.02
1933	58,164.86	6,964.51	50,859.78	22,393.41
1934	132,246.58	43,052.22	53,289.03	29,053.46
1935 [1]				
1936	149,064.42	62,320.61	93,767.42	55,110.41
Total	590,530.05	156,701.96	374,791.77	172,469.37

[1] No information available.

Mrs. Wilhelmina du Pont Ross (Renappi Corporation)—Additional tax if corporate entity of Renappi Corporation is ignored

Year	Income reported by Mrs. Ross	Tax thereon including tax reported by Renappi Corporation	Income of Renappi Corporation from sources other than racing and farm, less interest and taxes paid	Additional tax if such amount is added to Mrs. Ross' income from sources other than Renappi Corporation
1931	$150,469.67	$21,624.05	$361,055.78	$39,888.86
1932	100,584.52	22,740.57	180,185.81	31,880.94
1933	58,164.86	6,964.51	232,530.37	75,509.10
1934	132,246.58	43,052.22	168,196.27	15,861.34
1935 [1]				
1936	149,064.42	75,476.27	367,964.20	119,051.46
Total	590,530.05	169,857.62	1,309,932.43	282,197.70

[1] No information available.

A variation from other cases of incorporated estates is presented by the case of Mars, Inc., a Delaware corporation, whose address is 2019 North Oak Park Avenue, Chicago, Ill. This company is a close cor-

poration, the stock of which is held principally by Mrs. Ethel Mars, River Forest, Ill. It is a candy manufacturer, the principal product of which is a candy bar marketed under the name of "Milky Way", Its return for the year 1936 shows gross sales of $11,855,833.65 and a net profit of $857,971.59. A deduction was taken for operating loss on a farm in the amount of $288,477.79. The total corporate tax paid was $148,953.29, containing or consisting in part of normal tax running up to 15 percent and in part of surtax on undistributed profits running up to 17 percent in the top bracket. If the farm loss in question had not been deducted, the normal tax yield would have been greater by 15 percent of the amount deducted and the surtax might have been due at a higher rate, depending upon the amount of dividend distribution which the corporation would have made under those circumstances. An increased dividend would have meant more taxable income to the shareholders.

This case seems to differ from other incorporated farm cases in that here it appears to be a manufacturing corporation which is operating a farm and a racing stable as a sort of a corporate hobby. The loss is claimed as a deduction upon the theory that the farm, which is located at Pulaski, Tenn., and is called the Milky Way Farm, is operated by way of an advertisement for "Milky Way" products. Wherein the advertising value for a candy bar of this farm and racing stable consists does not appear.

It may be stated that the tax saving to the corporation on account of the claimed deduction of its farm and racing losses for 1934 would amount to approximately $38,000 and for 1935 to $28,000.

But the device of the multiple personality has been resorted to for other purposes than reduction of taxes by establishing deductions for what are in reality personal expenditures. The cases which follow are illustrations exemplifying the use of artificial devices for the creation of interest deductions.

Mr. Ronald Tree, of Chicago, Ill., whose principal source of income for many years has been as beneficiary of two estates, viz, that of Lambert Tree, his grandfather, and that of Marshall Field I, who it appears was his wife's grandfather, formed three Canadian holding corporations, the entire capital stock of one of which was issued to himself, of another to his wife, and of the third to his children. The corporation, the stock of which was owned entirely by him, was capitalized at $1,800,000, of which amount 10 percent was paid in cash. For the balance of $1,620,000 the taxpayer gave his demand notes which were never paid. He then proceeded to claim on his personal tax returns for each of the years 1929 to 1933, inclusive, deductions for interest alleged to have been paid on these notes in the amount of approximately $100,000 per year. Investigation of the case disclosed that the corporation was substantially overcapitalized as the greatest volume of business, which consisted in dealing in securities, done by it in any year was $175,000. The device of giving notes for inflated capital was clearly designed to support artificial deductions for interest as a means of reducing the taxpayer's income-tax liability. In this case the Income Tax Unit disallowed the interest deduction as fictitious, and the taxpayer agreed to and paid the resulting deficiency. This taxpayer was an American citizen until during the year 1933 when he became a British subject. His returns for later years have been requisitioned from the field but are not yet available.

Another case is that of Mrs. Nathan L. Miller, of New York City, whose husband is an attorney, a former governor of the State of New York, and the general counsel and a director of the United States Steel Corporation. In 1927 this taxpayer formed trusts for her seven children, naming her husband as trustee of each trust. The corpus of these trusts consisted of shares of stock in the United States Steel Corporation. In 1931 Mrs. Miller obtained all of these shares of stock from the trusts, giving her notes aggregating $381,414.66 bearing 5 percent interest in exchange therefor. From 1931 to the end of 1934 the taxpayer paid only a portion of the interest due on these notes, which amounted to about $19,070 per year. In 1935 the taxpayer paid $42,000 to her husband, the trustee, as interest on the notes for the current year and for previous years. In 1936 $35,039.71 was paid on the notes, which paid accrued and current interest in full. The facts indicate that nothing has ever been paid on the principal of these notes. This case suggests the possibility that a taxpayer on the cash basis may take advantage of loan transactions within the family to pay or withhold interest in such a way as to accomplish substantial tax savings, through concentration of interest payments in years when taxable income is large.

In the same general category falls the case of Mr. C. R. Lindback, Philadelphia, Pa., who is president of Abbott's Dairies, Inc., retail milk dealers in that city. On June 6, 1932, this individual borrowed $1,000,000 from the Irving Trust Co. which he gave to Mary F. Lindback, his wife. On the same day she created trusts for her own benefit by depositing the million dollars with the Irving Trust Co., as trustee. On the same date Mr. Lindback borrowed a million dollars from the trusts created by his wife on the security of four notes for $250,000 each, executed by himself and payable to the Irving Trust Co., as trustee. The million dollars was immediately used by Mr. Lindback to repay the loan from the Irving Trust Co. These transactions were all accomplished by the use of checks and no cash ever left the bank. These transactions were consummated a few hours before the Revenue Act of 1932, which revived the gift tax, was approved by the President.

Mr. Lindback has claimed deductions of $60,000 each year on his individual income tax returns for interest paid on these notes. These trusts being revocable, Mrs. Lindback has reported the interest received by the trusts on her individual income-tax returns. However, since the income of Mr. Lindback is much greater than that of his wife, and higher surtax rates are applicable to him, the tax saving from this shifting of income from husband to wife would be very substantial as will appear from the following figures:

Year	Tax saved by Mr. Lindback by interest deduction	Tax paid by Mrs. Lindback on interest	Net tax saving by use of device
1932	$17,431.56	$5,894.85	$11,536.71
1933	34,002.50	14,028.71	19,973.79
1934	33,708.66	15,555.76	18,152.90
1935	33,256.93	17,306.67	15,950.26
1936	37,249.25	16,391.71	20,857.54
Total	155,648.89	69,177.69	86,471.20

The Bureau of Internal Revenue has taken the position from the beginning that these interest items must be disregarded. The taxpayer has accepted an adjustment of this character for the years 1935 and 1936 but the tax liabilities for 1932, 1933, and 1934 are still undetermined. This case affords a clear example of an attempt by a husband and wife to accomplish a voluntary allocation of income between them and thus minimize taxes through the deduction of interest.

Cases of this type illustrate the difficulties presented in determining the genuineness and bona fides of alleged loans between members of families which are used as the basis for claiming deductions for interest.

Mr. VINSON. Mr. Chairman.

The CHAIRMAN. Mr. Vinson.

Mr. VINSON. What was the reason for the adjustment in the tax years 1935 and 1936? Was it some language in the 1934 act?

Mr. KENT. No. In the earlier years there had been a petition taken I believe to the Board of Tax Appeals, which case is pending and undecided. As to 1935 and 1936, it is possible under the law for the taxpayer to sign an agreement waiving the right to go to the Board and permitting immediate assessment, but, of course, he has the period of the statute of limitations within which to file a claim and bring a suit for a refund for that amount.

Mr. VINSON. That is, if the adjudications of the prior year justify it?

Mr. KENT. If they went in his favor; yes.

These difficulties flow largely from the fact that the family is essentially an economic unit. These difficulties are similar to those which led the Congress in section 24 (a) (6) of the Revenue Act of 1934 to deny recognition for tax purposes to losses from sales or exchanges of property between members of the same family.

Among interesting cases of a somewhat different type is that of Marion Otis Chandler et al., Los Angeles, Calif. (32 B. T. A. 720, affirmed by C. C. A. 9th Circuit, Apr. 12, 1937). The Chandis Securities Co., a personal holding corporation of the Chandler and Otis families, during the years 1916 to 1924, inclusive, issued its notes to Mr. Harry Chandler, in the total amount of $1,938,548.60, in exchange for divers assets of assertedly equal value. Mr. Chandler, in turn, assigned or gave these notes to his wife, Marion Otis Chandler, and their eight children. Interest on these notes had accrued to the amount of $1,577,058.28 as of December 31, 1929. The interest on these notes has been used as a deduction by the Chandis Co., which kept its books on the accrual basis, but was never returned by the individuals to whom it was credited. The individuals were assertedly on the cash basis.

Mr. VINSON. Mr. Chairman.

The CHAIRMAN. Mr. Vinson.

Mr. VINSON. How did the Chandis Co. get that deduction of interest?

Mr. KENT. Because it kept its books on the accrual basis, and on that basis of accounting, if the obligation to pay exists within the taxable year, the deduction may be taken even though the actual payment may not occur until a later period. That is well-settled law.

Mr. VINSON. The notes were the notes of the corporation?

Mr. KENT. That is right.

The Commissioner at first endeavored to tax the nine individuals involved in the years 1920 to 1923, inclusive, on the theory that constructive receipt of this interest was had as it accrued annually to

them, but the Board of Tax Appeals decided adversely to the Government on this point (16 B. T. A. 1248). In 1929 the Chandis Co. arranged to increase its capital stock and to use that stock to pay the principal amount of its notes, together with the accrued interest thereon. As the result of this exchange, additional taxes for 1929 in the amount of $335,760.05 were asserted against these nine individuals. The Board of Tax Appeals decided, however, that the exchange occurred in 1930 and never passed upon the question whether the nine individuals realized taxable income by reason of the exchange, and this decision was recently affirmed by the Circuit Court of Appeals for the Ninth Circuit. Since the case went off on technical grounds, the Chandis Securities Co. was thus successful in obtaining a large tax deduction for interest on the accrual basis, while the individual members of the Chandler family who owned the corporation never paid any income tax on that interest.

Another case of this general type involves Mr. Manuel Rionda, whose address is given on his return as 106 Wall Street, New York, N. Y., and who states on his return that he is a resident alien. His occupation is stated to be that of a corporation executive but the corporation is not identified. This individual has availed himself of what appears to be a plan to wipe out any income-tax liability by accruing interest on amounts owed to relatives, close business associates, and corporate entities in which he is a substantial or a controlling stockholder. In 1935, for instance, Mr. Rionda, who keeps his books on the accrual basis, claimed a deduction against gross income for accrued interest in the amount of $99,002.22, of which sum $49,010.43 was accrued as interest at 6 percent due on balances owing three nephews and a lifelong business associate. The account balances are now close to $1,000,000, with no apparent effort being made to reduce the amount. The creditors are on the cash basis and, since the accrued interest has not been paid, they are not required under the law to take up the accrued interest as gross income in their returns.

For no year for which returns have been examined has this individual shown any taxable income or paid any income tax to the United States. A computation covering a period of 4 years indicates that these interest deductions have saved him approximately $18,000 in taxes.

In the mine run of cases, where borrowers and lenders of money are dealing at arm's length, the self-interest of the creditor provides a reasonably satisfactory safeguard to the revenue, in situations where the borrower is on the accrual basis and the lender on the cash basis. The creditor is likely to insist upon prompt payment of interest and an item of interest accrued by the debtor in one taxable year will normally be actually paid to and returned as income by the creditor not later than the following year. But not so where the parties are not necessarily dealing at arm's length, as in cases of loans between members of families or between corporate entities within an affiliated group or between stockholders and their personal corporations. Since this form of reduction or postponement of taxes is not uncommon it is of considerable importance to the revenue that the statute be strengthened by placing such reasonable limitations upon the use of the accrued method as will effectively check such abuses.

One other group of cases in which the corporate device has been resorted to for the purposes of reducing individual incomes subject

to surtax may be described under the caption of Incorporation of Personal Talents. Many individuals enjoy large incomes from salaries or fee for services as actors, on the stage or in motion pictures, as stars of the opera or concert platform, or as authors of copyrighted plays, novels, and short stories. The common feature of the plans which have so far been encountered is that the individual transfers to a corporation of which he is the sole or principal stockholder, or in some instances perhaps members of his family, his income-producing copyrights and the right to contract out his services as actor, artist, or author to third parties for compensation to be paid to the corporation. The corporation agrees to pay to the individual a salary substantially less than the income derived by the corporation from his services and may or may not pay him additional amounts from time to time as dividends on his stock. To the extent that there are surplus earnings which are retained by the corporation, the amount of which has been very substantial in some cases, the Government loses the difference between the taxes paid thereon by the corporation and the amount which would have been payable by the individual had all the corporate income been included in his return. Where the principal source of income transferred to the corporation consists in royalties from copyrights, the corporation may be subject to section 351 but that section as now drawn will not cover many of the cases of this general type.

A striking illustration of this device of incorporation of personal talents is that of Mr. Ed Wynn, of Philadelphia, Pa., well known as an actor, radio entertainer, and show producer. In December 1932 Mr. Wynn organized in Delaware three corporations—Sonnykeen Productions, Inc., Minnylee, Inc., and Wynn Commercial Enterprises, Inc.—and in January 1933 a fourth company known as Airwynn, Inc. All of the capital stock of these corporations was owned by Mr. Wynn or his nominees. Three of these corporations were subsequently absorbed by merger into Wynn Commercial Enterprises, Inc.

These corporations appear to have been formed for the specific purpose of holding Mr. Wynn's highly remunerative radio-broadcasting contract with the Texas Co. and other contracts ($5,000 per broadcast), receiving the earnings from the contract, paying him a portion thereof as salary, which was duly reported on his annual personal returns, and investment of the surplus. The amount of money earned for each broadcast was paid directly to the corporations. Separate books and records and bank accounts were maintained by the corporations and by Mr. Wynn individually.

Examination of the contracts with the radio sponsors indicates that there were agreements for the actor's personal services only, as is evidenced by a provision that "in the event of the death of Ed Wynn during the period of this agreement, the agreement shall thereupon terminate without further liability of either party hereto to the other." Since it appeared that the contract in question was purely for the personal services of Ed Wynn, the Commissioner has taken the position that the earnings derived therefrom are taxable to him personally under the decision of the United States Supreme Court in *Lucas* v. *Earl* (281 U. S. 111 (1930)), in which the Court said [reading]:

> There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements, and contracts, however skillfully devised to prevent the salary when paid from resting even for one second in the man who earned it.

Whether the principle of this decision, which has been applied chiefly to assignments of rights to income under existing contracts, will be extended under existing law to govern cases in which by resort to a corporate device, the right to hire out individuals' services for a price and receive payment therefor is vested in a corporation owned by the individual cannot be known with certainty until the question has been passed upon by the courts.

Mr. Wynn has taken an appeal to the Board of Tax Appeals from the Commissioner's determination that the broadcasting income received by his corporations should be taxed to him. The exact computation of the net reduction in taxes which the recognition of these corporate entities would effectuate is made extremely difficult by the number of corporations involved and their interrelations, but the net tax saving has been estimated. In computing the net tax saving, the incomes of the corporations have been added to Mr. Wynn's individual income, with proper allowance for legitimate deductions and all sums paid by the corporation to Mr. Wynn.

Year	Income reported by Mr. Wynn	Income of corporations to be added	Revised total net income	Tax thereon	Taxes paid by Mr. Wynn and corporation to be subtracted	Net tax saving
1932	$52,673.79	$135,000.00	$187,673.79	$97,011.15	$29,825.67	$67,185.48
1933	[1] 10,077.36	238,874.64	228,797.28	102,975.92	32,889.45	69,086.47
1934	68,545.69	34,124.69	102,670.38	31,322.84	19,475.82	11,847.02
1935	82,009.87	67,093.49	149,103.36	57,370.00	32,746.00	24,624.00
1936	67,915.22	75,275.04	143,190.26	58,403.00	34,417.00	23,986.00
Total	261,067.21	550,367.86	811,435.07	347,082.91	150,353.94	196,728.97

[1] Deduction.

Mr. CROWTHER. Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. Are you through with those radio cases, with the entertainers?

Mr. KENT. The next one that I am about to present is a case that falls in the same general group as the case I have just discussed. I have three of them.

Mr. CROWTHER. Has the Department many cases where the checks are paid to the beneficiary and not to the performer?

Mr. KENT. There have been a number of cases in which attempts have been made to reduce taxes by assignment of income under existing contracts. Since the decision of the Supreme Court in the case I have referred to, those cases are pretty well out. This other development is much more recent, where the individual taxpayer hires himself out to a corporation owned and controlled by himself or by members of the family, and the corporation then in turn hires his services out to third parties for compensation to be paid to the corporation. Now as I have said, whether the second case will be held by the courts to be governed by the principle of the first cannot be foretold with certainty until the courts have definitely passed upon the question.

Mr. TREADWAY. Mr. Chairman.

The CHAIRMAN. Mr. Treadway.

Mr. TREADWAY. Would the witness kindly quote the law applicable to the amount of deduction allowable if salaries or earnings are turned over to other people or other corporations? Is there not a distinct amount stated as to how much can be so deducted?

Mr. KENT. No; I do not have in mind the provision to which you refer, Mr. Treadway.

Mr. TREADWAY. I do not have the law before me, but what I am referring to is an article written by one of the leading writers. Perhaps there is no harm in mentioning his name. I believe it was David Lawrence, who quotes a specific amount that can be deducted if earnings are turned over to charity. Is there not such a law as that?

Mr. KENT. That is a deduction on charitable contributions, which is, of course, limited to 15 percent.

Mr. CROWTHER. That is my understanding.

Mr. KENT. In the case of the income, the individual is limited to 15 percent, and it is 5 percent in the case of corporations.

Mr. TREADWAY. Have you cases of that nature? Are you going to illustrate the provisions of that paragraph? Is not the quotation that you just gave applicable—

> There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts, however skillfully devised, to prevent the salary when paid from resting even for one second in the man who earned it.

Mr. KENT. I have been dealing primarily, Mr. Treadway, with the resort to the corporate device and/or artificial devices for the reduction of individual taxes. Of course, in these charitable-contributions cases there will be many questions of fact to be determined, as to whether the contribution is made for a purpose recognized by the statute as charitable, but that has not been a major problem.

Mr. TREADWAY. Do you or your associates intend to bring up the question of assigning salaries or earned amounts to charity? Have you any illustrations of this practice which you expect to cite?

Mr. KENT. No; I have not.

Mr. VINSON. None of the cases to which you referred are gifts to charity?

Mr. KENT. No; they are not.

Mr. TREADWAY. Then is it not proper that suggestions should be offered of such cases, and that they should be presented to the committee at the proper time either by you or your associates?

Mr. KENT. I should like to have Mr. Magill answer that question.

Under Secretary MAGILL. Certainly; if you have any. Of course, this entire investigation is in the committee's hands. If you want any information of any sort that is within our power to give you, we shall be glad to get it.

Mr. TREADWAY. The reason I am bringing it up, Dr. Magill, is this: I just read, on the train coming down here, that you expected to conclude suggestions to the committee during the next few days. I think there was a statement of that kind in this morning's papers.

Under Secretary MAGILL. Yes; I saw that statement. I do not know where it came from.

Mr. TREADWAY. It did not come from you, then?

Under Secretary MAGILL. No.

Mr. TREADWAY. You were given credit for it, at least, in the press.

Under Secretary MAGILL. I did not see it. The fact is as you have observed here, doubtless, we are presenting these various facts in the order in which they appear to be in the Secretary's letter; and in conversation with the chairman and some members of the committee this morning, it appeared to be that our original statements, if you can call them that—that is, our statements of the problem as we see it, with respect to these different matters—would probably be concluded within the next few days. Of course, whether it will be done by the end of the week or not depends on the pleasure of the committee.

Mr. TREADWAY. Mr. Chairman, I do not want to intrude upon the orderly procedure that has been agreed upon between you and the witnesses for the Department, but I wish to reserve the right, and I think it is perhaps within the scope of a committee member's privilege, to ask for returns that possibly are not going to be presented by the Department itself.

The CHAIRMAN. I have not heard of any orderly procedure having been agreed upon between the Treasury and the chairman of the committee. I have not heard of it. It is news to me. The witness has stated that he is presenting these cases in the order mentioned in the letter of the Secretary?

Mr. TREADWAY. Oh, certainly.

The CHAIRMAN. I have nothing to do with that.

Mr. TREADWAY. That is perfectly agreeable.

The CHAIRMAN. And it is perfectly true.

Mr. TREADWAY. But I ask that the request for documents or information from the Department be not closed when the Treasury Department finishes its presentation.

The CHAIRMAN. I do not suppose that that will be done.

Mr. TREADWAY. Thank you.

The CHAIRMAN. We can only close the hearings by an agreement of the committee. The committee will determine when we will close, and not the Department.

You may proceed.

Another case in this group is that of Skippy, Inc., McLean, Va. This company was organized in May 1932, under the laws of Delaware, with an outstanding capital stock of 5,000 shares, of which 100 are held by Mr. Percy Crosby, 3,400 by his wife, Mrs. Agnes Dale Crosby, and 1,500 by Mr. Bernhard Knollenburg as trustee under trusts established for the benefit of two children of Percy and Agnes Crosby. This corporation is a personally owned company, but it is not certain that it is subject to tax under the provisions of section 351 though it did file forms 1120-H under that section beginning with the year 1934. The principal source of revenue of Skippy, Inc., is from contracts, trade-marks, and copyrights. Mr. Crosby was the originator of the character Skippy, and conducted a business of furnishing comic strips through King's Features Syndicate, Inc. At the time of its incorporation Skippy, Inc., took over all the copyrights, trade-marks, and franchise of the name "Skippy", together with all of the real estate then owned by Mr. Crosby and his wife, in exchange for the capital stock of the company.

It has been noted in a survey of the returns for the years 1932 to 1936 that, while Mr. Crosby is the owner of record of only 2 percent of the stock, the corporation pays him an annual salary of $52,000, which is regularly reported on his personal returns. Mrs. Crosby receives an annual salary of $2,600, which is likewise reported by her.

The corporate income considerably exceeds these salary disbursements. No dividends were paid by the corporation in 1932 and 1933, but a dividend of $21,616 was paid in 1934 and one of $18,000 in 1935 and 1936.

A computation of the additional tax which would be due and owing, if the net income of the corporation had been included in Mr. Crosby's return, after allowing for taxes actually paid with respect to such income by the corporation, Mrs. Crosby, and the trusts, shows a total of amount of $72,941.25, as reflected by the following table. In computing the sums to be added to Mr. Crosby's income on account of income received by the corporation, proper adjustments have been made for legitimate deductions and for dividends and salary actually paid by the corporation to him.

Year	Mr. Crosby's reported net income	Amount to be added thereto from corporate income	Revised total net income	Tax thereon	Taxes paid by corporation, Mr. and Mrs. Crosby and trust to be subtracted	Net tax saving
1933	$49,288.94	$86,185.27	$135,474.21	$49,709.53	$21,220.97	$28,488.56
1934	53,127.84	66,901.76	120,029.60	39,893.91	19,681.47	20,212.44
1935	51,662.78	51,370.36	103,033.14	30,503.89	16,470.99	14,032.90
1936	50,271.68	47,881.16	98,152.84	29,401.17	19,283.82	10,207.35
Total	204,351.24	252,338.55	456,689.79	149,598.50	76,657.25	72,941.25

A third case of this type is that of Mr. Fritz Kreisler, a citizen of Austria, whose American address is given as: care of Raymond M. White, 1 Wall St., New York, N. Y. Mr. Kreisler is famous as a violin virtuoso and composer, and earns large sums in the United States as a concert violinist. He transferred his contract sources of income to the Colonial Corporation organized under the laws of Maine, in 1924, and his royalty income to the Composers Corporation, organized also under the laws of Maine in 1926. He is employed by these corporations and receives as compensation a sum considerably smaller than the amounts received by the corporation.

The following table presents the facts as to the amount of the tax saving for the year 1934, by adding Mr. Kreisler's reported net income the proper amount from the corporation's income, as in the previous cases of this type.

Year	Mr. Kreisler's reported net income	Amount to be added thereto from corporate income	Revised total net income	Tax thereon	Tax paid by Mr. Kriesler and corporations to be subtracted	Net tax saving
1934	$48,750.21	$54,047.93	$102,798.14	$32,524.30	$16,403.90	$16,120.40
1935	46,537.96	38,540.55	85,078.51	23,096.77	12,953.47	10,143.30
1936	20,316.78	35,623.87	64,940.65	14,918.48	7,917.98	7,000.50
Total	124,604.95	128,212.35	252,817.80	70,539.55	37,275.35	33,264.20

In the majority of cases presented in the earlier portion of this statement, resort was had to the device of incorporation or the setting up of a trust as the mechanism to create a multiple personality and thus facilitate the reduction of taxes. But it was pointed out that

such a mechanism is not always necessary. In some situations individuals may in effect be split into different persons without creating a separate entity. A person enjoying a substantial income from investments or from salary or profits in an occupation in which he has made a great success acquires a farm or a racing stable, the operation of which nets him large losses over a period of years. Oftentimes his farm or stable is conducted on such a luxurious scale as to make such losses inevitable under existing conditions in agriculture or stock-breeding. Nevertheless, he insists that the enterprise is a business, not a hobby, that he entered into it with the hope and expectation of profit, and that he is entitled to deduct his operating losses from his income from other sources under section 23 (a) of the Revenue Act as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." As Mr. Magill has stated, whether it is an actual business or a hobby "becomes one of those vague questions of fact which are never settled."

The difficulty is that a rich man's hobby may be incontestably a business when conducted by another as a source of livelihood or when carried on in a different manner. Thus, the collection of first editions, old masters, or rare porcelains or stamps is in all probability a hobby with the majority of persons who can afford to sample its pleasures, yet any of these activities may be and are carried on as a business by others. Under the statute ordinary and necessary business expenses shall be allowed as deductions from grossi ncome; personal expenses shall not. The problem of drawing the proper line of demarcation between the two categories is a difficult one and is hopeless if form is allowed to obscure substance. Fixing this line is none the less important, for the amount of revenue annually lost by reason of the deduction of farm and racing-stable losses by wealthy taxpayers is very substantial.

Cases of this general type have had a checkered career in the Board of Tax Appeals and the courts. One of the leading cases on racing stable losses is that of *Commissioner* v. *Widener* (C. C. A. 3d, 1929; 33 F. (2d) 833). The taxpayers, who were very wealthy persons, in this case were operating a stable engaged in breeding, buying, and racing blooded horses. It appears that very large deficits were annually incurred. For example, the stables operated by one of the taxpayers sustained losses in excess of $333,000 over a period of 4 years. This taxpayer had operated the stable for 20 years and took a substantial personal interest in it. He testified that he set up the stable with the idea that he would come out even financially or make a profit. The opinion of the majority of the Board of Tax Appeals which was adopted by the circuit court of appeals relied chiefly on the fact that the taxpayers testified that at all times they sought to make a success of the stables and to operate them at a profit. The opinion of the minority of the Board in this case contains some interesting and pertinent comments upon the situation, from which I now quote:

> * * * The huge annual deficit disclosed by the record must have been made good by equally huge additional capital contributions. This is a process aptly described in the speech of the common man as "throwing good money after bad", and is rarely indulged in by real businessmen. Ordinarily it is impossible in an enterprise carried on for profit or as a means of livelihood, but it is not at all an unusual procedure for those who, regardless of expense, pursue some sport, recreation, or past time for personal gratification. * * *
>
> * * * These petitioners voluntarily engaged in an enterprise that is notoriously uncertain. They made good their losses and continued their operation after

it was clear that there was little if any prospect of profit. The motives and purposes that governed them were not based either on the hope of or the desire for profits. They were willing to pay and able to pay for the pleasure which they derived from indulging in the "sport of kings" and doubtless the resulting personal gratification was ample compensation for the costs incurred. * * *

I am convinced that Congress had incomes such as we have under consideration in mind when it provided that there should be no deduction on account of personal expenses. To permit these petitioners and others of their type to reduce their tax liability by the deduction of the costs of maintaining racing stables, expensive estates, and other similar activities, would result in a shifting of the burden of public taxation, which it seems to me would be wholly inconsistent with the public interest.

Mr. CROWTHER. Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. How many concurred in the minority report?

Mr. KENT. The Board was divided nine to six in this case, and the case was affirmed, as I have stated, by the Third Circuit Court of Appeals.

Mr. CROWTHER. I noticed in the last paragraph he spoke in the first person.

Mr. KENT. That just happens to be the language of the member writing the opinion.

Mr. TREADWAY. Mr. Chairman?

The CHAIRMAN. Mr. Treadway.

Mr. TREADWAY. Was that decision rendered in 1929?

Mr. KENT. Yes.

Mr. TREADWAY. I see there is a reference to that effect in your prepared statement.

Mr. KENT. Yes.

Mr. TREADWAY. So this method of tax avoidance has been known by the Department since that time?

Mr. KENT. That is right.

Mr. TREADWAY. Has there been any effort made to cure it?

Mr. KENT. We have been fighting these cases before the Board and in the courts in considerable numbers every year.

Mr. TREADWAY. But there has been no recommendation made to Congress previous to the present time, has there?

Mr. KENT. I think the matter was questioned by Mr. Vinson in 1935.

Mr. TREADWAY. It was just casually brought up?

Mr. KENT. I was not present at that time, Mr. Treadway, and I do not know how completely the matter was gone into at that time.

Mr. TREADWAY. Some of these cases started in 1932, and it has been brought out in this hearing that there has been neither any criminal prosecution nor any recommendation for amending the law, although the returns of the taxpayers have been contested. This sort of case goes back to 1929, I judge.

Mr. KENT. It goes back much earlier than that, Mr. Treadway. This is not a new problem.

Mr. TREADWAY. So it is not a discovery on the part of the Department at the present time?

Mr. KENT. Not at all.

Mr. TREADWAY. It does not come within the classification of that "discovery" item in Mr. Morgenthau's letter, that has been referred to, does it?

Mr. KENT. It is a problem that has been with us for a long time. Of course, its tax consequences in terms of the amount of revenue loss necessarily vary with the level of the income-tax rates.

Mr. TREADWAY. Let me just bring out one other point that probably you will admit is correct. Undoubtedly there are profits made from racing stables? I do not know of it personally, but is that not true in the case of some of these people who are in the racing business as a business and not as hobby?

Mr. KENT. I think that is doubtless true, although I cannot speak from personal knowledge in saying how often a profit is made out of them.

Mr. TREADWAY. But the general opinion is, is it not, that now and again distinct cases of large winnings occur?

Mr. KENT. I assumed that there might be individual years when a racing stable had some good horses and won some big purses, when they might break even, and if the stable was run in connection with a breeding farm which sold colts in large numbers and was managed on a conservative basis, it is possible that some profits might be realized.

The decision in the *Widener case* has been frequently cited and has exercised great influence in subsequent cases. Thus, in *Whitney* v. *Commissioner* (C. C. A. 3d, 1934; 73 F. (2d) 589), the taxpayer was operating a stable which incurred a deficit each year, the amount of which does not appear. The taxpayer kept books and supervised the stable's activities himself. He testified that he intended and hoped to derive profits from the operation of the stables. The court, reversing the Board of Tax Appeals, said:

> That the petitioner did not claim a deduction for losses prior to 1927 and that the stable was unprofitable for the 8 years it had existed will not support the decision of the Board under the evidence in this case. There is no substantial evidence to support the conclusion that the pleasure of owning the stable was the primary interest of the petitioner in operating it. The evidence in this case is so similar to that in the case of *Commissioner* v. *Widener* (33 F. (2d) 833, C. C. A. 3), that it is controlling here.

In line with the above cases is the decision of the Circuit Court of Appeals for the Second Circuit in *Commissioner* v. *Marshall Field* (67 F. (2d) 876).

In contrast to these and many other similar cases which might be cited is the case of *Deering* v. *Blair* (Ct. App. D. C. 1928; 23 F. (2d) 975). Deductions claimed by Mr. Reginald C. Vanderbilt for expenses in operating a stock farm were here in question. Mr. Vanderbilt, who resided in New York and was active in financial affairs, became interested in hackney horses and began operation of a stock farm and later built a large residence and numerous other buildings for residence and other purposes. Large losses had always been incurred in operation of the farm. As an example of such losses, in one year the expenses amounted to $27,260.81 and the total gross income was $2,285.53. The court, in holding that the expenses were nondeductible, said:

> In view of the apparently unbroken record, extending from the beginning to the close of Mr. Vanderbilt's operations of the farm, we think the Board was justified in the conclusion that the farm was operated as a place of pleasure, exhibition, and social diversion, and not as a business for profit.

A similar contrariety in judicial reasoning and result is found in the numerous cases involving the deductibility of farm losses. In *Plant* v. *Walsh* (D. C. Conn. 1922; 280 F. 722), the taxpayer had operated a farm since 1905, incurring a loss each year to and including 1914. In 1913 operations resulted in a loss of $107,680.70 which was about 200 percent of the gross receipts and in 1914 in a loss of $106,431.98 which was about 150 percent of the gross receipts. The taxpayer devoted much of his time to the farm operations and declared that he was endeavoring to develop a high-class modern farm. The court, in its opinion holding the losses deductible, said:

> I think, however, that the evidence establishes clearly that Mr. Plant's farm was conducted as a business enterprise and with the expectation that it would eventually become profitable. The mere fact that a heavy loss was incurred in the initial stages of so large an enterprise does not necessarily show the contrary. But, even though this is not so I do not believe that farming, when engaged in as a regular occupation and in accordance with recognized business principles and practices, is any the less a business within the meaning of the statute, because the person engaging in it is willing to do so without regard to its profitableness, because of the pleasure derived from it.

The case on its particular facts is difficult to criticise but the intimation in the opinion that the presence or absence of the profit motive in an enterprise is not controlling on the issue of deductibility of losses was surprisingly extreme.

The statement in the preceding case was later discussed by Justice Learned Hand in the case of *Thatcher* v. *Lowe* (D. C., S. D., N. Y., 1922; 288 F. 994), where the court held a farm loss nondeductible, as follows:

> With the utmost deference I cannot altogether agree with that statement. It does seem to me that if a man does not expect to make any gain or profit out of the management of the farm, it cannot be said to be a business for profit, and while I should be the last to say that the making of profit was not in itself a pleasure, I hope I should also be one of those to agree there were other pleasures than making a profit. Indeed, it makes no difference whether a man is engaged in a business which gives him pleasure, if it be a business; that is irrelevant as was said in *Wilson* v. *Eisner*. But it does make a difference whether a man engaged in occupation which gives him pleasure can honestly be said to be carried on for profit. Unless you can find that element it is not within the statute.

Earlier in the same opinion Judge Hand said:

> The question in this case is a narrow one, and is merely whether the farm which Mr. Davies operated during his lifetime at his residence on Long Island was a "lawful business carried on for gain or profit." I have no doubt that a lawyer can operate a farm for profit. However unlikely it may be he will succeed in the enterprise, the enterprise may in fact be intended as a business. But it is equally clear that a lawyer may run a farm merely as an adjunct to his country place, and between the two the test appears to me to be only of his actual intention. Moreover, in ascertaining that intention, I can see no escape from making the crux of the determination his receipts and expenditures.

Among the considerations which have apparently influenced the courts in cases where the deduction of losses has been allowed are the following: (1) A record of past losses year after year is only one factor and does not preclude the court from allowing the deduction; (2) the fact that the taxpayer had other business interests does not preclude the allowance of the deduction; (3) the thoroughness with which the taxpayer entered upon his agricultural enterprise indicates that his motive was profit; (4) the fact that farm produce was marketed to the public is important; (5) the keeping of accounting records of the operations of the farm is important; (6) the fondness of the taxpayer for farming does not prevent the farm from being a business operation; (7) the fact that the farm was operated on a practical and

businesslike basis is important; (8) the fact that the taxpayer's primary intention was to derive a profit is controlling. The last of these propositions, while unobjectionable in the abstract, is question-begging in character, since the real problem which causes the difficulty in these cases is how this primary intention is to be determined. Several of the other factors mentioned seem to evidence a desire to reduce losses as much or more than a primary motive of profit.

The fact that cases of this type turn so largely upon issues of fact and questions of the weight to be given to various kinds of evidence, including the taxpayer's own declarations as to his intent or motive, makes the problem involved peculiarly refractory to any solution which is not too complex from the point of view of administration and which will not operate harshly and unjustly in large numbers of cases. Yet there can be no doubt that a large amount of revenue is being lost every year by reason of deductions for farm and racing stable losses of doubtful justification. The following illustrative figures for the year 1935, which come from the offices of 24 internal agents in charge from all parts of the country, and are taken from the returns of 51 individuals for that year show the total of the net incomes reported in such returns and the total deductions claimed for farm and racing stable losses, and the data available does not permit a breakdown between farm losses and racing losses, but the former represents vastly the greater portion of the total. The total net income from all sources reported in the 51 returns was $13,325,155.38, and the deductions for the above losses claimed amounted to $3,176,278.91. As many of these returns fall into high surtax brackets, the revenue lost on account of these deductions is manifestly substantial.

Many of the taxpayers claiming these losses are prominent bankers, financiers, industrial leaders, and professional men, but, in the absence of full data regarding their individual cases, it is impossible to say what proportion of the deductions claimed are meritorious and what part open to question. In only one of the 51 cases was a net profit upon the farming operation reported, in the amount of $2,145.67. The list represents, of course, only a fraction of the total losses on farms and racing stables during that year which were claimed by persons whose principal activities and sources of livelihood are in other fields of activity.

As Mr. Magill has pointed out, the ordinary farmer knows that such activities cannot be conducted upon the scale and in the manner which characterize many of the above cases with any reasonable hope or expectation of profit. He feels that an unfair advantage is being taken of the income-tax law and his confidence in its integrity is to that extent impaired. He knows that, if wealthy taxpayers solicited to embark upon such rural enterprises applied to them the same standards which account for their general financial success, they would never consider doing so for a moment unless the personal pleasures and satisfactions to be derived therefrom were regarded as worth the cost to themselves. A wider application of hard-headed realism and common sense would go far toward solving this problem.

Mr. TREADWAY. In the section of the country where I reside there are numerous farms of this nature. Whether any of them are incorporated, or not, I have no knowledge, but I feel that it would be a very serious handicap to resort regions to have the inference made that this sort of farming—the breeding of cattle or horses—is more or less discountenanced under the recommendations of the Depart-

ment. It would very seriously interfere with New England as a resort region. We need help as it is, and we should not be handicapped in our efforts along that line by legislation or even criticism aimed at people who are doing this sort of thing. I do not say they are doing it in the corporate sense for tax avoidance purposes, but these farms, such as you are describing, which, of course, must be regarded as hobbies, are quite plentiful through the New England area. To have the Government take the attitude of opposition to it certainly would not encourage the resort business in New England.

Mr. KENT. Of course, there is no intent, Mr. Treadway, I hope you understand that, to criticize or discountenance any of these activities as activities. Hobbies are a very fine thing. I wish I could afford a nice country place myself.

Mr. TREADWAY. I wish you could, because then, if you used good judgment, you would be up in our country.

Mr. KENT. The question is simply this: It has been the policy of Congress to limit deductions for expenses to those expenses that are ordinarily and necessarily incurred in the carrying on of a trade or business. Can it fairly be said that a person can go out into a field of activity that is not his regular or principal field of activity, and carry on an enterprise year after year, and pile up staggering losses, and still be carrying on that enterprise with the motive of private profit as the dominating motive, rather than the motive of the pleasure and satisfaction that he gets out of it as a person?

Mr. VINSON. The mere fact though, that profit is not generally obtained could not be controlling. Take the oil business: I venture the assertion that the total number of dollars lost by the people of this country in attempting to strike oil overshadows many times the profits. People start when they are young, and they go all the way through. The lure keeps them on, and you can say that it is unprofitable, but yet the American spirit continues in that direction.

Mr. KENT. That is correct.

Mr. VINSON. And you could say certainly that they get a great pleasure. I never struck an oil well, but I just imagine that the kick that a fellow would get out of bringing in a gusher would be quite pleasant.

Mr. KENT. That is right.

Mr. TREADWAY. May I ask, Mr. Chairman, if the gentleman from Kentucky could not see the same pleasure and gratification in breeding good horses down in his State?

Mr. VINSON. It may be that the gentleman had already thought that.

The CHAIRMAN. I may have misunderstood your statement, but I did not understand it to be your purpose to discredit or discount the operations referred to by my good friend Mr. Treadway.

Mr. KENT. Not at all.

The CHAIRMAN. Your position is that if those operations are resorted to for the deliberate purpose of tax avoidance or tax evasion, then you would discredit that purpose or policy. You would not attempt to discountenance the ordinary and proper business operations that may be entered into, but you would discredit only those entered into for the purpose of avoiding taxes?

Mr. VINSON. Of course, that comes down to whether it is done personally, or whether the corporate device is used for that purpose; and, of course, the cases to which he has been referring here in the

last few minutes were cases of individuals who were engaged in farming on that scale. Is that right?

Mr. KENT. That is right.

Mr. CROWTHER. Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. It is a pretty close question, evidently, in the courts, is it not?

Mr. KENT. That is right.

Mr. CROWTHER. I wish you would read into the record at this point what the court said regarding deductible losses of this character, in the case of *Plant* v. *Walsh*. It is only a short paragraph.

Mr. KENT. If I read that, do you have any objection if I read another case in which that case was discussed?

Mr. CROWTHER. No. I am asking you to read it all.

Mr. KENT. In this case, the court in sustaining the deductible loss made the following statement. This was a district court in the southern district of Connecticut:

> I think, however, that the evidence establishes clearly that Mr. Plant's form was conducted as a business enterprise and with the expectation that it would eventually become profitable. The mere fact that a heavy loss was incurred in the initial stages of so large an enterprise does not necessarily show the contrary. But, even though this is not so, I do not believe that farming, when engaged in as a regular occupation and in accordance with recognized business principles and practices, is any the less a business within the meaning of the statute, because the person engaging in it is willing to do so without regard to its profitableness, because of the pleasure derived from it.

Now, the statement in the preceding case was later discussed by Justice Learned Hand in the case of *Thacher* v. *Lowe* (D. C. S. D. N. Y. 1922; 288 Fed. 994), where the court held a farm loss nondeductible, as follows:

> With the utmost deference I cannot altogether agree with that statement. It does seem to me that if a man does not expect to make any gain or profit out of the management of the farm, it cannot be said to be a business for profit, and while I should be the last to say that the making of profit was not in itself a pleasure, I hope I should also be one of those to agree there were other pleasures than making a profit. Indeed, it makes no difference whether a man is engaged in a business which gives him pleasure, if it be a business; that is irrelevant as was said in *Wilson* v. *Eisner*. But it does make a difference whether the occupation which gives him pleasure can honestly be said to be carried on for profit. Unless you can find that element it is not within the statute, * * *.

Earlier in the same opinion Judge Hand said:

> The question in this case is a narrow one, and is merely whether the farm which Mr. Davies operated during his lifetime at his residence on Long Island was a "lawful business carried on for gain or profit." I have no doubt that a lawyer can operate a farm for profit. However unlikely it may be he will succeed in the enterprise, the enterprise may in fact be intended as a business. But it is equally clear that a lawyer may run a farm merely as an adjunct to his country place, and between the two the test appears to me to be only of his actual intention. Moreover, in ascertaining that intention, I can see no escape from making the crux of the determination his receipts and expenditures.

Mr. CROWTHER. I think that illustrates how close the decision is.

The CHAIRMAN. We thank you, Mr. Kent, for your appearance and for the testimony given the committee.

Mr. COOPER. Mr. Chairman, I move that we adjourn until 10 o'clock tomorrow morning.

The CHAIRMAN. Without objection, the committee will stand adjourned until 10 o'clock tomorrow morning.

(Thereupon, at 12 noon, Wednesday, June 30, 1937, the committee adjourned until tomorrow, Thursday, July 1, 1937, at 10 a. m.)

TAX EVASION AND AVOIDANCE

THURSDAY, JULY 1, 1937

JOINT COMMITTEE ON TAX EVASION AND AVOIDANCE,
Washington, D. C.

The joint committee met in the hearing room of the Committee on Ways and Means in the New House Office Building, at 10 a. m., Hon. Robert L. Doughton presiding.

The CHAIRMAN. The committee will be in order. You may proceed, Mr. Magill. Who is your first witness?

Under Secretary MAGILL. Mr. Chairman, I have two matters here which have been requested at earlier meetings, that might be put into the record.

Senator George inquired the other day respecting the number of personal holding companies which have been organized since 1934. We have no information as to the number which have been organized, and I do not know how you could get that, but I can give you the number of personal holding companies' returns which have been filed for each year, in 1934 and subsequent years.

The Statistical Division reports that in 1934 there were 4,457 personal holding company returns filed; in 1935, 5,075; and up to May 31, 1937, there were 4,305 returns filed. The year is as yet incomplete.

As I have said, I do not think these figures give any light as to the number of personal holding companies which may have been in existence or which may have been formed. What they seem to show is that there have been more such returns filed under section 351, which may simply indicate that that section has been effective.

Senator HARRISON. When you speak of 1934, do you refer to the returns for the calendar year or for the fiscal year 1934?

Under Secretary MAGILL. This document reads "that during 1934, 4,457 personal-holding-company returns were filed."

The CHAIRMAN. That would be for the calendar year?

Under Secretary MAGILL. Yes, sir; I should think so.

Senator HARRISON. Mr. Chairman.

The CHAIRMAN. Senator Harrison.

Senator HARRISON. Were they required to be filed under the law, prior to 1934?

Under Secretary MAGILL. No, sir.

Senator HARRISON. So that must be the returns filed in 1935, rather than in 1934?

Under Secretary MAGILL. Yes. I think that is true.

I have here also another document. One member of the committee—I am not sure just who requested the other day that we file a statement respecting the corporation laws and tax laws of some

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of these countries in which foreign personal-holding companies have been organized. The Legal Division has prepared such a memorandum with respect to the Bahamas, Newfoundland, Panama, Prince Edward Island, and Lichtenstein, which I should like to put in the record, if it is agreeable.

The CHAIRMAN. Without objection; that may be done.

(The memorandum presented by Under Secretary Magill is as follows:)

STATEMENT RELATIVE TO LAWS OF CERTAIN FOREIGN COUNTRIES GOVERNING TAXATION OF CORPORATIONS FORMED UNDER THEIR LAWS, REQUESTED BY JOINT COMMITTEE ON TAX AVOIDANCE AND EVASION

The committee on June 8 requested that additional information be provided by the Treasury and inserted in the record upon the following questions:

(1) What taxes, if any, are imposed upon corporations in those foreign countries (Bahamas, Newfoundland, Panama, Prince Edward Island, Liechtenstein) which are actively engaged in issuing charters to personal holding companies formed by Americans and nations of other countries?

(2) What changes in tax rates and otherwise have been made in the revenue laws of Canada governing taxation of Canadian corporations and their shareholders during the past 5 years?

This information is set out hereinafter in this statement.

I. PERSONAL HOLDING COMPANY IN—

(1) *Bahamas.*—In the Bahamas there exists no form of income tax on the income of either corporations or individuals. For corporations the registration fee is in the form of a stamp tax of £3 on the first £1,000 of capital and £1 for each additional £1,000.

(2) *Newfoundland.*—Under the Income Tax Act of June 1, 1929 (20 Geo. V, cap. 30) a personal holding corporation (construed to mean a company having not more than five stockholders, all of whom are nonresident and 80 percent of whose assets, other than cash, consists of stocks, bonds, debentures, or other securities and 80 percent or more of whose income is derived from the investment in or trading in stocks, bonds, debentures, or other securities and which does not do business in that colony) is exempt from income tax. Such company pays instead an annual franchise tax based on its authorized capital of $50 for the first $250,000 or less, $0.10 per $1,000 for the next $750,000, and $0.05 per $1,000 for the excess above $1,000,000. However the maximum annual franchise tax is $250.

(3) *Panama.*—No special provisions apply to holding companies.

The income tax of Panama is Law 40, of 1934. An examination of Decree No. 19, of 1935 (Jan. 31) regulating the recollection of the tax known as the workers and agriculturers' fund, created by Law 49, 1934, discloses the imposition of an income tax beginning with the levy of one-half of 1 percent on monthly incomes of B50.01 to B75 (B, meaning Balboa, is on par with the dollar), and the rate is graduated (about 22 steps) until the maximum levy is reached—5 percent if the average monthly income is B2,000 and upward.

(The national assembly passed a law early in 1937 proposing a tax of 10 percent on dividends, but this law was vetoed by the President.)

(The draftsman of this memorandum observes that one of the reasons Panama is a favorite place of citizenship of corporations is that under Panama's corporation law there is great laxity in registration which confers citizenship. Registration may be accomplished without actual presence in Panama. It may be accomplished without actual presence and may be accomplished abroad before a consul of Panama or even before a consul of a freindly nation.)

(4) *Prince Edward Island.*—Prince Edward Island, a Province of Canada, perhaps has a tax rate less than that of other Provinces of the Dominion and certain advantages as a place of incorporation, but a comparative analysis has not been made. One peculiar provision of its income- and property-tax law is that where the amount of tax on personal property is greater than the amount of the tax on income from such personal property, the tax on personal property is the only tax payable in respect to both the income and the personal property; and if the relationship is the converse, then only the income tax is payable.

(5) *Principality of Lichtenstein.*—On foreign companies registered in Lichtenstein there is imposed no income tax. There is, however, a coupon tax of 3 percent (a flat rate) which is payable on profit paid out as dividends. (This tax would not

be payable on profit which is put into a reserve fund.) There is also imposed a small capital tax on a sliding scale. There are certain fees for registration, payable only once, and such registered foreign company is exempt from all other taxes.

(The capital of the registered organization need not be expressed in Lichtenstein currency. The interested parties need not go to Lichtenstein. Corporate bodies of any description can obtain registration in Lichtenstein, provided they are recognized by any known foreign law.)

II. Revenue Laws of Canada

All Canadian citizens are taxable at their individual rates (depending on the net income of the individual) on distributions received from personal holding companies. The holding company would pay the regular corporation income tax (15 percent) on that portion of its income distributed to nonresidents.

Any American corporation which operates through a registered Canadian branch or through a subsidiary company incorporated either under the company law of one of the Provinces (see Prince Edward Island, supra) or under the Dominion Companies Act is subject to the Canadian tax of 15 percent on its profits. Whether this 15 percent be on its profits in Canada or on all its profits is to be determined by the residence of the corporation, i. e., where it really keeps house and does business.

Certain types of companies (Canadian) whose business and activities are carried on without Canada are exempt from Canadian income tax. These are companies whose assets are located without Canada.

RECENT CHANGES IN CANADIAN LAW

By the amendment act of 1936 there was created a new category of companies for tax purposes, described as nonresident investment corporations.

Such a company is defined as one incorporated in Canada, at least 95 percent of the aggregate value of whose issued shares and all of whose bonds, debentures, and other securities or evidences of funded indebtedness are beneficially owned by persons who are nonresidents of Canada or are owned or held by trustees, etc., the gross income of which is derived (1) from the ownership of or the trading or dealing in bonds, stocks, etc.; (2) from the lending of money with or without security, or by way of rent, annuity, etc.; (3) from or by virtue of any right, title, or interest in or to any estate or trust. The income of such companies is taxable at one-half the ordinary corporate rate, i. e., at 7½ percent.

DIVIDENDS

By the 1933 act (Canada) dividends and interest received by nonresidents from Canadian investments are subject to a 5-percent withholding tax. However, under certain conditions, dividends and interest paid by non-resident-owned investment corporations (created under the 1936 act, cited supra) are not subject to the 5-percent withholding tax. The purpose of this exemption in favor of dividends paid by non-resident-owned investment corporations seems to be to exclude from the 5-percent withholding provision that part of the surplus which was earned but not distributed prior to 1933, the date the 5-percent withholding tax on dividends paid nonresidents was inaugurated.

REGISTRATION AND INCORPORATION FEES

Certain incorporation and registration fees are imposed upon corporations organized under the company law of the various Provinces or under the Dominion Companies Act. These amounts vary in various jurisdictions. The fees in question are comparatively small, and it has been impossible to determine whether any changes have been made in them in the last 5 years.

Mr. Vinson. Mr. Chairman.

The Chairman. Mr. Vinson.

Mr. Vinson. What was the figure for 1936, with regard to personal holding company returns?

Under Secretary Magill. The statement from the Bureau is "reports of the collectors, up to and including May 31, 1937", as to returns filed for 1936, the calendar year, showing that 4,305 returns have been filed.

Mr. VINSON. How many is that less than were filed the preceding year?

Under Secretary MAGILL. A little over 700. But that might be accounted for by fiscal-year returns that have not come in yet.

Mr. VINSON. It also might be accounted for by the dissolution of some personal-holding companies?

Under Secretary MAGILL. Quite true.

Mr. VINSON. Because of the 1936 act?

Under Secretary MAGILL. Quite true.

Mr. TREADWAY. Mr. Chairman.

Mr. CHAIRMAN. Mr. Treadway.

Mr. TREADWAY. May I ask Mr. Magill one question having to do with some previous evidence? I refer to the reports of the six men who took out single-premium insurance policies. Their deductions were disallowed by the Department from year to year, from 1932 on, were they not? I believe that is shown in the data we have here.

Under Secretary MAGILL. Mr. Leming is here. May he answer it? I did not make that investigation myself. Mr. Leming did.

The CHAIRMAN. Please come forward if you are going to testify, and give your name for the record.

Mr. LEMING. My name is Mason B. Leming.

The CHAIRMAN. All right, Mr. Treadway.

Mr. TREADWAY. The photostatic copy of the disallowed deductions, which was given us last week, showed that those returns went back to 1932.

Mr. LEMING. That is right, Mr. Congressman.

Mr. TREADWAY. In connection with that disallowance, why was nothing further done about it? Why was nothing done about it until now? The deductions have been disallowed for several years. I do not have a copy of the photostat before me, but as I recall, they were disallowed every year from 1932 to 1937. Is that correct?

Mr. LEMING. That is right, Mr. Congressman.

Mr. TREADWAY. Why was nothing more done about it by the Department after the disallowance?

Mr. LEMING. That was a matter of discussion the other day.

Mr. TREADWAY. I do not think you gave us any reason why that matter simply lay idle for 5 years.

Mr. LEMING. In that connection we agreed to furnish a schedule of all of the actions in each of the cases, and that schedule is in course of preparation, which will show the history.

Mr. TREADWAY. Will that show the reason why nothing was done for a 5-year period?

Mr. LEMING. Yes, it will, Mr. Congressman.

Mr. TREADWAY. The memorandum you are preparing for the committee will give the reasons why the Department did nothing for 5 years about these disallowed deductions?

Mr. LEMING. It will show this, if you please, Mr. Congressman: One is a schedule of all the actions taken in the cases. That will be set out in complete historical form. That was called for as a separate schedule, and is being so prepared. Then, files were asked for; that is, the complete files; and those complete files will be furnished, and they will show all that we have on it. They should show the reasons why.

Mr. TREADWAY. Will they show your reasons why nothing has been done about it?

Mr. LEMING. I should say the files will, Mr. Treadway.

Mr. TREADWAY. I now have before me the photostatic copy you gave us and will simply refer to the first case. That was the case referred to more often than others the case of Mr. Dwight. "Interest deduction disallowed" in 1932, $141,000; 1933, $143,000; 1934, $145,000; 1935, $147,000; making total disallowed deductions over that 4-year period, beginning 5 years back, of $578,072 against one man. Now, that is a tremendously large sum to an ordinary person like me. It may not be to the Treasury Department, or to big taxpayers. Of course, the Government deals in billions of dollars rather than in hundreds of thousands, but according to my conception, $578,000 is a whole lot of money; yet the Department has sat idle, with no move of any kind to collect the deficiency from time to time. I want to be sure that the report you are making will not go into all these details you are now telling us about, but will set forth conclusions as to why the Department has not acted.

Mr. VINSON. Mr. Chairman.

The CHAIRMAN. Will the gentleman yield?

Mr. TREADWAY. Cannot the gentleman wait?

Mr. VINSON. I just wanted to inquire whether or not, this matter having been gone over and schedules having been promised, our friend from Massachusetts is filibustering.

Mr. TREADWAY. Now, you are doing the filibustering. I am looking for a little information. If you do not want the information submitted by representatives of the Treasury, why bring up the question?

Mr. VINSON. While you were gone, and in your absence, the witness was here.

Mr. TREADWAY. No; I was here.

Mr. VINSON. Then you knew it was to be furnished.

Mr. TREADWAY. No; I did not know. He does not say yet that it is going to be furnished. He is going to furnish a lot of schedules, and so forth, but he does not say anything about conclusions as to why the Department did not act. I think that is a perfectly legitimate question, Mr. Chairman.

Mr. VINSON. It will show that the matter——

Mr. TREADWAY. Are we having a filibuster? Are you and I to debate the question back and forth, or do you want to let the witness answer my question?

Mr. VINSON. You are the one who is filibustering.

Mr. TREADWAY. No.

Mr. COOPER. Mr. Chairman, I am the one in the line of fire here.

Mr. TREADWAY. If there is any embarrassment about answering the question, I shall withdraw it. I do not care whether the Department answers it or not.

The CHAIRMAN. If the witness or anyone else present can answer Mr. Treadway's question, please do so.

Mr. VINSON. Nobody can do it.

Mr. TREADWAY. No; I guess not.

Mr. VINSON. Nobody can answer that question. That is a mere speech.

Mr. TREADWAY. You do not want to give them an opportunity to answer.

Under Secretary MAGILL. Mr. Chairman, may I answer the question? I will answer it officially on behalf of the Department. I assure you you will get the information which you are asking for.

Mr. TREADWAY. Thank you. That is all of that, Mr. Chairman.
Mr. VINSON. He did not answer his question.
Mr. TREADWAY. He assures us we will get the information.
The CHAIRMAN. That should settle the argument.
Mr. VINSON. That may settle the argument, but it does not answer Mr. Treadway's question.
Mr. TREADWAY. Yes; that will answer it. Mr. Leming says he is going to answer it, and Mr. Magill says he is. That is all the assurance I need.
The CHAIRMAN. Who is your next witness?
Under Secretary MAGILL. Mr. Chairman, the Department wishes to present to you this morning the situation with respect to multiple trusts and pension trusts, which I believe is the last of the various topics mentioned in the forepart of the Secretary's letter.
The matter of multiple trusts will be presented by Mr. Paul Bruton, who is an attorney in the Legal Department of the Treasury. The matter of pension trusts will be presented by Deputy Commissioner Russell, of the Bureau of Internal Revenue.
Mr. Bruton will give you the first statement.
The CHAIRMAN. All right, Mr. Bruton.

STATEMENT OF PAUL W. BRUTON, AN ATTORNEY IN THE OFFICE OF THE CHIEF COUNSEL OF THE BUREAU OF INTERNAL REVENUE

The CHAIRMAN. Mr. Bruton, do you prefer to make your principal statement without interruption, and answer questions later?
Mr. BRUTON. No; I shall be glad to try to answer any questions that you may wish to put.
The CHAIRMAN. As we go along?
Mr. BRUTON. As I go along.
The CHAIRMAN. Very well. You may proceed.
Mr. BRUTON. The history of the trust provisions of the various revenue acts is the story of a constant effort on the part of the Government to prevent persons of wealth from escaping their fair share of the tax burden. You will recall that in the 1924 act Congress inserted in that act the provision that the income of a revocable trust is to be taxed to the person creating it, a provision which some attorneys characterized as arbitrary, unreasonable, and unconstitutional. That is, they so characterized it until Mr. Justice Holmes, speaking for a unanimous Supreme Court, upheld its validity, saying, in his characteristic style:

> Taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid.

and

> The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income.

Mr. CROWTHER. Mr. Chairman, if I may interrupt the witness at that point——
The CHAIRMAN. Mr. Crowther.
Mr. CROWTHER. It seems to me that we ought to keep that in mind when we get to "community property." That is pretty good doctrine relative to community property, as to which the argument has been

advanced, and properly I think, that when the spouse who has the management and control of the property, still has the opportunity to pay taxes on only half of it, even though he has the management and control. I think we ought to keep that in mind.

Mr. BRUTON. You will also remember that at the same time Congress enacted the provision that the income from a trust is to be taxed to the person creating it if such income is applied to the payment of premiums upon policies of insurance on that person's life. This provision also has been sustained by the Supreme Court.

These two changes in the law are examples of the manner in which Congress has from time to time amended the trust provisions of the statute so as to improve greatly the operation of the tax, and they were changes which substantially achieved their immediate objectives.

Other illustrations might be offered of legislative changes aimed at maintaining the income tax as a tax based upon ability to pay. It appears that efforts in connection with the trust sections of the revenue act must now be pressed with renewed vigor, since persons seeking substantial reductions in their income taxes are becoming increasingly trust-minded, either of their own initiative, or what is more probable, upon the advice of their tax counsel.

It is true that the increased use of trusts to a certain extent may be motivated by purposes other than the reduction of taxes, but it is difficult to believe that even in these instances a tax saving of perhaps $200,000 to one taxpayer and $500,000 to another taxpayer is always a mere byproduct of a bona-fide transaction, and not contemplated by the parties involved. In any event, it is clear that many persons of wealth are creating trusts in such numbers and in such form as to constitute a serious challenge to the effective administration of the income tax.

Before entering upon the discussion of the specific cases, which will be presented in detail, I wish to call your attention very briefly to certain provisions of the revenue laws, which are not being overlooked by the trust-minded individuals I am about to name.

In 1913, when the first income-tax law was enacted, an effort was made to collect the tax at its source, whenever possible. For this reason, guardians, trustees, receivers, and other fiduciaries were treated as withholding agents and required to withhold and pay the normal tax on the income which they received for the persons for whom they acted. Trusts and other estates were not made taxable entities separate from the persons beneficially interested in them. It soon became apparent that this scheme of taxation gave rise to difficulty where trust income was being accumulated for unborn or unascertained persons. The beneficiaries being unascertainable, the Treasury was unable to point to any taxable person on whose account the trustee should withhold and pay the tax. Consequently, the income accumulated for such persons escaped tax entirely. To rectify this situation, Congress adopted in 1916 the plan, which is still in force, of taxing accumulated income to the trust as an entity and taxing the beneficiaries for any income which is currently distributable to them. Trusts and estates, having thus been made taxable entities with repect to accumulated income, were given the personal exemption accorded to a single individual.

This change in the law was not framed as a fundamental departure from the scheme of taxing trust income to the individual who actually enjoys it and who, consequently, should bear the tax burden. It

was simply adopted in an effort to deal fairly, and in a practical way with the tax problems created where trust income is being accumulated, and the identity of its real owners is in doubt. It was never contemplated by Congress or by the Treasury that a provision making trust estates taxable entities as to accumulated income and granting to them the personal exemption of a single individual would, with the coming of higher surtaxes, be utilized in such a way as to enable wealthy persons to enjoy their income while escaping a large portion of the tax they should pay. Yet, this is exactly what is being attempted. I propose to outline as clearly as I can the situation as it is developing.

The tax-saving trusts, which have been resorted to in the last few years, and which apparently are being created today in even greater numbers, are usually set up in such a way as to create several different trust estates for the benefit of the same persons, and the income is handled in such a manner as to make it taxable to the trustees rather than the beneficiaries. Trusts of this kind fall into about four important types which, for convenience, I am going to label as I go along.

The first type is composed of trusts created by parents for their minor children, the income of which is accumulated in numerous separate trust funds, each one of which is a distinct taxable entity. To illustrate this type, we present the case of Mr. and Mrs. Grenville Clark, of New York.

Mr. TREADWAY. Mr. Chairman.

The CHAIRMAN. Mr. Treadway.

Mr. TREADWAY. Can you identify them a little more closely? Have you their city address, or anything?

Mr. BRUTON. Of New York City. Mr. Clark is a member of the firm of Root, Clark, Buckner & Ballantine, I believe, of New York.

On December 31, 1931, Mr. and Mrs. Clark executed an instrument whereby $100,000 was transferred in trust to Mr. Clark and the Fiduciary Trust Co. of New York. It was provided that the trust property should be divided into three equal, separate and distinct funds, one for each of the Clarks' three children who were then 15, 13, and 6 years of age. The income of each fund was to be accumulated during the minority of the beneficiaries and paid to each as he or she attained the age of 21. Thereafter, the income was to be paid to the beneficiaries during their lives.

Mr. VINSON. I do not get that.

The CHAIRMAN. Mr. Vinson.

Mr. VINSON. You say the income on each fund was to be accumulated during the minority of the beneficiaries, and paid to each as he or she attained the age of 21?

Mr. BRUTON. That is right.

Mr. VINSON. You are speaking there of income?

Mr. BRUTON. That is right. The income of each fund was to be accumulated until the particular beneficiary of that fund became 21.

Mr. VINSON. Then you say, "Thereafter, the income was to be paid to the beneficiaries during their lives."

Mr. BRUTON. Thereafter to be currently distributable. The income accruing to the trust thereafter was not to be accumulated, but was to be distributed currently.

Mr. VINSON. All right.

Mr. BRUTON. Income-tax returns have been filed by the trustees on the assumption that this instrument created three separate trusts,

one for each child, thus enabling the trustees to claim a total personal exemption of $3,000 and divide the remainder of the income among three different returns, resulting in reduced surtaxes. However, had no additional trusts been created for the same beneficiaries, the reduction in taxes would not have been out of line with what a fair administration of the income tax would require. During the next 3½ years 13 additional trusts were created for the benefit of the same three children. According to the trust instruments, these trusts were established by Mrs. Clark acting alone.

Of these 13 additional trusts, 3 were created on June 2, 1932, 4 on December 31, 1934, and 6 on August 12, 1935. The three 1932 trusts were created 4 days before the enactment of the Revenue Act of 1932; the four 1934 trusts were established 7 months after the Revenue Act of 1934 became law; and the six 1935 trusts were set up just 18 days before the President signed the Revenue Act of 1935.

All of the trust instruments are similar in that they provide for no distribution of the income during the minority of the beneficiaries, thus making the income received during this period taxable to the separate trusts, the trustees of which are in each instance Mr. Clark and the Fiduciary Trust Co. The particular features of some of the trusts require special mention. One of the four trusts created on December 31, 1934, provided that the trustees might accept or acquire insurance against the death, disability, or sickness of Mr. Clark and might use the trust income and principal to pay the premiums on such insurance. During the life of Mr. Clark any surplus income—that is, income not needed for premium payments—is to be distributed to the children, and upon Mr. Clark's death the same disposition is to be made of the trust property, including the insurance proceeds. The returns indicate that no distributions have been made. If this trust had been created by Mr. Clark, instead of Mrs. Clark, the income from it would have been taxable to him under the express terms of section 167 of the applicable revenue act which provides that trust income is to be taxed to the grantor of the trust if it is used to pay premiums on insurance policies taken out on his own life.

Of the six trusts created on August 12, 1935, three were insurance trusts of this kind; with this difference, however: instead of creating one insurance trust for the benefit of all three children, as was done in 1934, a separate trust was created for each child.

Thus, during the taxable year 1936, each one of the three children was the sole beneficiary of five separate trusts and was in addition one of the ultimate beneficiaries of the insurance trust of December 31, 1934. Now, let us look at the result shown on the tax returns filed for 1936. Sixteen individual returns were filed by the trustees showing separate trust incomes ranging from $6,184.17 to $14,825.38. The total income returned by the trustees amounted to $170,236.41. The taxes paid for the separate trusts varied from $250.68 to $1,137.64 and totaled $10,930.07. In other words, on an annual income of over $170,000 a tax of less than $11,000 has been paid. This results, first, from the fact that $16,000 has been returned as absolutely tax-free of either normal or surtax, because an individual exemption of $1,000 has been claimed for each trust. Second, the remainder of the income has been split 16 ways, resulting in a drastic reduction of surtaxes.

Had one trust been created, the trustees would have paid $77,311.30 or $66,381.23 more than they did. Had no trusts been created and the trust income included in that of Mrs. Clark, the total taxes collected

would have been approximately $90,000 more than have been paid. Finally—and I think this is important—if one trust had been created for each child, approximately $24,300 more taxes would have been collected from the trustees.

Mr. VINSON. How much money was in the trusts?

Mr. BRUTON. In the corpus of the trusts?

Mr. VINSON. Yes.

Mr. BRUTON. We do not have the figures readily available. It consisted of stock, and if you wish that we shall be glad to supply you the figures on the value of that stock at the time the trusts were created.

Mr. VINSON. I should be glad to have that.

The CHAIRMAN. You will insert the figures later, will you?

Mr. BRUTON. We shall be glad to supply that.

The CHAIRMAN. Produce the figures, that they may be inserted in the record.

(The figures asked for, supplied later, are as follows:)

Date trust created	Grantor	Principal beneficiary	Value of property transferred in trust as of date of transfer
Dec. 31, 1931	Grenville Clark, Fanny Dwight Clark.	Mary Dwight Clark, Louisa Hunnewell Clark, Grenville Clark, Jr.	$100,000.00
June 2, 1932	Fanny Dwight Clark	do	94,807.50
Dec. 31, 1934	do	Mary Dwight Clark	67,409.30
Do	do	Louisa Hunnewell Clark	67,409.37
Do	do	Grenville Clark, Jr.	67,384.38
Do	do	Insurance trust for Mary Dwight Clark, Louisa Hunnewell Clark, Grenville Clark, Jr.	99,020.87
Aug. 12, 1935	do	Mary Dwight Clark	98,877.08
Do	do	Louisa Hunnewell Clark	104,945.58
Do	do	Grenville Clark, Jr.	105,264.33
Do	do	Insurance trust for Mary Dwight Clark	104,541.87
Do	do	Insurance trust for Louisa Hunnewell Clark	109,991.87
Do	do	Insurance trust for Grenville Clark, Jr.	104,541.87

NOTE.—Trustees have filed returns upon the theory that the trust instruments executed Dec. 31, 1931, and June 2, 1932, each created three separate trusts. The property transferred in trust on Dec. 31, 1931, was composed of cash; the property transferred under the remaining instruments consisted of stocks and bonds. The stock values were determined by using the average of high and low quotations given on the New York Stock Exchange or the New York Curb.

Mr. BRUTON. It is probable that this trust income of $770,000 is being applied in much the same way that it would have been had Mrs. Clark not created the trusts. In either event, it is likely that she would have used the funds to provide for her children. Yet by accomplishing her purpose through the use of 16 trusts she has saved $90,000 in taxes in 1 year.

Right here I should add just what the Bureau's position has been with reference to these trusts. As I pointed out, practically all of them are created by separate trust instruments. Each trust was made entirely separate. Consequently the Bureau has felt that there was no ground on which it could assert that these trusts were not separate and distinct, and to be so treated. The only question that has arisen has been with reference to the first trust created by Mrs. Clark, which as I said was created by one trust instrument. On that there has been contention by the Bureau that in fact it created one trust

instead of three. The taxes have been paid by the trustees on the basis of that trust having created one single estate. However, they have reserved the right to file claims for refund on those taxes that have been paid.

Mr. TREADWAY. Mr. Chairman.

The CHAIRMAN. Mr. Treadway.

Mr. TREADWAY. I judge, from your prepared statement that you have now concluded the Clark case.

Mr. BRUTON. That is correct.

Mr. TREADWAY. May I ask a question or two in that connection?

The CHAIRMAN. Certainly.

Mr. TREADWAY. This is not for the purpose of filibustering, of course.

The CHAIRMAN. Go ahead.

Mr. TREADWAY. I wish to refer to the first of these trusts. The Department has accepted the tax payments continuously, has it not?

Mr. BRUTON. That is right; the taxes that have been paid by the separate trusts.

Mr. TREADWAY. They have been paid, and the Department therefor acknowledges that it was legally done?

Mr. BRUTON. I may say with reference to all of the trusts except that first one created by Mr. and Mrs. Clark, the Bureau has made no contention that they were not separate trusts under the law.

Mr. TREADWAY. That one was established on December 31, 1931, nearly 6 years ago. Is it assumed that at that time the Bureau saw that there was an avoidance of taxation or a reduction of taxes as a result of the creation of those trusts?

Mr. BRUTON. Of course, it is clear that whenever a person creates trusts transferring his property to a trustee, that may result in some reduction in taxes.

Mr. TREADWAY. So that for some 5½ or 6 years it has been apparent that there was a reduction in taxes of the Clark family as the result of the creation of these trusts? Now, Congress has passed two or three tax bills since that time. The Department has not insisted on the correction of this condition by legislation, has it?

Under Secretary MAGILL. Mr. Treadway, if I may answer your question, as Mr. Bruton has said in his statement, with which I would agree, the institution of trusts is of course of long standing, and there have been innumerable cases in which individuals have created trusts for their wives or for their children, and so on; and so I take it that the Bureau would not contend that there was the slightest illegality about creating a trust for your wife or for your children, or creating one trust each for all of them.

The point that I believe Mr. Bruton is making here is essentially this: That by virtue of the creation of five trusts for each of these children, where apparently one would have done the business, the taxes were very markedly reduced.

Mr. TREADWAY. But if that hole was there, no effort has been made to plug it?

Under Secretary MAGILL. No; that is true.

Mr. TREADWAY. One of the reasons given for your bringing this whole matter to our attention now is that this as well as other methods of tax avoidance is increasing?

Under Secretary MAGILL. Exactly, and as I said in my initial statement, and I think everything that has gone on here indicates its

truth, we have not discovered any marked number of new tax-evasion devices or avoidance devices which are coming into being in this current year. As the tax rates have increased there is increasing use of the old devices.

Mr. TREADWAY. Of course, articles, books, and so on, written to describe these things, simply attract the attention of the public to the possibility more and more?

Under Secretary MAGILL. We gave you the other day a circular advertising 47 different ways of reducing taxes. I do not know whether you were here or not.

Mr. TREADWAY. I have before me a copy of a book by Roswell Magill, entitled "Taxable I come." I refer to chapter 8, page 249. I shall not take your time to read the whole of it, but there are several extracts that might be well inserted here, as showing that Mr. Magill knew of this situation as a tax expert when he wrote this book; and now we are getting the benefit, in his official capacity, of his wisdom, as explained in the book some time ago. I note that that is one of the means of attracting attention. I hope it has increased the sale of the volume, if there is a royalty connected with it. Let me read just one sentence of it.

Under Secretary MAGILL. If it is of any interest to you, the entire royalties of that book go to Columbia University, so it is not a matter of personal interest to me.

Mr. TREADWAY. They need that, of course, to educate the youth of the land. I read from the book:

> In general, a trust is separate taxable entity; its income is reported separately from the other income of the trustee. The income so determined is taxable to the beneficiary (or guardian of an infant) if distributed or credited to him; and to the fiduciary if held or accumulated. The establishment of trusts by a father for the benefit of his wife and children is thus one means of providing for their support (as he must provide in any case), with the possible advantage of reducing the total income taxes payable by the members of the family, through the creation of one or more new taxable entities. In elaboration of the plan, the father may reserve a power of revocation, outright or conditional. Trusts, even revocable trusts, have had a long and honorable career antedating our income-tax laws; they do not smack too much of evasion or of avoidance as does an assignment by husband to wife of income to be earned.

That is simply the story that this witness is telling us right now, is it not?

Under Secretary MAGILL. Not quite.

Mr. TREADWAY. There is always a little difference?

Under Secretary MAGILL. If I may amplify it a little, I think if you will go on in that particular chapter you will find the explanation. I do not know the part you are reading, because I finished that book last summer, and I have not looked at it since. I was tired of it after that.

Mr. TREADWAY. I should think it would tire you.

Under Secretary MAGILL. The point I think I was calling attention to there was the later decision of the Supreme Court in the *Schweitzer* and *Stokes cases*, to the effect that if an individual creates trusts for the benefit of his minor children, and the income is distributable to the minor children for their education, support, and so forth, that income is nevertheless taxable to the father who created the trust, if he is charged with the duty of their support. So that far from pointing out any means of tax avoidance, what I was pointing out there was that the father by creating such trusts does not in any way escape the liability which would normally be his.

Mr. TREADWAY. No. There is one place here where you distinctly refer to the duty of the father to support his minor children.

Under Secretary MAGILL. That is the basis on which the Supreme Court went in their holding that the income was taxable to the father.

Mr. TREADWAY. All of this simply adds to the accumulation of evidence that was referred to the other day, that there has been no new discovery made so far as you were speaking here, and as we were supposed to infer from certain documents that were furnished us by the Department and administration.

Under Secretary MAGILL. I think we have said straight along—I know our intention has been to say so—that what we see is increased use of some of these devices, such as the trust, for purposes which apparently were not intended by Congress, and as I have tried to say here, so far as anything which was done in 1931 is concerned in this case, I would not think there was anything illegal or anything immoral about it.

You get to questions of degree. If the individual had created 12 trusts for each of these children, I suspect you would all agree that Congress had better step in and do something about the law.

Mr. TREADWAY. We have been pretty slow in doing it, have we not?

Under Secretary MAGILL. No; I do not think you have, because I do not think this situation has developed until recent years.

Mr. TREADWAY. You think that by the publication of books and in one way and another an opportunity for them to do it has been suggested?

Under Secretary MAGILL. I thank you for that, but I do not think that has done it.

Mr. VINSON. Mr. Chairman.

The CHAIRMAN. Mr. Vinson.

Mr. VINSON. Could we not limit the exemption for a particular purpose, or limit a particular person to one exemption, even though there might be a hundred trusts?

Under Secretary MAGILL. The Treasury made some suggestion of that sort in 1933 and 1934, when we were working together on the Revenue Act of 1934, that it would be desirable to tax family income as a unit, so far as that is possible to do. The situation was not accepted at that time, for various reasons, which I guess it is not necessary to go into.

Mr. VINSON. But that would be one way of reaching it?

Under Secretary MAGILL. That would be one way to reach it.

Mr. VINSON. And then to group the income to the particular person from trusts created by the same individual?

Under Secretary MAGILL. Yes.

Mr. VINSON. As taxable income?

Under Secretary MAGILL. So far as this type of situation is concerned, I was working yesterday afternoon with the legislative draftsmen, and the consensus seemed to be there that one plug which might be adopted would be to eliminate the personal exemption so far as trusts have accumulated, irrespectively, and then to provide that where several trusts are created for the same individual, the income should be lumped together.

The CHAIRMAN. We all seem to agree that that would be the fair thing to do.

Under Secretary MAGILL. I think so; yes.

The CHAIRMAN. Is there any reason why it cannot be done by an amendment to the law?

Under Secretary MAGILL. No.

The CHAIRMAN. Is there any reason that you know of?

Under Secretary MAGILL. I think that is possible.

Mr. CROWTHER. Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. What I want to speak of is the fact that in 1932 and in 1934 a subcommittee worked many hours and many days in an attempted revision of the tax laws, and it took up these various subjects of evasion. I remember that there was some discussion at that time, largely in 1932, and mentioned again in 1934, of the problem of these multiple trusts, but nobody from the Treasury Department came before the committee at that time, and we solicited from them all the information that they could give us on these various problems that were pending and had been pending for 2 or 3 years, neither did they do so in 1934. I think that they are grievously at fault for not having brought the existence of these things to the attention of the committee, that there were contentious cases that were before them at that time and awaiting action, and to see if something could not be done about them. I know it is difficult thing to attempt to cure without destroying the whole system of trust development or the formation of trusts, and so forth, which might be recognized as absolutely proper and legal, but at the same time we should have had an opportunity. We ought to have had it brought to our attention, and I think it was negligence on the part of the Treasury that they did not present the evidence to the subcommittee of the Ways and Means Committee, of the existence of these problems and these difficulties, over a period of years, during which we had two revisions of the tax law.

Under Secretary MAGILL. Of course, I cannot speak as to later years. I think these problems were presented either in 1933 or 1934. I may be in error on that, but it is my impression that we did present them.

Mr. CROWTHER. We have discussed multiple trusts. We discussed the problems at that time, but we had no evidence as to the existence of these. I ask Mr. Vinson, who was a member of that committee, if he subscribes to that statement.

Mr. VINSON. I never heard of any illustration being presented such as this, where there was an enormous amount of taxes evaded.

Under Secretary MAGILL. Of course the fact is, as I have explained earlier, that the reason for our bringing these things in now is the increased use of these devices, which is now costing us a good deal of revenue, and all I can repeat is, so far as I am concerned, as soon as one of these things comes to my attention, you will get it.

Mr. CROWTHER. I am glad to know that. The only point I make is that without that information the subcommittee was powerless to do anything. We are not cognizant of these developments in the Treasury Department. The only way we can get the information is for them to come to us and present the difficulties with which they find themselves beset and the tax evasion that is going on under the existing law.

Mr. BRUTON. May I make just this comment with reference to the position of the Treasury, regarding information on these things?

You will note here in the Clark trusts, the situation as I have outlined it was not accomplished until the taxable year 1935 and until then it would not have been shown in its entirety. The returns were filed in March 1936 and, of course, would come to the direct attention of the Treasury later when the returns were gone into. As Mr. Magill has said, it is an accumulative thing. It is not until people form a great many of these trusts that you have the problem presented in the form that it is now presented, and until you do have a great many multiple trusts, there may be some thought that it is better to leave the trust provisions as they are.

Mr. CROWTHER. But you had the problem before you of this original trust, of a deduction being taken as of three separate trusts, did you not, instead of one?

Mr. BRUTON. Yes.

Mr. CROWTHER. Since 1931?

Mr. BRUTON. Yes; but that created only one trust for each child.

Mr. CROWTHER. Yes.

The CHAIRMAN. I am wondering why, as suggested by Dr. Crowther very appropriately in my opinion, it was not dealt with more vigorously in its inception. It was certainly known that it was being practiced on a smaller scale; and the time to eradicate an evil or a disease is when it first makes its appearance. It seems to me this has grown and has become chronic, almost malignant. It could have been discovered and brought to the attention of the committee earlier. I am rather astounded that it was not.

Commissioner HELVERING. Mr. Chairman.

The CHAIRMAN. I would be glad to hear from the Commissioner.

Commissioner HELVERING. As you will observe, the trusts in this particular illustration are the result of single trusts made to these three children in the early years. I might state that on those years they have been examined by the Bureau, and the tax has been paid on those under protest and with the reservation of a right to file refund claims.

If you will notice, the multiple question commenced in 1934, when they created five additional trusts, and then more flagrant in 1935, when they created the six trusts.

Mr. VINSON. There were 10 trusts created after the 1934 Revenue Act?

Commissioner HELVERING. Yes.

Mr. VINSON. But is this not true, Mr. Commissioner, going back to the incorporation of yachts, farms, and so forth, that this practice began years ago, before you were appointed Commissioner of Internal Revenue? Is that not true?

Commissioner HELVERING. Yes; some of those matters go back before that period.

Mr. VINSON. Is it not a fact that, generally speaking, precedent has been created, and decisions were made in line with prior decisions in other administrations?

Commissioner HELVERING. Many cases occurred in which we disallowed a deduction for farm losses and the like on these big "hobbies" as we call them, that have been taken to the courts, and we have been defeated on them.

Take the yacht question for instance. Mr. Russell's unit in the Bureau has endeavored to reach a determination of the fair rental of the yacht, and to assess that as income to the properties, rather than

the amount disallowed by accumulation of the income on the securities which they hold.

Mr. TREADWAY. Mr. Chairman, may I ask the Commissioner one question?

The CHAIRMAN. Mr. Treadway.

Mr. TREADWAY. Going back somewhat, Mr. Vinson referred to the former hearings. I am further interested in the Dwight case and that whole group of cases that were presented relating to single premium insurance. When were you appointed Commissioner of Internal Revenue?

Commissioner HELVERING. In June 1933.

Mr. TREADWAY. June 1933 would have been about the time the 1932 report was made, then, would it not? It would have been made in March 1933?

Commissioner HELVERING. March 1933.

Mr. TREADWAY. Do the files of your Bureau show any correspondence with Mr. Dwight relative to this disallowance, from time to time?

Commissioner HELVERING. I am glad the Congressman asked that question, because while ago when you were referring to the 5-year period, the facts of the matter are that in the insurance-company cases the return for the year 1932 was filed in March 1933. That return was examined by the agent, and his report made on September 29, 1934. This report, made in September 1934, recommended the assertion of a deficiency of $53,593.01.

Mr. VINSON. That means a disallowance of interest as a deductible item?

Commissioner HELVERING. Yes. The taxpayer appeared before the agent's office in New York City and protested that tax at that time. The agent in charge upheld the examining agent in disallowing the deduction. Our file shows that the case came to the Bureau on the 27th of February, 1935, after conferences in the office of the agent in charge, in New York City.

Mr. TREADWAY. That was the 1932 return?

Commissioner HELVERING. That was 1932.

Mr. TREADWAY. That did not get to your office here until 1935?

Commissioner HELVERING. Yes. As you know, Mr. Congressman, under the procedure we were following at that time, we were prosecuting these cases.

Mr. TREADWAY. You were well behind.

Commissioner HELVERING. It took about a year and a half or 2 years to reach these cases. Now, as I say, that 1932 return was filed in the Bureau on the 27th of February 1935 in the special adjustment section. Soon after, in December 1935, the report came in for the year 1933, and the same policy was followed in disallowing the deduction; and I might continue this by saying that the one for 1934 was received on July 16, 1936. The same disallowance was made in that case. But when the case was in the Bureau, in the special adjustment section of the income tax unit, the question on Mr. Dwight's return was a legal one to be decided, and that was referred to the General Counsel's office about 2 months after it was received, to determine the question as to whether or not criminal prosecution should be entered on this case.

The difficulty as to deciding the criminal prosection, "right off the bat", as we might say in common parlance, was that Mr. Dwight had

placed on his return a notation to the effect that this big deduction of $140,000 plus was taken as the result of the payment of interest on money borrowed on a one-premium insurance policy. That was about the extent of the information, but with that information it was very doubtful, in the General Counsel's office, as to whether he had committed a crime, because he had given us that information.

Mr. TREADWAY. Then following the 1932 return, we have the returns for 1933, 1934, and so on. Did he offer the explanation each time, when you failed to allow him the deduction?

Commissioner HELVERING. No.

Mr. TREADWAY. That is, an explanation similar to the one you have just described here now?

Commissioner HELVERING. I did not examine any return except the 1932.

Mr. TREADWAY. But accompanying the 1932 return there is some statement from Mr. Dwight, wherein he explains his position in the matter?

Commissioner HELVERING. Yes.

Mr. TREADWAY. Now you say that was never passed on, either in your Bureau or in the General Counsel's office?

Commissioner HELVERING. As I say, that came to the attention of the General Counsel.

Mr. TREADWAY. Just a wait moment, and let me get the sequence here. After that came to your office, you did not know whether it was a case to be prosecuted or not. In about 2 months' time you referred it to the office of the General Counsel?

Commissioner HELVERING. Yes.

Mr. TREADWAY. You referred to him the statement made by Mr. Dwight to you as Commissioner of Internal Revenue. Now, what did the General Counsel's Office do with that statement of Mr. Dwight's?

Commissioner HELVERING. Of course, they took it under consideration, to decide whether or not under our procedure it should be sent to the office of the Attorney General for criminal prosecution. I do not know what their mental reaction was.

Mr. TREADWAY. Do you know what became of it, officially?

Commissioner HELVERING. There were several conferences held, and it was studied in the office of the General Counsel. I have been advised as to the advisability of sending that for criminal prosecution, but there was a grave doubt created by this statement.

Mr. TREADWAY. What decision did they reach?

Commissioner HELVERING. There was no decision reached until January 1936.

Mr. TREADWAY. Then what did they do?

Commissioner HELVERING. We were preparing assessments for the whole of the tax under the 3 years that were then under consideration.

Mr. TREADWAY. Then it may be said in fairness and justice to Mr. Dwight, may it not, that he did not conceal anything from you or from the office of the General Counsel in connection with this transaction, and that he provided annually a statement justifying what he had done?

Commissioner HELVERING. I do not agree that he did not conceal anything.

Mr. TREADWAY. But he complied with the law so far as the explanation was concerned?

Commissioner HELVERING. And he put us on notice, why the deduction had been made.

Mr. TREADWAY. I wanted that information.

Mr. VINSON. Did he give you the name of the company in which the policy had been taken?

Commissioner HELVERING. No.

Mr. VINSON. To that extent there would be concealment?

Mr. TREADWAY. It might not have been required by the law.

Commissioner HELVERING. Yes; he gave the name of the company.

Mr. TREADWAY. I see your are getting some recruits coming to help you out—some of your assistants.

Commissioner HELVERING. I read this report when it was made on the return.

Mr. VINSON. Did he give the address of the company?

Commissioner HELVERING. I think he said the Star Insurance Co., or whatever the name was.

Mr. TREADWAY. Did the law require that he should go into details about the company with which he was taking the policy?

Mr. LEMING. If I may answer, the statement on the return gave the name of the Standard Life Insurance Co., as I recall. I would like to say this in answer to the Congressman, that these files will contain each one of those returns, and will contain that statement which is attached to each return? That is to be furnished to the committee.

Mr. TREADWAY. The statement made by those New York people will be given to the committee?

Mr. LEMING. Yes; that is right.

Mr. TREADWAY. In connection with the memorandum you propose to file?

Mr. LEMING. That is right.

Mr. TREADWAY. Thank you.

Mr. LEMING. May I just add this: You asked if he disclosed all of the matters. Now, Mr. Congressman, he named the company. He said he had an insurance policy. The facts show there was not any insurance policy, as I think we probably could agree. He said he had a policy.

Now, coming down to the disclosure, on his 1934 return, he stated he paid certain interest, said he had a certain policy, and he referred back to his 1932 return. If you will recall, I showed you how the alleged interest was paid in 1934—by two checks issued by a company which had no money on which to draw the checks, they did not go through the bank, they were endorsed by Dwight's agent and returned to the company, and by that process he got his interest deduction.

Now, was interest paid? That is the query. Was there a disclosure of that? No. Now, it is one thing I think, Congressman, to say "I have an insurance policy, and I have interest." It is another thing to go into the detail, and for you to find out I did not have an insurance policy, and I did not pay any interest, the insurance company did not have any liability, it was not an indemnity policy.

Mr. TREADWAY. If you know all those things, why did you not prosecute him? Where is the loophole, that the General Counsel's office had not prosecuted Mr. Dwight, for 3 years or more, if he did all the things you are now saying he did, contrary to his statement.

Mr. VINSON. Just a minute.

Mr. LEMING. Could I answer the Congressman on that?

Mr. VINSON. In that connection, a whole lot of facts have been disclosed recently in connection with this investigation, that you did not know back at the time you wanted him prosecuted?

Mr. LEMING. That there was a complete nullity so far as the policy, so far as the interest, and so far as liability was concerned. Now, Mr. Treadway, there is no evidence of any mystery about this thing at all. Nobody is going to try to withhold a thing about that. There is good and sufficient reason why, as Commissioner Helvering has pointed out, and as he said the other day, when a taxpayer comes in and makes a protest, the Commissioner does not say, "Out with you! We are going to precipitate something right now." The Commissioner does not do that, and the record will show he did not do that.

It will show that he has cooperated with Mr. Dwight, and the record will also show that no statute of limitations has run against any action the Government might want to take, or as the facts might finally dictate they should take. Now, Mr. Dwight has been accomodated, the Government has lost nothing, the case has taken a regular course and an active course. It has not been an inactive file, and I am sure the Congressman will enjoy going through those complete files, and he will get a satisfactory answer.

Mr. TREADWAY. If my colleague on the committee would not accuse me of filibustering, I would like to follow up one or two of your remarks there. You make pretty long statements, and what struck me particularly as being of interest was this statement that the Government has lost nothing. You mean that they may collect later on, or something? This whole hearing seems to be based on what is represented to us as having been lost by the Government by reason of certain loopholes in the law.

Mr. LEMING. I mean, Mr. Congressman, the state of the law is just as it has been. There has been no change in the law, and the facts have been and are being accumulated. Whatever rights either party had, those rights are still in existence.

Mr. TREADWAY. Then this idea that we are losing hundreds of millions of dollars by tax avoidance is not altogether accurate, is it?

Mr. LEMING. My answer does not imply that at all, Mr. Congressman, I do not think.

Mr. TREADWAY. Well, you said we had lost nothing?

Mr. LEMING. What I said was that whatever rights either party had, they have got today, whatever those rights are.

Mr. TREADWAY. I am not going to filibuster. I want to get home by the 4th of July.

Mr. CROWTHER. Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. In regard to the development of this type of trusts, I notice that in the hearings before the Finance Committee 2 years ago, in 1935, in a letter of the Secretary to the President he made rather substantial reference to the fact that 64 trusts had been discovered, as having been created for the benefit of four members of an immediate family. I notice that Mr. Jackson, in his testimony before the Senate Finance Committee, said this, 2 years ago:

In analyzing one case, we found 197 trusts set up in one family.

So that this has grown to alarming proportions, and the Treasury Department and the Internal Revenue Bureau have been cognizant of this fact for some time. There were not only 64 but 197 trusts, Mr. Jackson said, set up in one family. It is strange that we did not hear anything about that in 1935, by the committee coming before us.

Under Secretary MAGILL. Your 197 trusts was the information given by the then General Counsel to the Finance Committee. Is that right?

Mr. CROWTHER. Yes; given to the Finance Committee by Mr. Jackson.

Under Secretary MAGILL. So the Treasury was not hiding its light under a bushel, exactly.

Mr. CROWTHER. No. I am showing the growth of it and the development of it.

Under Secretary MAGILL. Yes; and that is the point, of course, I was making earlier with Mr. Treadway.

Mr. CROWTHER. These 64 referred to are only just an illustration? That is not the largest case, by any means?

The CHAIRMAN. The witness will proceed.

Mr. BRUTON. One more illustration of cases of this kind, the use of multiple trusts for the benefit of minor children, resulting in large tax savings, is that of Martin F. Tiernan, of Belleville, N. J. On December 24, 1931, Mr. Tiernan executed two trust instruments and his wife executed one. Each instrument created five separate trusts, one for each of the five Tiernan children. Thus, 15 trusts were created in all and each child was the sole beneficiary of three different trusts. We do not have the figures readily available on the tax savings accomplished by the wife, but the savings on Mr. Tiernan's return alone for 1935 amounted to $104,782.91, and for the year 1936, amounted to $232,483.71. When I refer to these amounts as savings I mean they represent the net amount saved, allowance being made for the taxes paid by the trusts.

It appears that for some years Mr. Tiernan was closely associated with Mr. Charles F. Wallace. On the same date that the Tiernans created their trusts, the Wallaces executed practically identical trusts for their children, two trust instruments being executed by Mr. Wallace and one by Mrs. Wallace. Each instrument created separate trusts, one for each of the three Wallace children. Mr. Wallace's tax savings, as shown by the returns, amounted to $86,161.41 in 1935 and rose to $187,900.10 in 1936.

Thus, those two individuals in 2 years accomplished a total reduction in their income taxes of $611,328.13.

Mr. CROWTHER. What is the inference there, in the opening sentence, that it appears that Mr. Tiernan had been closely associated with Mr. Charles F. Wallace? What is the inference to be drawn from that?

Mr. BRUTON. Merely this, that in creating these trusts they may have used the same counsel, and may have acted concurrently in the matter. I mean they knew about the other trusts created by the associate.

Mr. CROWTHER. You do not know that they did?

Mr. BRUTON. No. All we know is that they were closely associated in business, and that on these dates, one day following the other, they set up these trusts.

Mr. CROWTHER. I think in several of these reports there have been too many "might nots" and "may have beens", instead of a definite statement, leaving inferences to be drawn. I think it is unusual.

Senator HARRISON. Did you state what business they were engaged in?

Mr. BRUTON. No; I did not. I believe that they were largely responsible for developing a process for purifying public water supplies, a process of chlorination, or something of that kind, which has been widely used in public water systems.

Senator HARRISON. Where are they domiciled?

Mr. BRUTON. In New Jersey.

Mr. TREADWAY. Are they business partners?

Mr. BRUTON. Yes. I do not mean it was technically a partnership. They were associated in this business of supplying this particular system, and owned stock in the company called Tiernan & Wallace. I believe that is the name, though I am not perfectly sure.

Mr. TREADWAY. You simply happened upon the two cases, and tied them in together, is that the idea?

Mr. BRUTON. We considered them together, because the trust instruments, as I say, are practically identical.

Mr. VINSON. They were executed on the same date?

Mr. BRUTON. That is right.

Mr. VINSON. Between two families, the heads of which had been closely associated together in business; is that right?

Mr. BRUTON. That is correct.

Mr. VINSON. I wonder what street they lived on. Maybe next-door neighbors.

Mr. TREADWAY. You have not shown that Mr. Wallace lived in Belleville, have you? Does he reside in Belleville, N. J., also?

Mr. CROWTHER. It does not say "associated in business." It says "associated."

Mr. VINSON. You said later, when you left the prepared statement, they were associated in business, did you not?

Mr. BRUTON. That is correct.

Mr. TREADWAY. You do not give the residence of Mr. Wallace.

Mr. BRUTON. No; we do not have his street address here. We will be glad to supply it. Mr. Wallace lives in Westfield, N. J., and Mr. Tiernan, in Essex Falls.

Mr. TREADWAY. You told us, in Belleville. Is that right?

Mr. BRUTON. I think that their business address is Belleville, but we can check that and put it in the record for you.

(This information, furnished later, showed Mr. Tiernan's address as Oak Lane, Essex Falls, N. J.; Mr. Wallace's address as 629 Tremont, Westfield, N. J.; and the address on the trust returns as 11 Mill St., Belleville, N. J.)

Mr. CROWTHER. Evidently they were not engaged in purification of the tax system.

Mr. BRUTON. The second type of tax-saving trust is the reciprocal trust, usually created between husbands and wives. That is, a husband will create a trust for the benefit of his wife, and as a part of the same transaction, she will create a trust for him. At least part of the income of each trust is not currently distributable and, therefore, is taxable to the trustees. Consequently, after the transaction is completed, there are, in addition to the husband and wife, two other taxable entities consisting of the trust estates. Thus, the parties have

succeeded in splitting their incomes four ways, while still having it readily available for their uses.

As an example of this type of trust, we have the case of Robert A. and Frank D. Stranahan, of Ottawa Hills, and Perrysburg, Ohio, respectively. The two Stranahans are brothers and are president and vice president of the Champion Spark Plug Co. of Toledo, Ohio. The principal asset deposited with all of the Stranahan family trusts is the stock of the Madison Securities Co., which is a personal-holding company for the Stranahan family. Prior to the formation of the Stranahan trusts, all of the stock of the Madison Securities Co. was owned by Robert A. Stranahan, his wife, Page E. Stranahan, the brother, Frank D. Stranahan, his wife, Marie C. Stranahan, and Elizabeth W. Stranahan, who is the mother of the brothers. The principal asset of the Madison Securities Co. is stock of the Champion Spark Plug Co.

It appears that from 1920 to 1932, the Champion Spark Plug Co. paid a total of nearly $25,000,000 in dividends, approximately $20,000,000 of which was paid to the Madison Securities Co. Total dividends paid by the Madison Securities Co. during the same period were $8,260,000, leaving undistributed earnings of $14,126,230 at the end of 1932. From this, it is apparent that in 1932 a situation was developing which would compel increased distributions by the family holding company.

On June 3, 1932, just 3 days before the approval of the Revenue Act of 1932, Robert Stranahan and his wife, Page, each created 10 trusts. By far the largest of these trusts were created for the benefit of the other. The other 18 trusts were created for the benefit of their 9 children, each child being the sole beneficiary of 2 separate trusts. I am not going to describe in detail the children's trusts, for they involve nothing particularly different from what we have presented in the case of the Clark trusts. The trusts to which I am going to give particular consideration are the two created by the husband and the wife for the benefit of each other.

Each trust provides: That $60,000 a year is to be distributed to the beneficiary, and the remainder of the trust income is to be accumulated. However, supervision over the expenditure of trust funds is vested in a so-called advisory committee. In the case of the husband's trust, this committee is composed of the donor's brother, Frank D. Stranahan, the donor's wife, Page, who is the beneficiary of the trust, Walter W. Hoffman and Edwin J. Marshall. Apparently Hoffman and Marshall are close associates of the family. In the case of the wife's trust, the advisory committee is identical, except for the substitution of Robert for Page. Thus, in the case of each trust, the advisory committee is composed of the chief beneficiary, the husband or wife, as the case may be, Frank D. Stranahan, and Messrs. Hoffman and Marshall. Each committee, as to its respective trust, has complete power to direct at any time the distribution of accumulated income or principal to the beneficiary or to any of the donor's children. It may be assumed that these advisory committees are under the control of the Stranahans. Thus, we have the following situation: Two-thirds or more of the income of each trust is accumulated, making it taxable to the trustees, yet it is always available for use by the Stranahans at any time they may wish to call upon it.

Before giving you some figures on these trusts, I should like to point out that the next day, June 4, 1932, just 2 days before the

approval of the Revenue Act of 1932, the brother, Frank D. Stranahan, and his wife, Marie, each executed 13 separate trusts, making a total of 26 trusts. Eighteen of these trusts were for the benefit of the nine children of Robert and Page, who on the previous day had received two trusts apiece from their parents. Thus, each of these children now was the sole beneficiary of four separate trusts. Of the remaining trusts created by Frank and his wife, six were for the benefit of a son and two grandchildren. As in the case of Robert and his wife, the two largest trusts created by Frank and his wife were reciprocal trusts for the benefit of each other. The trust provisions were in all important respects substantially similar to those I have discussed above in the case of Robert.

Now, let us turn to the figures we have as to the tax savings involved. I will give you the figures as to the taxes saved solely by virtue of the accumulation of trust income by this array of different trusts: For the year 1932: Robert, $59,708; his wife, $41,446; Frank, $51,317; his wife, $47,657. This makes a total tax saving for the two families of $200,128 for the year 1932. For the year 1933, the total tax saving was less, amounting to $112,157.27. For the year 1934, the savings jumped to $388,941.04. The total income-tax savings for the 3 years of both families amounted to $701,227.48.

These figures give the tax reduction accomplished by the creation of the whole 46 trusts. As I just pointed out, the largest of these trusts were the reciprocal ones created between the husbands and the wives and, therefore, a large part of the savings resulted solely from the reciprocal trusts. This is shown by the figures for the year 1934. In that year the income of the trust established by Robert for his wife, Page, was $349,970.88. Of this, $290,297.02 was accumulated and $59,298.66 was distributed. The income of the trust created by Page for Robert was $300,684.65, of which $245,349.41 was accumulated and $58,435.74 distributed. You see, some $290,000 was accumulated in one trust and approximately $245,000 was accumulated in the other. Had these trusts not been created—that is, these two reciprocal trusts—the total tax collected from Mr. and Mrs. Robert Stranahan would have been increased by $62,934.73, allowance being made for the tax paid by the trustees.

A tax saving approximating this resulted from the creation of the reciprocal trusts by Frank and his wife, Marie. The income of the trust created by Frank equalled $168,069.05, of which $108,227.77 was accumulated and $59,841.28 was distributed. The trust established by his wife yielded an income of $300,756, of which $241,616.65 was accumulated and $59,139.35 was distributed. The total tax savings on these trusts for the year was $48,823.86.

Now, turning to the third type of tax-saving trusts, we refer to those which are utilized by persons who wish to have income taxed to a number of different trust estates, and yet have regular annual distribution of that income made to them. Upon first impression, this may seem impossible of accomplishment, but consider what was done in the case of Mr. George W. Olmsted of Ludlow, Pa.

On October 29, 1931, Mr. Olmsted created a trust, the income of which is to be paid to his wife during her life. If one were not thoroughly familiar with the operation of the income tax as applied to trusts, he would find nothing unusual in either the establishment of the trust or the terms of the trust instrument. However, if one

reads the trust agreement with an eye for tax-saving features, he will pause when he comes to the following:

(*a*) The trustee shall accumulate for a period of 1 year and 15 days the quarter annual income from this trust property, and at the end of said period pay the amount thereof over to Iva C. Olmsted for and during her lifetime.

(*b*) The quarter-annual periods shall be computed on a calendar-year basis, so that the distributions of income amounts shall be made as follows: The income of the quarterly period, January, February, and March, shall be accumulated until April 15 of the succeeding year, and on said April 15 the amount thereof shall be paid to Iva C. Olmsted if she then be living. The income of the quarterly period, April May, and June, shall be accumulated until July 15 of the succeeding year, and on said July 15 the amount thereof shall be paid to Iva C. Olmsted if she then be living. The income of the quarterly period, July, August, and September, shall be accumulated until October 15 of the succeeding year, and on said October 15 the amount thereof shall be paid to Iva C. Olmsted if she then be living. The income of the quarterly period, October, November, and December, shall be accumulated until January 15 of the second succeeding year, and on said January 15 the amount thereof shall be paid to Iva C. Olmsted if she then be living. The income of the period from the commencement of this trust until December 31, 1931, shall be accumulated until January 15, 1933, and on said January 15, 1933, shall be paid to Iva C. Olmsted if she then be living.

You will observe that the grantor has very carefully provided that the income received by the trustee in one calendar year shall be accumulated and distributed to the beneficiary in the succeeding calendar year. The accumulation does not take place over a sufficient period to build up any reserve and neither are distributions delayed sufficiently long to lead to the conclusion that it was the grantor s desire to withhold funds from the beneficiary. The reason for the provision is found in the section of the revenue act which provides that the income which is to be distributed currently to the beneficiary is to be taxed to the beneficiary and not the trustee. Conversely, of course, the income which is not to be distributed currently is taxed to the trustee and not the beneficiary.

Mr. Olmsted contends that income which cannot be distributed during the calendar year it is received by the trustee and which must be accumulated for a year and 15 days, is not to be currently distributed within the meaning of the law. After the first year or two following the creation of the trust, his wife is supplied with a regular annual income, but neither he nor she is taxable on it, according to his view.

Of course, one such trust may result in substantial tax savings, but one apparently did not satisfy Mr. Olmsted. The next day, October 30, 1931, he created another trust for his wife with identical provisions for the accumulation of the income, still another followed on November 19, 1931, and yet another on November 20.

For the year 1935 the income of these four trusts, as shown by the trustees' returns, totaled $29,000, upon which the tax paid by the trustees amounted to $395. Had this income been included in that of Mr. Olmsted, as shown by his return, the total taxes paid would have been increased by $5,861.65. This may not seem large after talking of tax savings in terms of hundreds of thousands, but consider the taxes saved as compared with the taxes paid, and this is a comparison which must always be kept in mind. The tax paid by Mr. Olmsted for 1935, as shown by his return, was $1,862.86. In other words, the taxes saved were over twice as great as the taxes paid by Mr. Olmsted and the trusts combined.

But, this is only one side of the picture. It may be said that since Mrs. Olmstead was the one who received the trust income, she

should have paid the tax. However, the return filed by her shows that she received in 1935 some $31,000 income other than what was distributed to her from the trusts. Consequently, if the trust income had been taxed to her the total taxes paid would have been increased by $7,005.04. This amount is over twice as great as the taxes paid by Mrs. Olmstead and the trusts combined. Consequently, for the year 1935, a tax reduction of approximately 70 percent has been accomplished, whether the matter is looked at from the standpoint of Mr. Olmstead or Mrs. Olmstead.

For the year 1936, the tax savings effected by the trust have been greatly increased. If the trust income were included in that of Mr. Olmstead, the total tax collected would be increased by $18,795. If the trust income were reported on Mrs. Olmstead's return, the total taxes would have to be increased by $20,881.

There is another way of making trust income taxable to the trustee, while permitting the beneficiary to enjoy it. The revenue acts have always provided that property received by gift or bequest should not be taxed as income to the recipient. The Supreme Court has held that the bequest of an annuity from the testator's estate is the bequest of property within the meaning of the act, and, therefore, the amounts received by the annuitant or legatee are not subject to tax as income received by him. What is meant by annuity here is an absolutely fixed sum to be received periodically, as for example, where A dies and bequeaths B $1,000 a year so long as he shall live. Frequently, the payment of such an annuity is provided for through the creation of a trust. Thus, in our hypothetical case, A may, in his will, direct that his executors create a trust to pay B an annuity of $1,000 per year. If any year the income of the trust is insufficient to pay this amount, so much of the principal may be used as is necessary. In this situation, the Supreme Court has held that the trust income paid to B in satisfaction of the annuity is not taxable income to B and, therefore, must be treated as income taxable to the trust.

It is easy to see how an annuity trust may be made a tax-saving trust of the highest order. A man may make a gift of a $20,000 annuity to his wife and create a trust to pay it. Although $20,000 is distributed currently to the wife, it is not taxable to her, but to the trustee.

The fourth type of tax-saving trust to be considered includes trusts which are created for purposes of reducing taxes on capital gains. It has always been recognized that the gain which results from the sale of capital assets at a profit is in many respects a special type of income.

Mr. VINSON. Mr. Chairman.

The CHAIRMAN. Mr. Vinson.

Mr. VINSON. Before we get into that new subject: This last trust, the income from which is paid as an annuity to the wife, if that income is taxable in the hands of the trustee, what is wrong about that?

Mr. BRUTON. I should say that I would not characterize it as wrong. I would put it this way: That by having the income taxable to the trustee instead of the beneficiary, it will result in great tax reduction, if the beneficiary has other income, you see.

Mr. VINSON. I know, but you just got through saying here that the Supreme Court said that you could not tax it as income to the beneficiary.

Mr. BRUTON. That is right. They said that, under the act as it now stands. The Supreme Court did not specifically say what Congress might provide. It simply construed the act as it now stands, and also

added this fact that, of course, he may split it up and have several trusts, resulting in greater reduction in tax.

Mr. VINSON. It just seems to me that you collected the tax on it, on the income derived. Unless you abolish trusts, we are going to have to be satisfied with one tax.

Mr. BRUTON. But consider this point. For example, the $1,000 exemption which is given to trusts plays a part here, too.

Mr. VINSON. I know, yet that is not the big point, in my mind. Certainly trusts created for the benefit of your wife or for taking care of your children are proper.

Under Secretary MAGILL. Yes. I am sure you recall we went over this ground in 1933 and 1934. I recall it. For some time the decisions of the Supreme Court were in a good deal of doubt as to whom annuities were taxable, and how they were taxable, and finally in the *Whitehouse case* and the *Pardee case* the Supreme Court arrived at a result which, as you have pointed out, brings about the fact that annuity income is taxable either to the trustee or to the beneficiaries. There is none of it escaping taxation at the present time.

Now, the way it works out in substance, as I understand the decision, is this, that if the decedent, for example, charges the annuity upon the corpus of the trust, then the amount paid to the beneficiary is not taxable to the beneficiary, but the trustee gets no deduction for the payment; or in other words the trustee pays the tax on the income of the trust.

Mr. VINSON. If it were paid out of corpus, it would not be income.

Under Secretary MAGILL. That is true, and that was the general line of reasoning that the Court followed in the *Whitehouse case*.

Mr. VINSON. You understand my statement does not go to multiple trusts?

Under Secretary MAGILL. Yes.

Mr. VINSON. I am differentiating. As to this one particular trust, the thought seems to be that there ought to be a change, in taxing that income. I would just like to know how you are going to do it.

Under Secretary MAGILL. I suspect the reason that Mr. Bruton brought that before you is this: I know that in 1933, and I dare say since, attorneys have been arguing to us that the present framework of the law is undesirable. Personally I do not think I agree with them. That is, personally I think we are safer to go along with the decisions as they stand. But the argument is rather complex, and the thought is this: Suppose that I die and leave an annuity to my wife, which is charged against the corpus as well as against income. In the particular year the annuity is all paid out of income, in fact. Now, the trustee has to pay the tax on it, as decisions stand now. The argument of these attorneys is that my wife, who was actually enjoying the benefit of the income, ought to be the one to pay the tax on it, and that the effect of the present decisions is that the remainderman in effect has to pay the tax.

Mr. VINSON. And those lawyers might want the law changed to let the tax be applicable to income in the hands of the beneficiary? And then the Supreme Court would invalidate that, and for that period of time they would not be paying any tax at all.

Under Secretary MAGILL. Your conclusion agrees with mine. I thought on my part that on the whole it was best to leave the situation the way it is.

Mr. VINSON. As one trust, where the income is taxable and payable by the trustee?

Under Secretary MAGILL. That is right. But you will probably meet this same contention as you go along through these hearings.

Mr. CROWTHER. Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. I notice, in a volume entitled "Federal Taxes on Estates, Trusts, and Gifts", by Montgomery and Magill, at page 408, under the title Creation of Trusts, they say:

> The principal tax consideration in the creation of inter vivos trusts are those outlined above in other connections: (1) To spread income tax liability among several taxpayers, and thereby to reduce the total sum of taxes due; and (2) to reduce the total of transfer taxes payable.

Is that a very fair general definition or statement of the reason for creating trusts?

Under Secretary MAGILL. The reason for creating the multiple trusts is primarily to get the benefit of a series of exemptions instead of only one, and then also to reduce surtaxes, due to the fact that you get several starts on them instead of one.

The CHAIRMAN. Proceed.

Mr. BRUTON. The fourth type of tax-saving trust to be considered includes trusts which are created for purposes of reducing taxes on capital gains. It has always been recognized that the gain which results from the sale of capital assets at a profit is in many respects a special type of income. It frequently represents an appreciation in the value of investments which the taxpayer looks upon as principal to be reinvested, rather than used for current expenditures. Herein lies the great utility of the trust as a device for reducing taxes on this kind of income. If a taxpayer owns securities, which have greatly appreciated in value, and he wishes to sell them and invest the proceeds in other property, he can very conveniently transfer them in trust, have the trustee make the sale and hold the proceeds in trust.

If he is willing to make an irrevocable trust within the meaning of the revenue act, and usually he can arrange it so there is no disadvantage in doing so, the capital gain will be taxable to the trustee, rather than to him. When there is added to this picture the possibility of splitting the gain among several trusts, the stage is set for unlimited tax saving.

As an example of this kind of transaction, we have the case of a man whose enthusiasm for trusts simply knows no bounds—Mr. Louis Blaustein, of Baltimore, Md. Mr. Blaustein has been in the oil business for many years; apparently, he was an independent dealer during the early days of the automobile. After the war, he pioneered in the field of high-test gas and put out the particular brand known as Amoco. Apparently, this gave great impetus to his business, and in 1921 he organized Lord Baltimore Filling Stations, Inc., acquiring all of its stock. The next year he organized the American Oil Co., also wholly owned by him. In 1924 he transferred one-fourth of his holdings in both companies to his son, Jacob.

The stock of both Lord Baltimore Filling Stations and American Oil was equally divided between class A and class B shares. In 1924 all of the class A stock of both companies was sold outright to the Pan-American Petroleum & Transport Co., and about this same time, the control of Pan-American was acquired by the Standard Oil Co. of Indiana.

During the year 1932 the Blausteins entered into a tax-saving trust transaction, which is not the principal one I wish to discuss, but which I will describe to show the background of what happened later. On March 7, 1932, Louis and Jacob Blaustein executed declarations of trust whereby each declared himself trustee of substantially 50 percent of his holding in the American Oil and Lord Baltimore corporations. The sole beneficiary of each of these trusts was the American Trading Co., and the sole stockholders of the American Trading Co. were Louis and Jacob Blaustein. In other words, the Blausteins declared themselves trustees of stock, which they already owned, in favor of a corporation, which they also owned. In October 1932 dividends were declared on the American Oil stock, and the Blausteins received as ostensible trustees the sum of $522,900 which they promptly distributed to the American Trading Co. as beneficiary. The Blausteins paid no tax as trustees on the ground that the income had been currently distributed to the beneficiary. The American Trading Co. paid no tax because the income constituted dividends from another corporation. As you know, the law at that time did not tax a corporation for dividends received from another domestic corporation. If the Blausteins had included the dividends in their income, Louis Blaustein would have paid some $212,200 more in taxes and Jacob Blaustein's tax liability would have been increased approximately $64,800.

Mr. Bruton. The Bureau has assessed deficiencies on this basis and the matter is now pending before the Board of Tax Appeals.

As I have said, this trust arrangement in 1932, by which the Blausteins lifted themselves by their own bootstraps, was simply the forerunner of greater things to come. In 1933, father and son exchanged their filling station and American oil stock for stock in the Pan-American Petroleum & Transport Co. This was a tax-free exchange under the revenue act. At the time the Blausteins acquired the Pan-American stock an agreement was entered into with the Standard Oil of Indiana, which still controlled Pan-American, to the effect that if there was disagreement between the Balusteins and the Pan-American board of directors, Standard Oil would buy the Blausteins' stock at a stated price.

This disagreement occurred, and in 1934 the Blausteins were ready to compel the Standard Oil of Indiana to buy them out. This sale would involve a liquidation of the Blaustein interests in the oil business which had been building up since about 1905. The prospective profit was tremendous. On October 30, 1934, Louis Blaustein created 64 trusts, 19 for his wife, 14 for his son Jacob, 17 for his daughter Ruth, and 14 for his daughter Fanny. To these trusts he transferred 277,500 shares of Pan-American stock, and promptly thereafter this stock was sold to Standard Oil of Indiana at a profit of $3,697,243.50. As you know, Congress and the Treasury have long felt that the total gain resulting from the sale of capital assets, which have been held by the taxpayer for a considerable period of time, should not be taxed at the full surtax rates applicable to a profit made entirely in 1 year. Most persons believe that this would impose too heavy a burden upon profit that is not periodic, but which has been accruing over a long period of time. Consequently, the revenue acts in force since 1934 have provided that when a taxpayer sells a capital asset, which has been held by him for over 10 years, only 30 percent of the gain is to be included in his income. Therefore, the sale of the Pan-American

stock, which had been transferred in trust, resulted in taxable income of $1,543,571.99.

Let me just add this now. This is not the tax reduction that we want to point out. We will start now with the income upon which he should have paid the tax, namely, $1,543,571.99.

Now, under our income-tax system, as Congress presumably intended it to operate and as the people have a right to expect that it should operate, what tax should have been paid upon that income? By whose ability to pay should the tax have been measured?

In the ordinary course of events, Mr. Blaustein might have done either one of three things, which would not necessarily have been regarded as unusual, and which would not have distorted his tax liability.

First, he could have made the sale of stock himself and set up a trust for the benefit of his wife and children. Second, he could have transferred the stock to one trust which could then have sold it. Third, he could have made final gifts of the stock to members of his family in the same proportions as reflected by the aggregate trusts which he has created for their respective benefits.

If he had followed plan 1 and sold the stock himself, his taxes for the year 1934 would have been $573,222 greater than the aggregate tax which he and the several trusts have paid.

Had he followed plan 2 and transferred the stock to a single trust, the tax liability of that trust would have been $532,034 greater than the aggregate tax of $109,114, which has been paid by the 64 trusts. If he had made outright gifts of the stock to the four members of his family who are the beneficiaries of the trusts, the aggregate income tax imposed upon the profit from the sale would have been $378,197 greater than the total tax which the 64 trusts have paid.

If we are thinking in terms of a truly progressive income tax, one which will increase in proportion to the real taxpayer's actual ability to pay, the most that Mr. Blaustein should have been permitted to do was to divide the capital gain four ways among the members of his family who have in reality received it. Yet judged by this standard, the one most favorable to Mr. Blaustein, he has secured an apparent reduction in tax amounting to nearly $400,000, and $64,000 has gone absolutely tax free.

This is the picture for only 1 year and, of course, tax savings will be repeated every year in which the accumulated trust income is split 64 ways. In the time we have had to work upon this case, we haven't been able to secure all of the data with reference to the year 1935. It is possible that the accumulated net income of each of the remaining 42 trusts was under $1,000 and no returns were filed. For the year 1936 the information is almost complete, only a few of the trust returns being as yet unavailable. In that year the accumulated income of the trusts totaled approximately $143,509, and nearly $43,000 was distributed to the beneficiaries. From the figures we have, we can be certain that at least $50,000 of income escaped all tax for that year. The taxes paid for the year have been at least $80,000 less than the tax which the Government would have collected if the property had been given to the members of the family by outright gift.

Mr. Vinson. What about the operation of a gift tax?

Mr. Bruton. He paid the gift tax of a little over $500,000, but if that is to be brought into the total tax picture, of course you must

set off against that the estate tax which he saved, which would have been something over that.

Mr. VINSON. I know; but have you taken into consideration this gift tax in regard to the amount of taxes that he saved?

Mr. BRUTON. No.

Mr. VINSON. Thirty percent of $1,500,000, on your capital gain, would be substantially $500,000?

Mr. BRUTON. These figures are only with reference to income taxes, the figures of a person.

Mr. VINSON. I am talking about dollars that go into the Treasury. That is what I am talking about.

Mr. BRUTON. If you consider dollars actually gone into the Treasury thus far. You must take into consideration the $500,000, approximately $500,000 gift tax paid.

Mr. VINSON. That is $500,000?

Mr. BRUTON. Yes.

Mr. VINSON. And that is substantially 30 percent of $1,500,000; and then in addition to that, the other taxes that were paid?

Mr. BRUTON. Yes.

Mr. VINSON. So it seems to me that by paying the gift tax and the other taxes that were paid, just offhand, it looks to me as if he paid more than he would have paid if he had taken one of your suggestions here and not used the trust device.

Mr. BRUTON. If he had not used the trust device and he had sold the stock himself, true—he would not have any gift tax at that time, unless he later made a gift of the proceeds, and then, of course, ultimately there would have been an estate tax collected when he died.

Mr. VINSON. I know; but that question of estate tax is something else. The securities might be worthless at the time of his death. I do not think it is fair to go out and figure on saving estate taxes.

Mr. BRUTON. Yes; taking the picture of actually what has been paid in thus far, it is fair enough to consider the gift tax of something over $500,000 which was paid.

Mr. VINSON. It seems to be a pretty fair tax.

Mr. BRUTON. Of course, you must remember that this income-tax saving has not stopped now, but will continue indefinitely as long as the trust exists.

Mr. VINSON. I know, but under the law whenever a gift is made, it is not in the picture as to what income the gift will produce. That gift tax settles that. Under the law a person has a right to give away his property, if he pays the gift tax. Is that not true?

Mr. BRUTON. Correct. (See p. 289.)

I wish to emphasize the tremendous task it has been for the revenue agents to assemble this information. Five different trust companies and banks have been made trustees; some of them are located in New York and some in Maryland. Therefore, the returns have been filed in different collectors' offices located in different States. When the revenue agents suspected that multiple trusts had been created, they went to the office of Mr. Karl F. Steinmann of Baltimore, who is Mr. Blaustein's attorney, and requested additional information. This information was not forthcoming and consequently, the agents set about assembling what returns they could find in the Baltimore district. They thus located about 25 returns and returned to Mr. Steinmann's office seeking information as to whether any other trusts had

been created. This was refused with vague explanations which might have been taken to indicate that Mr. Steinmann's office did not have a complete record of all the trusts. Ultimately, all of the returns for the year 1934 were located in Baltimore and in New York. Finally to complete the picture, which I have outlined, it was necessary to examine and study comparatively some 350 different returns. That is for 3 taxable years.

That Mr. Steinmann did not have all the information with reference to the 64 trusts seems incredible. I have here a copy of one of the 64 different trust instruments. On the first page appears this statement:

Conceived by the office of Karl F. Steinmann, Baltimore.

You will note that it is done up in a form worthy of a college degree. Further on in the trust instrument is a provision to the effect that Mr. Steinmann's office is recommended to the trustees as counsel, because of their familiarity with Mr. Blaustein's affairs.

This completes the cases that we wished to submit, illustrating these different types of trusts I have mentioned. I wish to summarize the situation by giving you an illustration of the problem graphically by describing a case which might come before the Treasury Department. That is, it might come unless some effective means is taken to prevent it. This will bring out the point, I think, or one of the points, that I had in mind with reference to annuity trusts.

Mr. TREADWAY. As I understand the gentleman, this is entirely a supposition? That is, it might happen possibly sometime?

Mr. BRUTON. That is correct.

Mr. TREADWAY. It is not an actual case you are going to state?

Mr. BRUTON. No; it is not an actual case on the basis of the facts I am going to cite.

Mr. VINSON. The gentleman is submitting it for our information.

Mr. BRUTON. That is right.

Mr. VINSON. So that it may be met before it does occur.

Mr. BRUTON. There is nothing new in the particular device used, but the particular facts are hypothetical. This will be the case of Mr. and Mrs. X, who each own securities yielding an annual income of $100,000 a year. They each execute 100 trusts for the benefit of the other, the income of each trust to be used to pay a $1,000 annuity to the beneficiary. The result: Mr. and Mrs. X would be receiving $100,000 a year each; the income tax paid, 0.

Mr. VINSON. That is because of the $1,000 exemption for each trust. It just happens that up to date you have not found anybody that just wanted to be the whole hog?

Mr. BRUTON. That is right.

Mr. VINSON. In connection with your last illustration, I take it there would be a gift tax.

Mr. BRUTON. That is correct.

The CHAIRMAN. We thank you for your appearance and for the information you have given the committee.

Mr. COOPER. I move we recess until 10 o'clock in the morning.

The CHAIRMAN. Without objection, we will stand recessed until tomorrow morning at 10 o'clock.

(Whereupon, at 12 o'clock noon, the committee adjourned until tomorrow, Friday, July 2, 1937, at 10 a. m.)

TAX EVASION AND AVOIDANCE

FRIDAY, JULY 2, 1937

JOINT COMMITTEE ON TAX EVASION AND AVOIDANCE,
Washington, D. C.

The joint committee met in the hearing room of the Committee on Ways and Means in the New House Office Building, at 10 a. m., Hon. Robert L. Doughton presiding.

The CHAIRMAN. The committee will be in order. Mr. Magill, are you ready to proceed?

Under Secretary MAGILL. Yes, Mr. Chairman. There are one or two matters here that I would like to present to you before the regular statements. Mr. Vinson inquired yesterday regarding the gift taxes which were paid at the time of the transfers by Mr. Blaustein to those 64 trusts. I do not know why that material was not included in the statement; it should have been; and I have the information here, which I would like to insert in the record.

The CHAIRMAN. Without objection, that may be done.

(The memorandum submitted by Mr. Magill is as follows:)

ADDITIONAL INFORMATION REGARDING THE GIFT TAX ON THE BLAUSTEIN TRUSTS

According to the records available in the Treasury, Mr. Louis Blaustein was, on October 30, 1934, the owner of 964,866 shares of stock of the Pan American Petroleum & Transport Co. No information is available as to what other property he may have owned on that date. According to the gift-tax return filed by him, the stock had a value of $13.52 per share. This would indicate that the total value of the Pan American stock held by him amounted to $13,044,988.32. Had Mr. Blaustein died in 1934 leaving a net estate of this amount, the Federal estate tax would have been $4,659,594.86.

On October 30, 1934, he executed a gift of 277,500 shares of stock in the Pan American Petroleum & Transport Co. The gift was in the form of 64 trusts, the trustees of which were: First National Bank of Baltimore, Equitable Trust Co., Union Trust Co. of Maryland, all of Baltimore, Md., and Manufacturers Trust Co., Irving Trust Co., and New York Trust Co., all of New York City. According to Mr. Blaustein's gift-tax return, the value of the stock transferred in trust was $3,751,800. Upon the gift of this stock he paid a gift tax of $556,212 on March 15, 1935.

The value of the Pan American stock which Mr. Blaustein retained was $9,293,188.32. Had he died during 1934 leaving a net estate of this amount, his estate tax would have been $3,017,484.61. The net saving, in total Federal gift and estate taxes, making allowance for the gift tax paid, would have been $1,085,898.25.

Mr. Blaustein was aged 65 in 1934.

Under Secretary MAGILL. A question was asked the other day, when Mr. Kent was discussing incorporated yachts, as to whether the yacht *Nourmahal* was incorporated or not, and I have had that looked up. I am advised that it is not, and that the expenses have not been deducted on the personal return of the owner.

The CHAIRMAN. By whom was that yacht owned?

Under Secretary MAGILL. Vincent Astor.

The CHAIRMAN. That is what I thought.

Mr. CULLEN. A significant question.

Under Secretary MAGILL. At the meeting yesterday we mentioned among other things that we hoped to present the subject of pension trusts. That section has been in the revenue act for a number of years; I think for some 16 years. It apparently has not been made use of much, at least, for the purposes of tax savings, until recently, and even yet we have comparatively few cases on the subject. The deputy commissioner, Mr. Russell, has prepared a discussion of the provision and included an article or two which have been written by insurance men indicating the possibility that there may be some loopholes there which we had not thought of heretofore. Since there are a number of other matters to be presented, it occurred to me that possibly the most expeditious thing was simply to put this document into the record. There are no names or cases. It is simply a discussion of the subject with a view to possible improvement in the legislation.

The CHAIRMAN. Without objection, the document will be inserted in the record at this point.

Under Secretary MAGILL. These go with it.

(The matter referred to is as follows:)

STATEMENT PREPARED BY HON. CHARLES T. RUSSELL, DEPUTY COMMISSIONER OF INTERNAL REVENUE, RELATING TO PENSION TRUSTS

As a means to encourage employers to provide old-age security for their employees, Congress for 16 years past provided that contributions to, or earnings of, trusts created by an employer as a part of a stock-bonus, profit-sharing, or pension plan for the benefit of "some or all" of his employees are not taxable to the trust or to the employee until distributed or made available to the employee. These provisions were enacted by Congress as section 219 (f) of the Revenue Acts of 1921, 1924, and 1926, and section 165 of the Revenue Acts of 1928, 1932, 1934, and 1936. On the other hand, contributions to pension trusts to provide for the payment of "reasonable" pensions to employees are deductible by the employer, provided the trust fund is placed beyond control of the employer and answers the requirements of the statute. The Revenue Act of 1928 specifically incorporated the previous practice of allowing deductions for contributions to the trust during the taxable year to cover pension liability accruing during the year; and added an additional deduction for a reasonable amount transferred or paid into the trust during the taxable year to cover in whole or in part pension liability applicable to years prior to the taxable year but not paid into a trust. Subsequent revenue acts continue these provisions. This second deduction must be apportioned in equal parts over a period of 10 consecutive years. These provisions were enacted by Congress as section 23 (q) of the Revenue Acts of 1928, 1932, and 1934, and section 23 (p) of the Revenue Act of 1936. The purpose of this modification of, and addition to, the statute was explained in Ways and Means Committee Report No. 2, page 22, dated December 7, 1927, and also in Finance Committee Report No. 960, May 1, 1928, Seventieth Congress, first session, page 21. In the latter it is said:

"A considerable number of business concerns, however, established pension plans for the benefit of their employees a good many years ago, under arrangements by which the company set aside a pension reserve fund, to which annual additions were made, the reserve fund not being turned over to a trustee. The yearly additions to such reserve funds were not deductible for income-tax purposes. These employers now desire to adopt the more satisfactory plan of turning over the pension reserve funds to trustees to hold for the benefit of their employees. Under existing law, no deduction would be allowed for such a transfer representing past accumulations, though distributions from the fund are taxable to the employee as additional compensation. The committee proposes an amendment in section 23 (q), which permits such reserve funds to be turned over to a trustee and allows the amount thereof to be prorated as a deduction over a period of years equivalent to the time during which the reserve fund was accumulated.

This prevents the employer from taking the entire deduction in the year of transfer and operates equitably to the employer and to the Government."

This statement shows a desire to correlate taxability and deductibility, but not to permit a distortion of income for any particular year by deduction therein of amounts not properly allocable thereto.

However, neither section 23 (p), relating to deductibility, nor section 165, relating to taxability, require that the pension trust be irrevocable.

The problem of pension trusts contains two elements: First, the deductibility by the employer of the amounts contributed to the pension trust and, second, the taxability to the pension trust or the employee of the amounts contributed. The pension trust may either invest the contributions to provide pensions or use the contributions to purchase annuities from insurance companies. The employer may derive benefit through increased efficiency and loyalty of employees. I understand that ordinarily a good pension plan tends to prevent employees from resigning to enter the service of competitors or other employers. It also serves to relieve the employer from the moral obligations of keeping on the pay roll employees with years of service who have passed the age of efficiency. The employee is not subject to tax on the contribution until retirement and gains the benefit of a lower tax rate, and, in the case of small pensions, may not be taxable at all.

Our purpose in bringing this matter to the attention of the committee at this time is merely to call attention to the possibility of abuse of the statutory provisions. Information available indicates that some taxpayers are attempting to convert into a tax-avoidance mechanism a statutory provision designed to encourage pensions. The evidence on hand indicates that some closely held and closely controlled corporations are attempting to distribute profits in the guise of pensions. It is further indicated that some corporations are attempting to pass what really amounts to compensation or bonuses into pension trusts, thus postponing the taxation thereof until the period of their retirement, at which time it is expected their individual brackets will be much lower because they will not be receiving salaries.

For example, a closely held corporation having a distributable profit of $200,000 for the taxable year may pass on to two or three stockholder officials the benefit of $50,000 by contributing that amount to a pension trust to invest or purchase annuities to provide pensions for these officials. The corporation is, of course, entitled to deduct the $50,000 from gross income and thus realize a benefit for the purpose of the corporate income tax and surtax on undistributed profits. However, the stockholder officials will also realize a benefit since no part of the $50,000 will be taxable to them until distributed to them in subsequent years in the form of annuities or pensions. By this method a corporation distribution is effected in such a way as to avoid the higher surtax rates which would be applicable if the distributions had been made in lump sums to the taxpayers during the current year. Moreover, in such a case it is possible for the corporation to recapture tax free not only the principal contributions previously paid to the trust and deducted for tax purposes but also any accumulated earnings of the trust by merely terminating it during a year in which the corporation has deductible losses sufficient to offset the sum recaptured. And bear in mind that under the law these accumulated earnings of the trust which may be recaptured tax free have not been taxed to the trust.

Again, a corporation may pay large bonuses to a few stockholder officials or key men. The corporation is entitled to deduct such amounts for income and surtax purposes, while the recipients of the bonuses escape any tax thereon until distributions are made to them from time to time in smaller amounts in the form of pensions or annuities which will normally enable them to keep their income in the lower surtax brackets. In either of the cases mentioned it may well be that the corporation would have distributed the profits or paid the bonuses direct to the stockholder officials and key men were it not for the tax advantages realized by the use of the pension trust plan.

Such tax reduction mechanism may be employed not only by closely owned and closely controlled operating companies but also it may even be employed by personal holding or investment corporations with a few employees such as a stenographer, clerk, and bookkeeper. As to the sums used the Board of Tax Appeals or the courts may hold that a pension of $25,000 annually is not unreasonable for an officer receiving a salary of $50,000 a year.

This abuse of the plan for tax avoidance or reduction we wish to prevent without costly controversies and litigation. I do not believe abuse is widespread at this time, but the material which I will later submit for your consideration indicates it may well become so.

Pension plans may conceivably be employed by corporations with widely distributed stock, though in some cases the temptation to make improper use of the provision is less because the provision cannot be so readily employed to distribute dividends in the guise of pensions. However, it must be remembered that even in the case of large corporations with widely scattered stockholdings, benefits may be derived by the recipients of the pensions, as distinguished from the corporations; in other words, abuse of the statute is possible in the case of both closely held and controlled corporations and corporations which are not within that category. The distinction is that in the case of closely held or controlled corporations there is a benefit to the corporation in that a deduction is secured for pensions which would not be possible for dividends. In the case of a corporation with widely distributed stockholdings the benefit to the corporation is a matter of internal organization and the tax benefit is limited to those who ultimately receive bonuses, consisting of the taxation of the amounts paid into pension trusts at the lower surtax brackets applicable after retirement rather than the high surtax brackets of the current year when the amounts are superimposed upon a current salary. As I have said, so far as we have been able to ascertain at this time without an examination of recent returns the pension provisions have not been availed of for avoidance in a great number of cases, though examination of 1936 returns may show a good deal of such avoidance. But we are fearful that improper use of the provision is being stimulated by propaganda at a rapid rate. I quote from a photostatic copy of a reprint of an article appearing in the National Underwriter, issue of April 23, 1937:

"NEW YORK, April 22.—Pension trusts present an enormous opportunity to life-insurance men and open up a field that is certainly as big as anything that has gone before, M. M. Goldstein, assistant manager, Clifford L. McMillen agency, Northwestern Mutual Life, New York City, told New York City Chartered Life Underwriters and their guests at the April meeting. 'In my opinion, this represents the largest single untapped field for service and sales in our business today', he declared."

I quote further excerpts from the article:

"The pension trust plan can be used for advancing the interest of the corporation, but must not be used as an attempt at tax evasion, or it will endanger the savings that the corporation hopes to effect. He said that with the motto 'let your conscience be your guide' most pension plans would get along all right."

Please note he said nothing about avoidance. Permit me to quote further from the article:

"As to the tax angle, the speaker said that when the normal Federal corporation income tax, the New York franchise and the Federal undistributed profit tax are taken into account, it works out that the employer is using 64-cent dollars when he contributes to a pension trust, rather than adding it to surplus. In other words, for each $1 that goes into a pension trust fund, the actual cost to the employer is only 64 cents. Mr. Goldstein warned, however, that he tax advantages must be translated into terms of the employer's interest and pocketbook."

So, if under Mr. Goldstein's plan the employer is to pay only 64 cents then, of course, the Federal Government is paying the remainder through tax reductions. I will quote from the article:

"Demonstrating the saving that accrues to an executive having, for example, a total income of $100,000 a year which would be subject to an income tax of about 70 percent, Mr. Goldstein showed how $10,000 paid to him as present salary would amount to a tax-free income of only $3,000. However, this same $10,000, if put into a pension trust plan, would provide three and one-third times greater capital or monthly income when the executive reached age 65".

If that be true, and it is true except I believe the figures are a little off, then the Federal Government is paying for that portion which is three and one-half times greater.

Permit me to quote further from the article:

"Assuming that the man in question were 55 at present, he, or his employer, would have put into the pension plan on his behalf $100,000, the value of which would be much greater in terms of income than would be the case if he had received it direct, paid income tax on it and then purchased a life annuity or other form of investment."

That is something of considerable importance. Note the words "or other form of investment": The article further states:

"Commenting on the legality of the pension trust idea, Mr. Goldstein said that the provision in the Federal revenue law which permits it has been in force since 1921."

I submit for the consideration of the committee reprints of the article in the National Underwriter, issue of April 23, 1937, and the Eastern Underwriter, issue of April 23, 1937. Now, Mr. Goldstein said the pension trust fund plan must not be used as an attempt at tax evasion, and said nothing about avoidance. I will submit for your consideration a prospectus sent out by Mr. Goldstein, presumably to prospective customers, explaining his plan and quoting sections of the Federal income tax law. On the first page of the prospectus is stated:

"Substantial tax advantages: Besides the very desirable benefits already detailed, the corporation pension trust brings with it tax exemptions."

At the end of this prospectus he said in large capital letters:

"We would be pleased to discuss this matter with your attorney or tax consultant. All information will be held in strict confidence."

According to the prospectus it was copyrighted in 1937 by Meyer M. Goldstein.

Inquiries from other sources would indicate that the plan is of great interest to many and that abuse of the pension provision is apt to become widespread. The many inquiries relating to pension trusts that are being received would indicate a recent widespread interest. I am advised there have been approximately 1,000 inquiries in the second New York division. Many inquiries have been made in Washington.

It is difficult to ascertain to what extent the propaganda referred to has been accepted by taxpayers and to what extent insurance companies or insurance agents have exploited the possibilities of avoidance of taxation through the instrumentality of pension trusts. However, it must be remembered that one form of investment for pension trust funds is insurance, and we believe that insurance companies and insurance agents will not be slow to publicize and sell by individual canvass a scheme which results in the purchase of substantial insurance, with insurance commissions to insurance agents.

I quote excerpts from an article by Mr. George T. Altman appearing on pages 324, 325, and 326 of The Tax Magazine, issue of June 1937. Mr. Altman is described as being an attorney-at-law, a certified public accountant and advisory editor of The Tax Magazine. Mr. Altman says:

"When the subject of pension trusts was first suggested to me I was only faintly aware of the vast amount of interest which the subject had developed in insurance circles. True, several men had previously approached me for information and advice in connection with it, but I dismissed the propositions submitted to me as a little too clever to be sound. Not that a plan may not be clever and still hold water. But ordinarily a plan is in the form rather than in the substance; it is a different method of accomplishing the same purpose. As a result, even though the method chosen accomplishes the purpose, if it is an unnatural, impractical, or round-about method, it is easy for a court to 'look through it', as they say, and determine what was done from the purpose itself."

After some remarks by Mr. Altman about a man visiting a lady friend a couple of doors from his home by walking around the block he goes on to say:

"Just how far insurance men have carried the pension trust idea I do not know. Inquiries I have made in various parts of the country during the last 2 weeks convince me that the idea has stirred up more heat and dust than closed deals. The idea in its most appealing form is somewhat as follows: Let the corporation establish a pension trust for its key men. The corporation assumed is a closed corporation and its officers and stockholders are assumed to be its key men. If the trust is within the pension trust provisions of the Federal Income Tax Act, then under section 23 (p) the payments into the trust in a reasonable amount are deductible, including the payments made to cover the pension liability accruing during the year and also prorated over a 10-year period, the payments necessary to cover the pension liability in respect of services rendered in prior years. Under section 165 the trust is not subject to tax and the employees themselves are not subject to tax except on the amounts actually distributed or made available to them.

"From the insurance angle, the trust funds may be converted into annuity contracts. The regulations covering pension trusts, article 23 (p)-1, now recognize this. They state what special information must be furnished by the taxpayer where the pension plan is underwritten by an insurance company. It may be also, if the trust is irrevocable, that a limited insurance feature may be included for the protection of the employees' dependents. This thought is based on article 23 (a)-9 of the regulations rather than on the pension trust provisions of the act. The proceeds of such insurance would be nontaxable under the life insurance provisions of the act. To what extent the amounts received under the annuity contracts would be subject to tax is not altogether clear. The annuity provisions of the act under which only 3 percent of the consideration paid is

taxable until such consideration is recovered, would probably not be applicable because of the clause excluding the effect of the annuity provisions where the contracts are transferred for a valuable consideration. Even so, as a result of the spread over a period of years the amounts received fall in lower brackets, so that the tax may be small if not eliminated altogether.

"The effect thus is deductibility to the corporation of the payments into the trust and at the same time nontaxability of these payments to the employees, except as they actually receive them. No wonder the idea of a pension trust for key men is appealing."

Mr. Altman also says: "Applying these principles to the pension trust situation, the question is first whether the beneficiaries of the pension trust could, if they so pleased, have the amounts contributed to the trust paid instead directly to themselves. If so, the further question arises, why the pension trust?"

I submit for the consideration of the committee the June 1937 issue of The Tax Magazine.

Our regulations provide "Devices of whatsoever nature for withdrawing profits or paying salaries to officers are not pension trusts within the meaning of the act." Article 23 (p), Regulation 94. We have also in these regulations, as compared with the equivalent article in Regulations 86, requirement that taxpayers claiming the benefits of the pension deduction present elaborate detailed data under nine headings in order that the Bureau may be fully advised as to the exact nature of any given plan. We do not believe this is sufficient. Any taxpayer with the intentions I have just described will not admit that the plan is for such purpose and then we are headed for controversies and litigation which seriously interfere with enforcement and clog the Board and courts.

It will require very careful study to correct the pension provision of the revenue act in such a way as to prevent abuse by the guilty without doing injury to the innocent. One of the phrases in the act deserving of special study is the expression "some or all" in section 165. Literally this language would permit the benefits of section 165, consisting of postponement and reduction of tax, in cases in which only a few top employees were participants in a plan. Some substitute phrase would seem desirable making it clear that a plan must be for the benefit of a reasonable number of employees.

It will also be noted that section 23 (p) refers merely to pensions, whereas section 165 refers to trusts created by an employer "as part of a stock bonus, pension, or profit-sharing plan". It would seem that some study should be given to a more exact correlation of these two sections.

We seek earnest consideration of the committee also of the question whether some maximum restriction should be placed in the statute as to the amount of a pension which may be deducted under section 23 and treated as exempt under section 165.

It may be that the committee will consider it advisable also to state more definitely the number or percentage of employees which are necessary to make a plan reasonable, though such a provision may perhaps unduly restrict the discretion of the Commissioner in the administration of the law.

We further seek consideration of the committee as to statutory provisions to prevent the recapture of contributions to pension trusts tax free during a year of loss.

(The articles and statements referred to and submitted by Deputy Commissioner Russell, are as follows:)

"CORPORATE PENSION TRUSTS—A TIMELY SUBJECT OF MAJOR IMPORTANCE TO EVERY CORPORATION EXECUTIVE

"(By Meyer M. Goldstein, C. L. U., Corporate Pension Trusts, 347 Madison Avenue, New York)

"THE IMPORTANCE AND NECESSITY FOR CORPORATE PENSION TRUSTS

"It is obvious to every thinking corporation executive that the Social Security Act does not provide genuine security for the executive with a substantial salary. The corporate pension trust begins where the Social Security Act leaves off, assuring the executive in the higher wage bracket that in later years he will have a definite and substantial life income which will enable him to maintain a standard of living in keeping with that to which he has been accustomed.

"From every viewpoint, it is sound business policy to create such a corporate pension trust which will establish the position of executives more firmly with the organization, assure highest loyalty and endeavor, and provide for easy retirement when the age of decreasing utility has been reached. Officers are, of course, included as direct beneficiaries of the corporate pension trust.

"Furthermore, it is most important to realize that the corporation, by offering a better substitute of its own, in the form of a corporate pension trust, provides the soundest and most substantial argument against further extension and encroachment of government social security activities in business.

"SUBSTANTIAL TAX ADVANTAGES

"Besides the very desirable benefits already detailed, the corporate pension trust brings with it tax exemptions, which are specifically covered by section 165 of the Revenue Act of 1936, which reads as follows:

" 'SEC. 165. Employees' Trusts: A trust created by an employer as a part of a stock bonus, pension, or profit-sharing plan for the exclusive benefit of some or all of his employees, to which contributions are made by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, shall not be taxable under section 161, but the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him. Such distributees shall for the purpose of the normal tax be allowed as credits against net income such part of the amount so distributed or made available as represents the items of interest specified in section 25 (a).' (Sec. 25 (a) exempts interest on United States obligations; sec. 161 provides for imposition of tax on the income of ordinary trusts; thus trusts under sec. 165 are exempt from the taxation that would be imposed on the income of a private trust.)

"An analysis of section 165 reveals the following points:

"1. In order to create the necessary trust, a written document must be drawn, detailing in full all its provisions and enumerting the beneficiaries. A trustee must be appointed. The fact that the funds of the trust must be kept separate and that other important provisions must be worked out in accurate detail, make it imperative that competent counsel should prepare the plan.

"2. The operation of the plan may be fixed according to choice, so that the contributions to the pension trust will be made either by the corporation alone or the employees alone, or by both.

"3. Participating employees make no income-tax payments on moneys received through contributions of the corporation into the corporate pension trust until the employee retires.

"The corporation's contributions to the pension trust are definitely a deductible expense, and are not taxed. This consideration is fully covered by section 23 (p) of the Revenue Act of 1936, as follows:

" 'SEC. 23 (p). Pension Trusts: An employer establishing or maintaining a pension trust to provide for the payment of reasonable pensions to his employees (if such trust is exempt from tax under section 165, relating to trusts created for the exclusive benefit of employees) shall be allowed as a deduction (in addition to the contributions to such trust during the taxable year to cover the pension liability accruing during the year, allowed as a deduction under subsection (a) of this section) a reasonable amount transferred or paid into such trust during the taxable year in excess of such contributions, but only if such amount (1) has not theretofore been allowable as a deduction, and (2) is apportioned in equal parts over a period of 10 consecutive years beginning with the year in which the transfer or payment is made. Any deduction allowable under section 23 (q) of the Revenue Act of 1928 or the Revenue Act of 1932 or the Revenue Act of 1934 which under such section was apportioned to any taxable year beginning after December 31, 1935, shall be allowed as a deduction in the years to which so apportioned to the extent allowable under such section if it had remained in force with respect to such year.'

"The special importance of section 23 (p) is this: Although annual payments by the corporation for future pensions to employees would be a deductible expense, note also that this section provides that the corporation may anticipate future pension liability for past services if these payments to cover future liability for past services have not previously been allowed as a deduction, and if they are apportioned in equal parts over a period of 10 consecutive years.

"ANY PENSION PLAN MUST BE ACTUARIALLY SOUND

"It becomes obvious, since Treasury regulations specifically provide that any pension plan must be actuarially sound, that such a plan can best be undertaken by a corporation in cooperation with a life-insurance company. Such cooperation provides additional advantages of immediate payment to heirs of the pensioner, facilitates investment problems, and simplifies payments to all those participating in the plan. Deposits cannot be touched by either the company or the pensioner, nor can funds be attached because of financial difficulties of the corporation.

EACH CORPORATION PROVIDES AN INDIVIDUAL PROBLEM

"For the most economical arrangement, and for the utmost benefits to both the corporation and participating executives, it is necessary to analyze the specific problems and fit a plan to the individual organization which it will serve.

"Your inquiry is invited for discussion and elaboration of the considerable benefits of corporate pension trusts, which cannot be detailed in this limited space. Our experience in providing smoothly functioning plans for many different types of corporations is assurance of our ability to furnish you with the most efficient, most effective plan for your particular needs.

"We would be pleased to discuss this matter in detail with your attorney or tax consultant. All information will be held in strict confidence."

[Reprinted from the The National Underwriter, issue of April 23, 1937]

"PENSION TRUSTS ARE TERMED RICHEST FIELD YET UNTAPPED

"NEW YORK, April 22.—Pension trusts present an enormous opportunity to life-insurance men and open up a field that is certainly as big as anything that has gone before, M. M. Goldstein, assistant manager, Clifford L. McMillen agency, Northwestern Mutual Life, New York City, told New York City Chartered Life Underwriters and their guests at the April meeting. While the pension idea has been getting the most intensive attention in the last few years, it has been going very fast during the last decade, Mr. Goldstein said.

"'In my opinion, this represents the largest single untapped field for service and sales in our business today', he declared.

"MANY MAKERS OF FAMED PRODUCTS HAVE SUCH PLANS

"To show graphically the spread of the pension idea among prominent employers, Mr. Goldstein took a hypothetical busy business executive through the first few hours of an ordinary day. This man uses Proctor & Gamble Ivory soap for his bath, Mennen's shaving cream, weighs himself on a Fairbanks scale, at breakfast drinks orange juice made from California Fruit Growers Association oranges, consumes Shredded Wheat and Beechnut bacon and coffee, the latter being sweetened with American Sugar Refining Co. sugar. His breakfast is cooked with gas provided by the Consolidated Gas Co., and his toast is made with electricity from the New York Edison Co. After a look at his Elgin watch, this man gets into his automobile, say, a General Motors or Studebaker car, and is off to the city, where many more of the articles or services he comes in contact with are from firms which have pension plans, as have those listed.

"Most executives, Mr. Goldstein pointed out, when they have surplus funds to invest, put them in the stock or bonds of some prominent concern which in almost every case has a pension plan. For example, the pension expense of the Bell Telephone System in 1936 amounted to 2.75 percent of its pay roll and about 7.0 percent of its profits. If these concerns are good enough for the executive to invest his surplus funds in, why is not the pension idea a good thing for the concern in which the executive or the proprietor invests the bulk of his time and money? Mr. Goldstein asked.

"LACK OF PLAN IS MERELY BUILDING FUTURE TROUBLE

"Since all employees and executives must eventually become too old to work, Mr. Goldstein said that the concern which fails to have a pension plan is merely postponing the inevitable and exaggerating today's profits at the expense of tomorrow's stockholders by failing to set up a sinking fund for something which has to happen. If an accountant failed to set up a reserve for depreciation of machinery, for example, he would be properly subject to criticism for exaggerating current profits, Mr. Goldstein said, and the same thing applies to human obsolescence.

"Federal social security, he said, has not defeated private pension plans but has simply accelerated interest in the subject. The Federal act, he said, will never do more than provide a small income for the great band of employees. The better-paid and more valuable men must be taken care of by private plans.

"TIME CAN BE CONSERVED BY JOINT CONFERENCES

"In setting up a pension plan, he strongly advised joint conferences of the employer, his attorney, his tax consultant, along with the representative of the trust company if there is to be a corporate trustee. The life-insurance agent

would, of course, be a party to the conferences. Mr. Goldstein said that a great deal of time is wasted if individual conferences are held rather than joint meetings.

"As some of the fundamental reasons why there has been so much widespread interest in the subject of pension trusts, Mr. Goldstein listed the world panic, out of which we have just come, which he termed the worst, statistically, in the history of our civilization, and the consequent yearning for individual security; the Federal Social Security Act which has taken that yearning and put it into concrete form; the desire for tax saving, the spreading of the tax consciousness of the American people, and the greater realization that the pension-trust plan is adaptable to small- and medium-sized concerns as well as large ones.

"CONCERN MUST BE STABLE ENOUGH TO COMPLETE PLAN

"The first essential in the type of employer to be approached for a pension plan is that the concern shall be permanent enough to have a reasonable chance of completing the plan. There are many types of business, Mr. Goldstein pointed out, which obviously won't be in the business even until the boss is 65, to say nothing of the younger employees. Also, the firm which needs money for working capital must meet this need first and is not in a position to set up a pension trust, even through it might appreciate the savings from doing so. There must be a surplus available for this deferred method of compensation, since if the compensation is more needed by employees for necessities of life today, there will be little chance to set up a pension-trust plan.

"Answering in advance possible questions of his audience, Mr. Goldstein said that more important than the trust agreement itself is to find out what the employer is trying to do to provide pensions. The pension-trust plan can be used for advancing the interest of the corporation but must not be used as an attempt at tax evasion, or it will endanger the savings that the corporation hopes to effect. He said that with the motto 'let your conscience be your guide', most pension plans would get along all right.

"NOT NECESSARY FOR PLAN TO BE MADE IRREVOCABLE

"The trust plan need not be irrevocable; and even though a plan is established and then later canceled, the corporation and the employee are entitled to the same benefits while the plan is in operation that they otherwise would be.

"The pension-trust plan need not include all employees, since the plan is established by the employer, who is primarily interested in the plan for the benefit that it will be to his business, Mr. Goldstein said. How far down the line the plan should extend is something which should be left up to the employer, he advised.

"SAVING IN TAXES PERMITS PAYING IN 64-CENT DOLLARS

"As to the tax angle, the speaker said that when normal Federal corporation income tax, the New York franchise tax, and the Federal undistributed-profit tax are taken into account, it works out that the employer is using 64-cent dollars when he contributes to a pension trust, rather than adding it to surplus. In other words, for each $1 that goes into a pension-trust fund, the actual cost to the employer is only 64 cents. Mr. Goldstein warned, however, that the tax advantages must be translated into terms of the employer's interest and pocketbook.

"Demonstrating the saving that accrues to an executive having, for example, a total income of $100,000 a year, which would be subject to an income tax of about 70 percent, Mr. Goldstein showed how $10,000 paid to him as present salary would amount to a tax-free income of only $3000. However, this same $10,000, if put into a pension-trust plan, would provide 3⅓ times greater capital or monthly income when the executive reached age 65. Assuming that the man in question were 55 at present, he, or his employer, would have put into the pension plan on his behalf $100,000, the value of which would be much greater in terms of income than would be the case if he had received it direct, paid income tax on it, and then purchased a life annuity or other form of investment for his old age.

"Commenting on the legality of the pension-trust idea, Mr. Goldstein said that the provision in the Federal revenue law which permits it has been in force since 1921 and that Congress has on nine different occasions reenacted the same law with only one change, and that change improves the position of the beneficiary of the pension trust.

"As to the possibility that pension-trust funds might be attached by creditors, Mr. Goldstein said that he believed New York's section 55a and similar statutes

in other States protecting life-insurance proceeds and cash values against claims of creditors of the insured would not apply to pension trusts; but he said he thought that section 55c, which protects annuitants by limiting attachments to garnishee proceedings and barring creditors from taking the entire sum, might be invoked. He pointed out that the employee's contribution to the pension trust can be reached by his creditors, but, of course, the employer's part cannot be. On the other hand, creditors of the corporation cannot make any claim on the portion contributed either by the employer or the employee, since the employer divests himself entirely of ownership of the funds in turning them over to the pension trust."

[Reprinted from the Eastern Underwriter of Apr. 23, 1937]

"TALK ON PENSION TRUST PACKS CHARTERED LIFE UNDERWRITERS MEETING—MEYER GOLDSTEIN IS SPEAKER—NEW YORK CHAPTER PLAYS HOST TO MANY IN ALLIED FIELDS WHO ARE FOLLOWING SUBJECT

"The Chartered Life Underwriters of New York City last Thursday held a meeting which surpassed even the recent anniversary banquet. It wasn't as serious an affair, nor as dignified, but the subject of pension trusts was one that swelled the attendance to approximately 200, making it one of the largest luncheon meetings the New York chapter has ever held. Besides members of the chapter those present included several attorneys, accountants, and tax specialists, trust-company representatives, actuaries, some prospects, and one representative from the Internal Revenue Department.

"The speaker was Meyer M. Goldstein of the McMillen agency, Northwestern Mutual Life, New York City. Mr. Goldstein has made an intensive study of stock bonus, profit-sharing and pension-trust plans. He assisted in setting up the Northwestern Mutual pension plan and recently he has completed a book entitled 'Stock Bonus, Profit Sharing, and Pension Trusts', which is still in the hands of the printer.

"After Mr. Goldstein's general remarks about the background of pension-trust plants, their current use by industry and business and the economic advantages of such a plan, he answered a score of questions about the technical aspects of the plan, tax-exemption angles, etc. Leroy N. Whitelaw, Prudential, president of the New York chapter, presented the questions. What Mr. Goldstein said in part was this:

"IMPROVING EMPLOYEE'S ECONOMIC STATUS

"Pension-trust or profit-sharing plans are set up because they help make profits for the employers aside from any human or social aspects. They form a part of the industrial-relations picture today and to fit into it properly we must get the employer's point of view as to what has gone before and what is to come. The plan is not limited to any one certain type of employer but it is limited to those who expect to stay in business. We fit into the picture at the problem of improving the employee's economic status.

"In the growth of employer-employee relationship activity as large a growth as any in the past 10 years has been in connection with pension plans. Industries whose products we are using every day have had pension plans in operation for years. The plan of American Telephone & Telegraph, in operation 24 years, paid out $5,600,000 in 1936. There are 7,765 retired on the pension rolls of that company. In the Bell telephone systems 11 percent of profits went into this type of pension plan last year, providing for retirement, disability, and sick benefits.

"When a company doesn't have a pension plan, it is postponing the inevitable. Employees must grow old and if a company does not provide for that they are exaggerating this year's profits at the expense of tomorrow's stockholders. If an accountant did not set up a sinking fund for other types of depreciation, the stockholders would point out the exaggerating of profits. A sinking fund must be established for the inevitable—namely, old age, death benefits, sickness, and disability.

"STEPS NECESSARY IN ESTABLISHING PLAN

"The pension plan does not compete with but supplements the Social Security Act. The two together keep the employee at a standard of living to which he has been accustomed.

"Steps necessary in establishing a plan are these: Through a questionnaire get the facts about the employer and his business. Have the actuarial department draw up a schedule of rates. Determine what amounts must be set up to meet the objectives and whether or not it will be a contributory plan. Arrange a

joint conference with the employer, attorney, tax consultant, underwriter, and corporate trustee being sure that you have the point of view of each of these experts. Have the attorney draw a draft of the plan and also a trust agreement, cooperating with the trust councilor.

"The board of directors of the company then authorizes the plan, the trustee is appointed, the funds are deposited with the trustee and then if life insurance is a part of the plan, annuities and life insurance policies are drawn on the lives of the pensioners and the plan is put into operation."

[From the National Underwriter, Chicago, Cincinnati, New York, and San Francisco, Friday, Jan. 15, 1937]

"PENSION TRUSTS ARE FEATURE OF UNDERWRITING 'CLINIC'

"NEW YORK, January 14.—Pension trusts got the spotlight at the advanced underwriting clinic which closed the Northwestern Mutual Life's regional convention. The clinic was conducted by M. M. Goldstein, assistant manager, Clifford L. McMillen agency, New York City. Mr. Goldstein, having just completed a large pension trust case which necessitated his going to Washington to obtain at first hand the Treasury Department's attitude toward pension trusts, was able to give his audience a very definite idea of what can and cannot be done in this line under the present revenue act. He made it clear that one could not make a plan from benefits in direct proportion to stockholdings or which would tend to be a subterfuge for the evading of income tax.

"However, he also indicated that the various angles that can be used providing they come within the provisions of the law and regulations as to reasonableness, actuarial soundness, and a specific trust aside from the assets of the corporation—in other words, a true trust reserve in which the corporation divests itself completely of the assets.

"DETAILS NECESSARY STEPS IN COMPLETING THE SET-UP

"Describing the various steps necessary to the completion of the entire operation, Mr. Goldstein presented a questionnaire in which he obtained the basic facts from the client. This was followed up by a proposal in which he made the recommendation to the client as to the amount of special retirement security contract with insurance necessary to carry out the desires of the client. There followed a conference between the attorneys, the client, and the agent. The attorney drew the agreement, it was checked by the attorney's trust company, and a trip to Washington was made to get Federal approval.

"This having been accomplished it was approved by the board of directors of the company, ratified, the manager of the corporation was appointed as manager, a corporate trustee was designated, the corporation paid its check to the trustee, the applications were signed, the examinations for the insurance were arranged, the policies were deposited with the trustee, and the premiums were paid by the trustee to the insurance company, the policies and rights remained with the trustee, and the entire transaction was completed.

"SAYS CONFINING IT TO KEYMEN ONLY IS NOT BARRED

"'A plan which includes the key employees of the company is acceptable under the law providing it is not confined exclusively to stockholders and exclusively to officers,' said Mr. Goldstein, 'although there is nothing in the present law which says that such a plan is not acceptable even though it is confined exclusively to stockholders and officers. At the same time, it does make the plan safer, not only from the standpoint of the law but makes a more genuine pension trust for the junior people who are coming along in the organization and will some day be the executives who should likewise be included in the pension plan.

"'After all there are some very important attributes to the pension plan which have nothing to do with the saving of income taxes and no client should buy these plans who is interested solely and exclusively in the income-tax benefits. They should be buying a pension plan, they should believe in a pension plan, they should want a pension plan. Savings of income tax should simply be an incident, not the main inducement, which forces him to go into it perhaps a little more quickly, just the same as if one is making charitable gifts today one should have the basic desire to give to charity and then be influenced to make those gifts perhaps a little more quickly or a little larger because the Government comes along and says, "Here, if you decide to make a charitable bequest, if you are making $50,000 a year, I will contribute no less than 37 percent of the cost of those charities at that top bracket which is within 15 percent of your earned income."'"

"GOVERNMENT WILLING TO ENCOURAGE SOCIAL ENDS

"The Government, in other words, for a socially desirable measure is making an inducement. So it is with pension trusts and Government insurance; the Government is perfectly willing to encourage any socially desirable moves providing the basic concept of the whole plan is primarily a pension trust.

"The test question to ask the client is: 'Would you buy the pension trust without the tax saving? If you wouldn't, don't buy it.' Apply that test, then, to see whether they really have in mind a wish to go through with this and make it a pension trust; and if so, then they take the tax savings along as an inducement, but they don't base their whole concept on it merely and exclusively and entirely on the tax saving.

"The basic sincerity of the plan needs to be considered, and it should be basically and fundamentally a pension trust. If this material is placed in the hands of an expert, many a case can be saved, because it can show the client the other advantages aside from the savings of income taxes and pension trusts, can be created. The mistake the average underwriter is making today is that he is going out and talking taxes, taxes, taxes, as if that was the only thing in connection with the pension trusts.

"A word of caution should be given to the underwriters; every underwriter in the country seems to think that he is an expert on pension trusts just because he writes them or somebody has told him something about it. As a matter of fact, going out the way the average underwriter does, in ignorance, he is repeating the same error that agents do who have been passing out loose information on the combination subject of insurance and taxes, whether they be estate taxes, business insurance, or now, pension trusts.

"MUST USE GREAT CAUTION IN MAKING PRESENTATIONS

"These subjects must be presented very carefully. The place of the attorney and tax expert must be made clear and definite. We are not tax experts. We are insurance underwriters, and we should leave the decision and the discussions as they pertain to taxes to the proper experts in those fields. Most of the difficulty that appears in this subject is because the insurance underwriters are inclined to be tax experts."

"In the part of the clinic dealing with programming and auditing, Mr. Goldstein was assisted by R. U. Redpath, Jr."

"MEYER M. GOLDSTEIN,
"*Chartered Life Underwriters,*
"*347 Madison Avenue, New York, N. Y.:*

"Please send me, without obligation, your booklet on Private Pension Trust to Supplement the Social Security Act.

"Name ....
"Address .... City .... State."

[Reprint from the New York Journal, New York, Jan. 15, 1937]

"WHAT PRICE SEMIACTIVE EXECUTIVES? WALL STREET ASKS

"By Leslie Gould, financial editor

"The salaries of one of the leading financial institutions of the country have just been published and have stirred up an interesting controversy on the matter of a scale of pay for active, semiactive, and inactive executives.

"This particular institution has four men on the executive pay roll receiving around $70,000 or more a year, but only one of these men is really an active officer, and his salary is no. 2 from the bottom.

"The active, recognized head is the president. He is an able, aggressive fellow, who is doing a bang-up job. He is one of the group of young men who have come up in Wall Street in recent years. His salary is a little over $75,000 a year. * * *

"There is a vice chairman, who receives just a little under $70,000 a year; a board chairman, who draws down a little more than $90,000; and the chairman of another board, who also receives a little more than $90,000.

"These last three are men who are getting along in years. They are no longer active workers, although they are still drawing down the salaries of full-time working executives.

"All three have given long years of valuable service, and one, in particular, can claim most of the credit for making it the great institution that it is today. * * *

"In the good old days of 1929, no thought probably would have been given to the matter—if the able president were receiving at least as much as the two semiactive chairmen. But times have changed, and there is a new attitude on the matter of salaries, pensions, etc.

"Today a man at 65 is supposed to retire—not on his peak salary, but a percentage of that. This has been recognized by such corporations as United States Steel, which has adopted options—the choice is the company's—retirement at 65 and forced exit at 70. * * *

"So the salary schedule of this financial institution has started Wall Street tongues wagging. The salaries of the semiactive executives total nearly a quarter of a million dollars a year. That is gratitude in capital letters, and maybe it is deserved."

"The only sound answer to the above problem is to have an adequate private pension trust to take care of retiring officers. The corporation must either set up a sinking fund in advance to provide for the future retirement of its executives or it must find itself later in the unfortunate position of either carrying superannuated employees on the pay roll or else being heartless to the men who have helped build the business.

"Vanderbilt 3-5500
"Murray Hill 2-1531

"MEYER M. GOLDSTEIN,
"*Chartered Life Underwriters,*
"*347 Madison Avenue, New York, N. Y.:*

"Please send me, without obligation, your booklet on Private Pension Trust to Supplement the Social Security Act.

"Name ....
"Address .... City .... State ...."

"PENSION TRUSTS FOR KEYMEN [1]

"By George T. Altman [2]

"When the subject of pension trusts was first suggested to me I was only faintly aware of the vast amount of interest which the subject had developed in insurance circles. True, several men had previously approached me for information and advice in connection with it, but I dismissed the propositions submitted to me as a little too clever to be sound. Not that a plan may not be clever and still hold water, but ordinarily a plan is in the form rather than in the substance; it is a different method of accomplishing the same purpose. As a result, even though the method chosen accomplishes the purpose, if it is an unnatural, impractical, or roundabout method, it is easy for a court to 'look through it', as they say, and determine what was done from the purpose itself.

"EVASION MASQUERADED BY CIRCUITOUS PROCEDURE

"Suppose, for example, that a man is desirous of visiting a lady friend just a couple of doors east of his home. He tells his wife that he is going out for a stroll westward around the block and will stop in and see his friend Joe around the corner. Now his wife knows that he has no penchant for strolling, and that he and Joe are not unusually good friends. She may not know about the lady friend a couple of doors east, but she can certainly smell a rat. She watches, and lo and behold, the devious performance westward around the block is just a roundabout way of reaching the lady only a couple of doors east.

"That is what I mean by plans being too clever. Looking through form to substance, the stroll westward is interpreted as a walk a couple of doors eastward. It is just such a thing that happened in the *Gregory case* [3] decided by the Supreme Court about 2 years ago. It was desired to make distribution of certain securities as a dividend. In order to masquerade the distribution as a reorganization a second corporation was created, and the securities to be distributed were run through the second corporation to the stockholders by steps precisely within the terms of the statutory provision covering reorganizations. As soon as the distri-

[1] Address delivered before a meeting of the Los Angeles Chapter of Chartered Life Underwriters, May 5, 1937.
[2] Attorney at law; certified public accountant; author of Introduction to Federal Taxation; advisory editor of the Tax Magazine.
[3] 293 U. S. 465.

bution was completed the second corporation was dissolved. The procedure was unnatural and the Court was quick to discover the purpose and to boil the procedure down to what was really accomplished. Although the taxpayer made all the moves necessary to a reorganization under the statute, the Court discarded the moves not essential nor germane to the purpose and thereby carved out of the circuitous procedure the transaction that had actually taken place.

"PENSION TRUST DEFINED

"You can understand now what I meant when I said that I had dismissed certain pension trust plans submitted for my opinion as being too clever to be sound. Of course, there is such a thing as a pension trust. The term 'pension' however, is in common use. There is nothing technical nor mysterious about it. Its definition may not be entirely simple; but there are certain things which are clearly not pensions. A distribution of dividends is not pensions. Compensation to officers for services currently rendered is not pensions. As a result, if either of these things is accomplished by the devious procedure of a pension trust, whether or not insurance contracts are involved a court will look through the pension trust form and see what actually took place. You have perhaps observed that the Federal income tax regulations were amended to warn the taxpayer of this very thing. I refer to article 23 (p)–1 of Regulations 94, in which it is provided that 'Devices of whatever nature for withdrawing profits or paying salaries to officers are not pension trusts within the meaning of the act.'

"DEDUCTIONS AND EXEMPTIONS ALLOWED

"Just how far insurance men have carried the pension trust idea I do not know. Inquiries I have made in various parts of the country during the last 2 weeks convince me that the idea has stirred up more heat and dust than closed deals. The idea in its most appealing form is somewhat as follows: Let the corporation establish a pension trust for its key men. The corporation assumed is a closed corporation and its officers and stockholders are assumed to be its key men. If the trust is within the pension trust provisions of the Federal Income Tax Act, then under section 23 (p) the payments into the trust in a reasonable amount are deductible, including the payments made to cover the pension liability accruing during the year and also, prorated over a 10-year period, the payments necessary to cover the pension liability in respect of services rendered in prior years. Under section 165 the trust is not subject to tax and the employees themselves are not subject to tax except on the amounts actually distributed or made available to them.

"ANNUITY CONTRACTS

"From the insurance angle, the trust funds may be converted into annuity contracts. The regulations covering pension trusts, article 23(p)–1, now recognize this. They state what special information must be furnished by the taxpayer where the pension plan is underwritten by an insurance company. It may be also, if the trust is irrevocable, that a limited insurance feature may be included for the protection of the employees' dependents. This thought is based on article 23(a)–9 of the regulations rather than on the pension trust provisions of the act. The proceeds of such insurance would be nontaxable under the life-insurance provisions of the act. To what extent the amounts received under the annuity contracts would be subject to tax is not altogether clear. The annuity provisions of the act under which only 3 percent of the consideration paid is taxable until such consideration is recovered, would probably not be applicable because of the clause excluding the effect of the annuity provisions where the contracts are transferred for a valuable consideration. Even so, as a result of the spread over a period of years the amounts received fall in lower brackets, so that the tax may be small if not eliminated altogether.

"PAYMENTS TO KEY MEN

"The effect thus is deductibility to the corporation of the payments into the trust and at the same time nontaxability of these payments to the employees, except as they actually receive them. No wonder the idea of a pension trust for key men is appealing. The question is whether the particular trust comes within the pension trust provisions of the act and whether the pensions are reasonable. On the latter score there is no definite rule. Perhaps a guide can be determined from the ratios of pensions to current compensation under the various pension plans in force in industry. It would seem that any ratio not too far out of line

would be sustained. But the question whether or not the pension trust is within the provisions of the act is not to be so quickly resolved. It is not necessary that all the employees be covered by the plan, for the act itself says 'some or all of his employees.' Of course, it should be possible to explain why only certain of the employees are covered. The regulations now require that such explanation be submitted with the return. But it does not seem unreasonable that a corporation should protect only its key men. Holding them may be vital to the organization; turnover among the rest of the force may not be so serious. However, calling the men 'key men' and making the payments to them through a trust in the form of pensions does not of itself make the payments pensions. If the men who are to receive the pensions are themselves in control of the corporation, so that they could, as the pleased, pay the sums into the trust or directly to themselves as additional salaries or dividends, then the pension characteristic disappears and the principle of constructive receipt comes forward to make the payments into the trust, at the time paid in, income to the beneficiaries. As far as the corporation is concerned, if the payments represent only reasonable additional compensation, they may be deductible as such; if not, they may be treated as dividends. In any case, the pension trust angle is out and the principle of constructive receipt is in. In fact, it is the applicability of the principle of constructive receipt which changes the color of the situation; for if that principle is applicable the amounts paid into the trust are in effect paid in by the beneficiaries, not by the corporation.

"AVAILABILITY AS BASIS OF CONSTRUCTIVE RECEIPT

"Here we come to the essence of the question. Constructive receipt is based upon availability to the taxpayer. It has nothing to do with technicalities. If income is certainly and unconditionally available, but is not received because receipt is neglected to avoided, it is treated as constructively received. The same is true where the amount is paid to another at the order or instance of the person to whom it is so available. Thus if a commission is due you and you order it paid to a creditor of yours, payment to the creditor is constructive payment to, and receipt by, you. Mere payment of income into a trust for your ultimate benefit is not enough to constitute the amount income to you at the time paid into the trust. The amount must have been available to you at that time and paid into the trust on your direction or by your consent. The necessity of unqualified availability to the taxpayer was shown in the Supreme Court's decision in the *Avery*[4] *case;* and also in the very recent decision of the Supreme Court in the *Tex-Penn Oil*[5] *case.* In the *Avery case* a dividend check mailed out on December 31 of one year and received by the taxpayer on January 2 of the next year was held to be income in the latter year, not in the former, where the dividend check was not actually available to the taxpayer had he called for it on the 31st. In the *Tex-Penn Oil case* the taxpayer received securities in a transaction, but due to a restriction on his disposition of them, and to their highly speculative character, was unable to realize on them. Although in his hands, they were in fact not available to him. But if an amount is unqualifiedly subject to the taxpayer's demand, avoidance of actual receipt or payment to another at his direction cannot prevent the amount being income to him.

"PRIMARY PURPOSE OF PENSION TRUSTS

"Applying these principles to the pension trust situation, the question is first whether the beneficiaries of the pension trust could, if they so pleased, have the amounts contributed to the trust paid instead directly to themselves. If so, the further question arises, why the pension trust? The primary purpose of a pension trust is to provide pensions, not to save taxes. The officers and stockholders may be key men, but they may not be the only key men. Again, the pension interests of the beneficiaries may bear a close relation to stock holdings. These and other factors may show that the pension trust is only a devious scheme for paying additional salaries or dividends in the guise of payments into a pension trust. In this view it is possible to treat the payments by the corporation as payments available directly to the beneficiaries but paid to the trust at their direction. The principle of constructive receipt is then applicable to make the payments into the trust income at that time to the beneficiaries. While the conclusion may not be drawn that every pension trust of the officer-and-stockholder variety will not hold water as a tax saver, every one of them will surely be scrutinized and certainly only a few will be sustained.

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[4] 292 U. S. 210.
[5] 374 CCH q 9194.

"There is, nevertheless, a broad field left for the use of pension trusts limited to key men. As I have already stated, there is nothing in the statute denying the pension trust privileges in the case of pension trusts covering key men only. Here, particularly in the motion-picture industry, there would seem to be a fertile field for such trusts. The average screen actor or actress is valuable for only a short period, after which his income from pictures may drop sharply or disappear altogether. If he has not saved a large part of his screen income the precipitous drop from luxury can really mean distress. It would seem that the pension principle is particularly applicable there; and certainly there is no better method of providing and guaranteeing these pensions than conversion of the funds of the pension trust into annuity contracts.

"THE 'BAD BOY' CONTRACT

"The idea, however, must be sold not so much to the employee as to the employer. Even from an income-tax angle it may not make much of a difference to the employer. He can retain control of the employee by means of the so-called 'bad boy' contract, similar to the usual stock-bonus agreement. Under such a contract a part of the salary is paid into an irrevocable trust and the funds thus accumulated are turned over to the employee on the statement of the employer that the employee has properly completed his contract. The payments by the employer into the trust are currently deductible on the employer's tax return under the principle of the *Oxford Institute case* decided by the Board of Tax Appeals [6] and the *Texas Pipe Line case* in which a decision of the Board was affirmed by the United States Circuit Court of Appeals for the Third Circuit.[7] The principle in those cases is that, the trust being irrevocable, the payments into the trust cannot be recovered by the employer except as the result of circumstances entirely within the control of the employee. But what is the effect as to income taxes as far as the employee is concerned? The entire accumulated fund becomes taxable to him in the year in which he receives it. This was shown in the *Adolph Zukor case* decided by the Board of Tax Appeals,[8] whether the position of the Government or of the taxpayer in that case was correct. The Government's position in that case was that the accumulated fund should be taxable to the employee in the year in which, under the terms of the trust agreement, the fund was required to be turned over to him, while the taxpayer's position was that the amount was not taxable to him until actually turned over to him. There was a gap of only 6 days between the two dates, but it so happened that one of them was December 31 of one year, and the other January 6 of the next. Under either position taken in that case the whole fund was taxable in 1 year. The effect of such a contract is thus to throw the income of several years onto 1 year's return. If the amount is large, considering both the Federal and California rates the contract might as well name the tax collector as beneficiary of the trust instead of the employee who spends several years working for it.

"CONCLUSION

"The advantage of a pension trust to an employee in such a situation is obvious. It not only defers taxability but spreads the income out in a lower tax bracket. However, if the entire fund is available to the employee at the conclusion of his employment but is thus spread out in the form of pensions on the employee's direction, then on the principle of constructive receipt the entire fund will be taxable to him at the time it becomes available to him but its payment deferred on his direction. That the funds accumulated by the trust be paid out as pensions must therefore be required by the employer. That is the reason why I have said that the pension-trust idea must be sold to the employer.

"It seems possible that a strong argument can be presented to the employer for that purpose. It should be a matter of some concern to him that the dollars which he pays out are worth only 25 cents, ex-tax, when they can be made to be worth 75 or 90 cents. Viewing those dollars ex-tax may in fact enable the employer to save a part of them for himself. In any case selling the idea to the employer is the problem, and considering the use to which annuities can be put in a pension trust the task of solving that problem properly belongs to the insurance man."

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[6] 33 B. T. A. 1136.
[7] 87 Fed. (2d) 662.
[8] 33 B. T. A. 324.

Under Secretary MAGILL. I believe that that concludes, Mr. Chairman, the several matters which were mentioned in the Secretary's letter to the President on June 1.

You will recall that in the Secretary's letter he mentioned three other matters on which he thought that corrective legislation should be adopted. Those were nonresident alien taxation, community property, and percentage depletion. If it meets with your approval, Mr. Kent will present a brief discussion of the nonresident alien situation, indicating changes which we think might be made in that connection.

The CHAIRMAN. In that connection, Mr. Magill, those suggestions had no relation to tax avoidance or tax evasion, but merely suggested amendments of the law?

Under Secretary MAGILL. That is true.

The CHAIRMAN. I so understand.

Under Secretary MAGILL. That is, in each of these three cases, as I think the Secretary pointed out, there is no suggestion that the taxpayers have been taking advantage of the law. The law simply stands this way, and the question is whether or not the committee at this time may want to make some changes with respect to these matters. I have here a statement, and perhaps I should put this in before Mr. Kent proceeds. It is a statement with respect to community property, which I think might be simply inserted in the record, if you wish, to show what that situation is.

The CHAIRMAN. Is that your statement?

Under Secretary MAGILL. Yes, sir.

The CHAIRMAN. Without objection, that may be done.

Mr. TREADWAY. Mr. Chairman.

The CHAIRMAN. Mr. Treadway.

Mr. TREADWAY. In that connection, I desire to make a suggestion, since there has been so much interest in community property. We are getting a very large number of insertions in the record.

Under Secretary MAGILL. Would you like me to read this?

Mr. TREADWAY. The probability is a good many of these insertions will be neglected. I personally suggest that Mr. Magill read his statement on community property, if it is agreeable to the other members of the committee and to him.

The CHAIRMAN. Very well, if there is no objection.

Under Secretary MAGILL. It is a short statement, and if you wish me to read it, I shall be glad to do so.

Mr. CROWTHER. Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. It seems to me if the document is short that I, for one would like to hear it. I do not know about the rest of the committee, but if it is not a lengthy statement, I should like to hear something about these pension trusts. Is there not a short statement there describing what they are and the method used, and so forth?

Under Secretary MAGILL. Yes, sir.

Mr. CROWTHER. I think we ought to have that.

Under Secretary MAGILL. Mr. Russell's statement is somewhat longer, consisting of 13 pages.

Mr. CROWTHER. Let us hear the shorter of the two.

Mr. COOPER. Will the gentleman yield?

Mr. CROWTHER. Certainly.

Mr. COOPER. Mr. Magill, cannot you or Mr. Russell give us a succinct and brief statement pointing out the salient points on this pension trust matter? That is what you have in mind, is it not, Dr. Crowther?

Mr. CROWTHER. Yes.

Under Secretary MAGILL. I might present this, right there, and then if you want a fuller statement, of course, you can have it.

The pension trust provision, as I understand it, and I am certainly no expert on the subject of pension trusts, the pension trust provision was put in I believe back in 1921 originally, to encourage a sort of social security on the part of individual corporations for the benefit of their own employees, the thought being that an individual employer might want to set up such a trust for the benefit of the employees. Generally speaking the provisions have varied somewhat in their terms, but the present one I believe provides in substance this: That the employer receives a deduction for the amount of contributions made to the trust, the trust is I believe not taxable on its own accumulations, and then when the employee receives amounts from the trust he is taxable upon whatever he receives.

There was a good deal of discussion at one time in the legislative history, as to whether the provision should be only for irrevocable trusts—that is, whether or not there was a danger that an employer might set up one of these trusts and then revoke it, to the disadvantage of the revenues. As the provision stands now, there is no mention of revocable or irrevocable, so that I take it that a revocable trust might conceivably be within the provisions, and there might be some danger there.

The other question which we have had in our minds regarding the provision, and as I have said it is more doubt than a certainty, because there have been very few cases of the sort at all, it seems to be perfectly possible under the provisions as they stand for these trusts to be set up simply for the leading officers or the controlling stockholders of the corporation; that is, that it is not necessary that it should be set up for all of the employees or for any particular percentage of the employees; so that we have the possibility that a close corporation might make use of it to our disadvantage.

Mr. VINSON. Mr. Magill, would it not be better to say "As set up for those who own the corporation?"

Under Secretary MAGILL. That is right. So that in the case of the close corporation, you might set up one of these trusts for the benefit of the two or three men who own it and who would normally be its principal officers, providing for very large pensions, so that the scheme becomes in effect a method of saving on their behalf. That is, in this case they make or can make their personal investments in this way instead of in some other way.

Mr. VINSON. The point is that this money that these folks in the close corporation, who own the corporation, put aside into the pension trust is a deductible item under the existing law?

Under Secretary MAGILL. That is right.

Mr. VINSON. And, of course, if two or three who own the corporation create this trust they are merely taking money out of one pocket and putting it over into the other pocket, and avoiding taxes upon that amount, is not that what it amounts to?

Under Secretary MAGILL. Yes. The principal stockholders for whose benefit it is set up would not be currently taxable upon these

amounts put into the pension trust. They will be taxable if, as, and when they get the annuity, but, of course, the tax will be much less at that time than as if it were currently taxable, because of the graduated surtax.

Mr. VINSON. But if they were to buy an annuity with this money from a bona-fide company, of course, that amount would not be deductible? That is, if they would buy it individually, that amount would not be deductible?

Under Secretary MAGILL. That is right. That is, they would be taxable on their full salaries.

Mr. VINSON. Surely.

Under Secretary MAGILL. And they would get no deduction for the amount.

Mr. CROWTHER. Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. This money finally becames taxable when it becomes income?

Under Secretary MAGILL. When it is received by the individual beneficiary; yes.

Mr. VINSON. But if it is a revocable trust, then, of course, the trust can be dissipated or dissolved whenever it becomes opportune for these folks to do it?

Under Secretary MAGILL. Yes.

Mr. VINSON. Let us say they had a large loss in some particular year; would that be an opportune time for them to dissipate it, or to dissolve the trust?

Under Secretary MAGILL. That is our worry about it as it stands; that is, whether or not the committee may want to put in some provision at this time requiring that the trust shall be irrevocable, and possibly also requiring that it should be set up for such and such a percentage of the employees of the company, and not merely for a few of the top officials.

Mr. COOPER. The point is that as long as it is revocable it is within their control.

Under Secretary MAGILL. That is true.

Mr. COOPER. They may manipulate it to meet their needs, so far as paying taxes are concerned, just as in the case of all these other devices.

Under Secretary MAGILL. Yes. I think we have somewhat the same dangers that you had in the case of the revocable trust created by an individual grantor, that he can manipulate it to suit himself; and you have already provided that the individual grantor shall be taxable on the full income. Now, perhaps you should provide here that the trust must be irrevocable if these deductions are to be allowed.

Mr. VINSON. Of course, there is no thought in your mind or in the mind of the Treasury that the suggestions made would hamper a bona-fide private pension plan?

Under Secretary MAGILL. Oh, no. Obviously we would not want to hamper such a thing, and we advance these suggestions really along the lines of some of the criticisms that have been made here, that the Treasury is not bringing some of these things to the attention of Congress soon enough. This seems to be one of those developing things, and it may be worth while to consider it now before it gets worse.

Mr. COOPER. Of course, the irrevocable feature of it would be in the interest of the integrity and stability of the pension plan, and certainly to the interest of the employees, because there would be a degree of permanency there?

Under Secretary MAGILL. Certainly.

Mr. COOPER. And they could look to it with greater assurance that the pension fund would be intact, and they would receive their benefits from it as a going concern instead of leaving it in the uncertain situation of being disrupted or dissolved at any time the management wanted to?

Under Secretary MAGILL. That is right.

Mr. TREADWAY. Mr. Chairman.

The CHAIRMAN. Mr. Treadway.

Mr. TREADWAY. Mr. Magill, you made some reference to having some worry about the individual trust. What is the difficulty about that?

Under Secretary MAGILL. I had in mind the situation that Congress corrected in 1924, and it has been improved since. You will recall that there was originally a good deal of question whether, if an individual set up a revocable trust in favor of his wife and children, or whomever, whether the income was taxable to the beneficiaries of the trust or whether it is taxable to him.

Mr. TREADWAY. It is taxable to him, is it not?

Under Secretary MAGILL. And in 1924 it was provided it should be taxable to him, on the ground that he still had control over the property, and that situation has remained as to those individual revocable trusts.

I did not make clear what I had in mind, that in the pension trust you have not a similar requirement at the present time. The pension trust can be revocable and so under the control of the company, and nevertheless the company got the deductions, and so on, with a possibility, as has been stated by Mr. Vinson and Mr. Cooper, that the company might see fit to revoke the trust in some year when it was to their tax advantage, thereby preventing its operation as to the employees.

Mr. TREADWAY. With an individual revocable trust, there is no possibility of tax avoidance, is there?

Under Secretary MAGILL. That is true. That is the point I was trying to make, that as to the individual trust I think you have quite successfully stopped the loophole, and it may be well at this time to take similar action with respect to the pension trust.

Mr. TREADWAY. I see. Thank you.

The CHAIRMAN. Now, if that concludes the discussion with respect to the pension trusts, you may proceed, as requested, Mr. Magill, to read your statement on community property.

Under Secretary MAGILL. I have this very brief statement, and I kept it brief primarily because, as you will recall, you had rather lengthy hearings in 1934, which are much more elaborate than what I will read here.

Mr. COOPER. Mr. Chairman.

The CHAIRMAN. Mr. Cooper.

Mr. COOPER. In that connection it might be well to observe that in 1934, I think it was, a subcommittee of the Ways and Means Committee was appointed on the subject of community property, and held hearings. Those printed hearings are still available, and

the whole subject was covered rather extensively during the course of that hearing. I remember ex-Governor Shallenberger, of Nebraska, who was then a member of this committee, was chairman of that subcommittee, and people came here from all over the country, from as far as the Pacific coast, and made appearances, and that whole record is still available. It was a printed hearing, and it is available, of course, to the committee.

Under Secretary MAGILL. In 1933, the Acting Secretary of the Treasury presented a statement to the Committee on Ways and Means calling attention, among other things, to certain tax consequences arising from the impact of the income-tax law upon the incomes of husbands and wives in the various States. It was pointed out that 8 of the 48 States have community property laws, which under the present income-tax law, have been held to permit each spouse to report one-half of the community income, although it was all earned by, and was expended under the control of, the husband. That situation is still with us. For example, under the tax laws now in force a husband domiciled in a community-property State and having a net income from earnings of $25,000 is permitted to throw one-half of it into a separate return filed by his wife, the two paying a total normal tax and surtax of only $1,575, whereas a husband in a noncommunity property State having the same net income from earnings is required to file and return the full amount in his return and pay normal and surtax amounting to $2,480, even though he may have made a legally valid assignment of his salary to his wife before any of it was earned. Translated into terms of annual revenue this means that the use of separate returns by husbands and wives in the eight community property States produces, at present rates, a tax which is less by approximately $34,000,000 than that which would be payable if separate returns of community income were eliminated.

Mr. VINSON. Mr. Magill, I thought the other day it was suggested it would be $80,000,000. Was not that the suggestion made at the beginning of the hearing, or some place along the line?

Mr. COOPER. Will the gentleman yield?

Mr. VINSON. Certainly.

Mr. COOPER. I think we have had estimates presented to us over the last several years, ranging all the way from about $20,000,000 up to $80,000,000.

Mr. VINSON. The figure given here is $34,000,000.

Mr. COOPER. At one time we hear of it, it is $30,000,000, at another time $50,000,000, and at another time $75,000,000, and we have heard of it being as high as $80,000,000. Of course, they are all estimates.

Under Secretary MAGILL. They are all estimates. This seems to be a conservative figure, then, I take it.

Mr. VINSON. It is $6,000,000 less than was that estimated in 1934, because I recall at that time the figure was $40,000,000.

Under Secretary MAGILL. We said $40,000,000.

Mr. VINSON. Yes.

Under Secretary MAGILL. I am not an estimator. I take what they give me on that.

Mr. VINSON. All right.

Under Secretary MAGILL. Of course, under the present law, a husband and wife living together may make separate returns in noncommunity property States and if each has an income of any considerable size this will ordinarily be done in order to reduce both normal and

surtaxes which would otherwise be payable. Thus, if a husband and wife in New York have an income of $10,000 each for a taxable year and separate returns are filed the tax consequences are substantially no different from those which obtain in a community property State under similar circumstances. However, there is this very important distinction between the two groups of States: Ordinarily, it is only in those instances where each spouse domiciled in a noncommunity property State earns an equivalent salary, or, each owns property producing equivalent incomes, that the tax consequences are on a par with those resulting to spouses in the community property States.

In his statement to the Committee on Ways and Means the Acting Secretary also pointed out that the problem of taxing the incomes of spouses has a broader aspect than that of eliminating the discrimination in favor of husbands and wives living together in community-property States. Since spouses living together in noncommunity-property States may file separate returns, there is a strong incentive for them to arrange their property holdings in such a way as to realize the greatest possible tax advantage through a division of income or an allocation of losses.

Our estimates indicate that, at the present rates, if husbands and wives who live together but file separate returns, should be taxed on their respective incomes at the rates applicable if the total of their separate incomes were included in a joint return, the increase in income-tax revenue for the calendar year 1937 would be approximately $103,000,000. Perhaps I had better restate that. The suggestion which we made in 1933, and which we make again now, is that in our view if husbands and wives are living together, that in determining ability to pay you should consider the total income of the two spouses.

Now, on account of constitutional difficulties it would no doubt be necessary, after a tax had been computed on the total income so arrived at, to provide that each spouse should pay the tax on his share, that is, a pro rata part of the total tax, but if that were done—that is, if the committee deemed it advisable to provide that husbands and wives should in effect pay the tax on the income of the two taken together, and then the total amount be prorated between them—that the increased revenue would be $103,000,000. This includes the $34,000,000 of which I spoke a few minutes ago.

Mr. VINSON. On page 15 of your statement back in 1934—I take it you wrote it, though it is signed by the Acting Secretary of the Treasury—I find the figure $40,000,000 to which I referred.

Under Secretary MAGILL. The only explanation that is given me—I have asked some of my staff on that—is that the $34,000,000 is based on 1937 figures, and the $40,000,000 was based on the 1934 figures.

Mr. VINSON. I just cannot understand that, because we recognize that the increased income naturally applied to those eight States, because it is Nation-wide. The increased prosperity is fully recognized.

Under Secretary MAGILL. It does not seem to me a very good explanation either. This figure of $103,000,000 includes the estimated $34,000,000 representing increased revenue due to the elimination of separate community-property returns in the eight community-property States.

In view of these considerations we believe there is ample justification for legislation designed to eliminate the inequality resulting from

the discrimination now made in favor of spouses residing in community-property States and, at the same time, eliminate the administrative difficulties and tax-avoidance possibilities which are inherent in the application of the present taxing provisions to spouses living in the non-community-property States.

Now I have here two tables showing the tax advantage to residents of community-property States, with respect to assets and with respect to incomes; that is, simply bringing out what this amounts to if the husband's income or his property is taxed to the two or is taxed to the one.

The CHAIRMAN. Do you wish those figures to go into the record in connection with your statement?

Under Secretary MAGILL. I would like to, if that is agreeable.

The CHAIRMAN. Without objection, they may go into the record in connection with your statement.

(The tables referred to are as follows:)

TABLE 1.—*Federal estate tax liability on estates of specified size in community- and and noncommunity-property States* [1]

Net estate before exemptions	Estate-tax liability			Net estate before exemptions	Estate-tax liability		
	Non-community-property States	Community-property States			Non-community-property States	Community-property States	
		Amount	Advantage			Amount	Advantage
$50,000	$100		$100	$300,000	29,000	10,800	18,200
$65,000	540		540	$400,000	43,700	18,300	25,400
$75,000	1,050		1,050	$500,000	60,300	27,300	33,000
$100,000	3,000	$200	2,800	$1,000,000	160,700	78,700	82,000
$125,000	5,625	750	4,875	$5,000,000	1,306,300	696,700	609,600
$150,000	8,550	1,600	6,950	$10,000,000	3,583,700	1,805,300	1,778,400
$200,000	15,300	4,200	11,100	$50,000,000	22,981,900	13,181,900	9,800,000
$250,000	21,800	7,250	14,550				

[1] It is assumed that each of the estates consisted of realty, 50 percent; tangible personalty, 25 percent; common stock, 15 percent; insurance payable to wife, 10 percent; and that the entire estate, with the exception of 20 percent of the realty acquired by the decedent prior to marriage, was acquired during coverture.

TABLE 2.—*Federal income-tax liability on incomes of specified size in community- and non-community-property States* [1]

Net income before exemptions	Income-tax liability			Net income before exemptions	Income-tax liability		
	Non-community-property States	Community-property States			Non-community-property States	Community-property States	
		Amount	Advantage			Amount	Advantage
$3,500,000	$26	$26		$102,500,000	$33,944	$19,288	$14,656
$5,000,000	80	80		$202,500,000	96,944	67,888	29,056
$7,500,000	210	170	$40	$302,500,000	163,944	129,888	34,056
$10,500,000	458	278	180	$402,500,000	233,944	193,888	40,056
$20,500,000	1,664	1,118	546	$502,500,000	305,944	259,888	46,056
$52,500,000	9,644	6,028	3,616	$752,500,000	490,944	432,888	58,056
$76,500,000	19,484	11,708	7,776	$1,002,500,000	680,944	611,888	69,056

[1] Tax computed on basis of $2,500 exemption for married persons and maximum earned-income credit.

Mr. TREADWAY. Mr. Chairman.

The CHAIRMAN. Mr. Treadway.

Mr. TREADWAY. Would it not be advisable, Mr. Magill, to break-down the other $34,000,000 or $40,000,000 whichever you decide is the loss to the Government by States, showing the amount saved in the eight community-property States separately?

Under Secretary MAGILL. I imagine it would be pretty hard to do it, but we can try it.

Mr. TREADWAY. Why? How do you arrive at your $34,000,000? That must be done by adding up something.

Under Secretary MAGILL. I do not know. I can only presume what that was.

Mr. TREADWAY. I would not want to put you to any undue trouble, but I just thought as a matter of interest it would be worth while if you could do that.

Under Secretary MAGILL. I will find out, and if they can do that, we will be glad to do it.

Mr. TREADWAY. May I ask one other question?

The CHAIRMAN. Go ahead.

Mr. TREADWAY. The Treasury believes in overcoming in some way the advantage that the 8 States have over the other 40 in the matter of taxation?

Under Secretary MAGILL. That is true.

Mr. TREADWAY. Are you prepared, during the time of this hearing, to offer any suggestions other than what we have previously had as to the way to accomplish this purpose?

Under Secretary MAGILL. I do not know whether we have got anything essentially different from what was worked out in 1933 and 1934 or not. I have not been able to go over that carefully in the last 2 or 3 weeks. As I say, our net suggestion is that we think it would be desirable over the country as a whole to provide that the incomes of husbands and wives living together should be aggregated and the tax computed with respect to the total.

Mr. VINSON. How much would that bring?

Under Secretary MAGILL. $103,000,000, according to this figure.

Mr. TREADWAY. Where do you get this $103,000,000 and the $34,000,000? I do not quite understand. The $103,000,000 includes all of the States?

Under Secretary MAGILL. That includes all of the 48 States. It is common practice, which has plenty of other justification than tax justification, for property to be given by a husband to his wife, or for both of them to have property, or for both of them to have incomes, and so on. Our general philosophy is this, that if a husband and wife living together have an income of $20,000, that whether it is split $10,000 and $10,000 or $15,000 and $5,000, or howsoever, that they ought to be taxed as for a $20,000 family income.

Mr. COOPER. Will the gentleman yield?

Mr. TREADWAY. Certainly.

The CHAIRMAN. Mr. Cooper.

Mr. COOPER. In effect the suggestion simply amounts to this: To require a joint return from husband and wife, throughout the whole country.

Under Secretary MAGILL. That is the easiest way to say it. I do not know that we would actually require them to file a joint return. If for some reason the wife wanted to keep her affairs separate from those of

her husband and wanted to file a separate return, I take it there would be no objection to that. For instance, what I mean is this: In England as I understand it husbands and wives can file separate returns, but the tax-assessing officials put the two returns together and assess the tax with respect to the net total income, and then mail each spouse a notice.

Mr. COOPER. It just means one of two things would have to be done, under the suggestion: First, either have a joint return for husbands and wives, or second, if they file separate returns, compute them together, and assess the tax as if it were a joint return.

Under Secretary MAGILL. That is it exactly. I think that is a correct statement.

Mr. COOPER. And, of course, it is recognized that under court decisions we have considerable legal difficulties in approaching that method; do we not?

Under Secretary MAGILL. That is right. You have the *Hoeper case* staring you in the face, which you will remember we discussed in 1934.

Mr. COOPER. Yes.

Mr. VINSON. That is a case in which the State of Wisconsin tried to do that very thing.

Under Secretary MAGILL. I think not that very thing, Mr. Vinson. That is the question.

Mr. COOPER. Just one other question, if I may. Has there been any change in the status of the legal phase of the thing since we last considered it?

Under Secretary MAGILL. I rather think so. As you see I present this recommendation fully conscious of such difficulties as you and Mr. Vinson have in mind as to the Supreme Court. Mr. Kent read you a paragraph from one of the decisions the other day, and I could read you others indicating that a majority of the Court seems gradually to have taken the idea that economic control or social control over income is sufficient to justify the tax, and then in the case of *Burnet* v. *Wells*, an insurance-trust case, the Court seemed to go somewhat beyond that. Now that was a 5-to-4 decision. The reason that I answered Mr. Vinson as I did a minute ago was this: The Court did not discuss much in the *Hoeper case*, whether the provisions for the allocation of the tax between the two spouces were applicable. On the whole, they discussed the case as if the husband was going to have to pay the entire tax on the total income.

Mr. VINSON. Did they not say in the *Hoeper case* that there was not any way you could make one person pay a tax upon property or income of another person? They said that, if they said anything, did they not?

Under Secretary MAGILL. I think they said that in terms, as I remember it, that to tax A on the income of B was a violation of due process.

Mr. COOPER. Has there been any court decision since that time that would justify the hope that the legal situation has changed?

Under Secretary MAGILL. I would think so. I am thinking of *Burnet* v. *Wells*.

Mr. COOPER. All right. Now just one other question: Relative to the estimate of $193,000,000, the basis of that is a contemplated joint return, or computation of the tax the same as a joint return,

throughout the entire country, not only in the 8 community-property States, but in the whole 48 States of the Union?

Under Secretary MAGILL. That is correct.

Mr. VINSON. Did we not have before us the case of Burnet against Wells when the subcommittee was having its hearings? Was not that case decided in 1934?

Under Secretary MAGILL. I cannot tell you offhand.

Mr. KENT. I think it was.

Mr. VINSON. Mr. Kent says it was.

Mr. KENT. I think it was.

Mr. VINSON. You referred to a quotation in Mr. Kent's testimony. Was that the Holmes quotation?

Under Secretary MAGILL. In *Lucas* v. *Earl*, yes.

Mr. VINSON. What page is that in Mr. Kent's testimony? I would like to read it into the record right here in connection with community property. To me that statement is authority that at the present time we cannot make one person pay a tax on another person's income, and that at the present time we cannot take the income of one individual and add it to the income of another, and thereby make the latter individual pay more taxes than he would if you did not take the income of the other party into consideration. Let us take page 29 of this statement.

Under Secretary MAGILL. Perhaps I should say here, I think you appreciate this. This thing is a very nice legal question, there is no question about that. In *Burnet* v. *Wells*, which I would rely on chiefly, the decision was a 5-to-4 decision in favor of constitutionality, so you see where you are there, right at the start.

Mr. VINSON. This is not the quotation to which I referred. I wanted the quotation in Mr. Bruton's testimony. I am reading from a statement made by Mr. Bruton.

The CHAIRMAN. When was the statement made?

Mr. VINSON. It was made at this hearing yesterday.

The CHAIRMAN. That is what I thought.

Mr. VINSON. I thought it was to that statement that reference had been made.

Under Secretary MAGILL. Perhaps I got them mixed.

Mr. VINSON. No; this is a quotation from an opinion written by Mr. Justice Holmes. Is that the one you had in mind?

Under Secretary MAGILL. I really had the one in mind that is in Mr. Kent's testimony; but why not read the one you have before you now by Justice Holmes?

Mr. VINSON. I quote:

> Taxation is not so much concerned with the refinements of title as is it with actual command over the property taxed—the actual benefit for which the tax is paid.
>
> The income that is subject to a man's unfettered command and that he is free to enjoy at his own opinion may be taxed to him as his income.

The situation we are up against is that in a community-property State, where under the law of that State it is divided between husband and wife, the income of the wife is not subject to the husband's "unfettered command." That income is hers. Then the husband is not free to enjoy at his own option any income of the wife.

Under Secretary MAGILL. Of course, the question here is one of due process. Your chief question would be whether or not Congress can rationally do what we are talking about here, and it seems to

me one important bit of evidence in that connection is the fact that England does do it, and has done it for a long time.

Mr. VINSON. I know; but England did not have California come in under a treaty. England did not have Texas, first a part of Mexico and then an independent republic, and then coming into the Union. England did not have the civil law appertaining to Louisiana and Texas and California, and in these other States, when they came into the Union, either.

Under Secretary MAGILL. That is true.

Mr. VINSON. At any rate, we cannot settle it today, can we?

Under Secretary MAGILL. I do not believe so.

Mr. TREADWAY. Mr. Chairman.

The CHAIRMAN. Mr. Treadway.

Mr. TREADWAY. I believe I yielded to both of these gentlemen.

Mr. VINSON. Thank you.

Mr. TREADWAY. We have referred somewhat to the discussion of this subject in 1934, to the extensive hearings, and to the fact that nothing was done at that time. If I remember rightly, among the measures considered then was one that I had introduced. I never like to quit or fall down on a proposition after I once got started at it, so at the opening of this session of Congress I reintroduced the same measure, which I would like to read to you. It is very brief.

[H. R. 200, 75th Cong., 1st sess.]

A BILL Relating to the taxation of community-property income

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That for the purpose of determining the income-tax liability of any individual during any taxable year beginning after December 31, 1936, property of a marital community shall be considered as the property of, and income of a marital community shall be considered as the income of, the spouse who has the management and control thereof under the law of the jurisdiction in which the marital community exists, and such spouse shall alone be entitled to the deductions and credits allowed under the internal-revenue laws which are properly allocable to such property or income.

SEC. 2. For the first taxable year beginning after December 31, 1936, the periods of limitation for assessment, credit, or refund of income taxes shall be extended for a period of 1 additional year in the case of any individual having such management and control or in the case of his or her spouse.

I suppose you would not care to express an opinion as to whether or not that is drafted in a way that would accomplish our purpose in getting at the avoidance income tax in the community-property States?

Under Secretary MAGILL. I do not think that particular bill has ever come before me. I do not know.

Mr. TREADWAY. No; we have had no hearing on it at this session. I realize that, and probably no reference of the bill has been made by the committee to the Department for an opinion.

Under Secretary MAGILL. I would not like to express an opinion offhand. As I said here earlier, in the view of the Department, we would prefer to see this situation dealt with for the country as a whole.

Mr. TREADWAY. Yes. In other words, to get at the $193,000,000 instead of the $34,000,000?

Under Secretary MAGILL. Exactly.

Mr. TREADWAY. I think that would be fair. We are looking for more tax money to expend. We need it, do we not, in order to carry on?

Under Secretary MAGILL. Certainly.

Mr. TREADWAY. However, when this subject is really considered, I shall be very glad if you will take that measure under advisement.

Under Secretary MAGILL. I will be very glad to.

Mr. TREADWAY. Thank you.

Mr. CROWTHER. Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. Would there be any less difficulty regarding constitutionality, in dealing with a subject connected with the eight States, rather than at large?

Under Secretary MAGILL. I do not think so. That is a question on which better lawyers than I ought to pass.

Mr. TREADWAY. Are there any? Do not be too modest. Are there better lawyers than you?

Under Secretary MAGILL. Oh, lots and lots of them. For one thing, I am not a community-property State lawyer, and they should be allowed to say their own piece on this. There is, as you know, of course, Dr. Crowther, a series of decisions which the court had on the community-property situation, headed by a case called *Poe* v. *Seaborn*.

Mr. VINSON. That was from Washington, was it not?

Under Secretary MAGILL. That was from Washington; yes.

Mr. VINSON. A decision of the Supreme Court?

Under Secretary MAGILL. But I believe the Supreme Court has decided the same thing per curiam as to the other States except California. I am not sure about California. So there are legal difficulties whichever way you proceed, I think.

Mr. VINSON. In answer to Dr. Crowther as to which would be easier to meet, if you follow the management and control theory of trying to meet it, you would not have a Chinaman's chance in the 40 States that do not have community property, because you do not have management and control laws there.

Under Secretary MAGILL. I take it that Mr. Treadway drafted his law——

Mr. VINSON. No; I am speaking about Dr. Crowther's question as to which would be easier or less difficult, and in the 40 States you haven't management and control laws on which to hang it.

Under Secretary MAGILL. That is true.

Mr. TREADWAY. Mr. Chairman.

The CHAIRMAN. Mr. Treadway.

Mr. TREADWAY. If I may be permitted, in this connection, I think it would be useful to the committee to insert at this point the position that the Treasury took in 1934—a brief paragraph. I am quoting from the statement of the Acting Secretary of the Treasury before the Ways and Means Committee:

> The Treasury Department therefore recommends that the committee consider whether a husband and wife living together should not be required to file a single joint return, each to pay the tax attributable to his share of the income. Such a provision has long been in force in other countries.

That is practically along the line you have been talking just now, is it not?

Under Secretary MAGILL. Yes, sir; it is.

Mr. VINSON. Does that only refer to the community-property States?

Mr. TREADWAY. No.

Mr. VINSON. That only referred to the community-property States; is that correct?

Under Secretary MAGILL. I would have to refresh my recollection. I thought we were referring to all of them, but I may be wrong.

Mr. TREADWAY. Is there such a provision as that in other countries?

Mr. VINSON. I did not see anything in this, referring to the report before me, just glancing at it hurriedly.

Mr. TREADWAY. Perhaps as you said a few moments ago, we cannot settle this question this morning.

Mr. COOPER. Let us pass on.

The CHAIRMAN. All right. Without objection, we will proceed. Mr. Magill, who is your next witness?

Under Secretary MAGILL. Mr. Kent.

Senator HARRISON. Mr. Chairman, at one of the recent hearings I think Senator La Follette requested the Treasury to give us certain information with reference to certain taxpayers about whom testimony was given by representatives of the Treasury Department in executive session before the Senate Finance Committee when the revenue bill of 1936 was under consideration.

Under Secretary MAGILL. We have that this morning, and I was expecting to present it next. If you would like it before Mr. Kent begins, it makes no difference to us. We have it available here at any time.

The CHAIRMAN. Very well.

Mr. KENT. Before I present a very brief statement on nonresident aliens this morning, which I have prepared, I would like to offer for the record supplementary tables in connection with certain of the cases which I presented in my statement day before yesterday, that Mr. Vinson requested be filed and placed in the record along with my statement.

The CHAIRMAN. Without objection, the tables may be incorporated in the record at this point.

STATEMENT OF ARTHUR H. KENT, ASSISTANT GENERAL COUNSEL, TREASURY DEPARTMENT

Mr. KENT. The present revenue act imposes a fixed rate of 10 percent on nonresident aliens, not engaged in trade or business in the United States or having an office or place of business therein, with respect to fixed or determinable annual or periodical gains, profits and income such as interest, dividends, rents, royalties, annuities, and compensation from sources within the United States. In the case of foreign corporations, not engaged in trade or business and not having an office or place of business in the United States, a flat rate of 15 percent is imposed on these sources of United States income, with the exception of dividends from United States sources, where the rate is 10 percent. In neither of these cases is a tax imposed upon profits derived from transactions in the United States in stocks, securities, or commodities, or those effected through a resident broker, commission agent, or custodian. These flat taxes are, with a limited exception in the case of certain tax-free covenant bonds collected by withholding at the source. They are in effect taxes on gross income of the enumerated types. Since the usual deductions and credits are not allowed, there is also little or no occasion for making refunds. The filing of returns by the taxpayers, as a mechanism of tax collection, is necessary only in exceptional cases. Detailed returns are, of course, required from those persons upon whom the law places a duty to

withhold the tax. Nonresident aliens carrying on a trade or business or having an office or place of business in the United States remain subject to regular individual normal and surtaxes upon that portion of their incomes, including capital gains, derived from United States sources and are entitled to claim certain statutory deductions and credits, including the thousand-dollar personal exemption, in arriving at their taxable net incomes. Tax withheld at the source in such cases may be taken as a credit against the tax shown to be due on the return, with a right to refund to the extent of any overpayment. However, buying or selling upon a stock or commodity exchange in the United States through a resident broker, agent, or custodian does not of itself constitute engaging in trade or business therein. Similarly, foreign corporations engaged in the United States are taxed upon their total income, including capital gains, from United States sources, but at a flat rate of 22 percent.

The plan of the 1936 act contrasts sharply with the prior law under which the effort was made to subject the American income of all nonresident aliens to the normal and surtaxes imposed upon citizens and resident aliens, including the tax upon capital gains in transactions consummated here, with a personal exemption of a thousand dollars allowed in every case. There was, however, this important difference. With minor exceptions, citizens and residents are taxable upon their total incomes, from whatever source derived. The surtax rates are therefore fully effective and the criterion of taxation based on ability to pay is substantially satisfied. Not so in the case of the nonresident alien who derived from United States sources, only a portion of what might have been a very large total income, for in his case the maximum surtax was governed by the amount of that segment of his income derived from such sources, not by his total income. In view of the sharply graduated rates of the individual surtaxes, the discrimination in favor of aliens in the taxation of that segment of their income from United States sources under the law as it stood prior to 1936 is apparent.

Mr. VINSON. Mr. Chairman.

The CHAIRMAN. Mr. Vinson.

Mr. VINSON. Right at that point, do I understand that those two sentences are critical of the act of 1936?

Mr. KENT. Not at all.

Mr. VINSON. That is, in that the income of a nonresident alien from sources other than the United States should be included with the income from sources within the United States, to make them subject to the higher surtax?

Mr. KENT. Nothing that I have said thus far, Mr. Vinson, is intended by way of criticism. I am merely attempting to portray the situation existing prior to the 1936 act, that is, that we never have had real equality in taxation of residents and nonresident aliens.

Mr. VINSON. I know, but you state:

> In view of the sharply graduated rates of the individual surtaxes, the discrimination in favor of aliens in the taxation of that segment of their income from United States sources under the law as it stood prior to 1936 is apparent.

Mr. KENT. Yes.

Mr. VINSON. We have no power under the Constitution to tax that segment of a nonresident alien's income which is derived from sources without the United States.

Mr. KENT. I agree to that.

Mr. VINSON. There could not be any question about that, could there?

Mr. KENT. There could not be, not to tax it directly, I agree.

Mr. VINSON. Consequently under our system you could not add the foreign income to the domestic income in order to get the surtaxes that are levied upon resident taxpayers?

Mr. KENT. I would not be willing to concede as a matter of constitutional law that Congress could not if it so desired, and if it were administratively feasible, determine the rate upon that portion of the income derived from the United States sources by his total income. I recognize there would be formidable difficulties in it.

Mr. VINSON. Wait a minute. You are backing up aplenty.

Mr. KENT. No; I am not.

Mr. VINSON. Yes; you are. The Treasury is, because in 1934 upon my motion there was a section that went into that revenue act, that gave the President of the United States power, when foreign countries discriminated against our nationals, to make a penalty tax or to increase the tax 100 percent, upon the nationals of foreign countries, when that foreign country discriminated in the very manner to which you refer, namely, to choose the world income of our nationals to determine the taxes paid by our nationals upon income derived in that foreign country.

Under Secretary MAGILL. I think I would like to speak on that, since I was around, in 1934.

Mr. VINSON. Well, I was, too.

Under Secretary MAGILL. I would not contradict you at all. As I recall it the situation that we were thinking of—and please correct me if I am wrong—was France, was it not?

Mr. VINSON. It was France, and France had passed a measure.

Under Secretary MAGILL. As I recall it, what France had threatened to do, or had done——

Mr. VINSON. Had done.

Under Secretary MAGILL (continuing). Was to attempt to tax American firms purchasing goods in France, on their total income.

Mr. VINSON. No; American firms engaged in business in France. And they attempted to include the income of such American firms here with their income in France.

Under Secretary MAGILL. That is right.

Mr. VINSON. It was in the courts.

Under Secretary MAGILL. Yes.

Mr. VINSON. This particular statute enabled them to work out an agreement whereby they desisted from that practice.

Under Secretary MAGILL. That is true.

Mr. VINSON. That saved the American taxpayers, according to the information I have, in the first year, $120,000,000 in taxes payable to France.

Under Secretary MAGILL. I think your recollection completely accords with my own as to the French situation. Now as I understand it, what Mr. Kent was talking about—which I may say if you will wait you will find after he reads the paper is not the recommendation that we are making, but the thing that he was thinking of was this: Suppose that an individual has $10,000 income from each of a dozen different countries. It may be so worked out that his total taxes are considerably less than if he had that income all from one country, and so what Mr. Kent had in mind I think was the doctrine which was applied, for instance, by the State of New Jersey, with respect to

inheritance taxes, and which was upheld by the Supreme Court in Maxwell against Bugbee, to the effect that the State could take into account the total property in other States in determining the rates applicable to the property within the taxing State.

Mr. VINSON. That is an entirely different thing, because the taxable situs of one taxpayer is one State.

Under Secretary MAGILL. That is why I wanted to make this explanation.

Mr. VINSON. I did not know what my good friend Mr. Kent had in mind. I want to say to him and to you that as far as I am concerned I think he is tops. I think he is fine. All I know is what he said on this printed page, and he talks about discrimination against the domestic taxpayer because under our system we do not include the world income of the foreing taxpayer and add it to the income derived here. He says that we only tax a segment of that nonresident alien's income, and of course to my mind that is all we can tax. If we can get an income tax upon the income derived from sources within the United States we have done a pretty good day's work, and that is all we can do, is not that right?

Mr. KENT. I again should make a reservation on that.

Mr. VINSON. Well, you will do that every time. I have never seen you fail, and it is all right because you are so cautious and so conscientious that you are perfectly entitled to make your reservations.

Mr. KENT. Let me say, however, that so far as the term "discrimination" was used, it was not intended to be used in any invidious sense. I was merely attempting to call attention to the fact that where you are taxing income on the theory of source rather than domicile, there necessarily is that lack of equality, and it seems to me that that is the only point I was trying to make.

Mr. TREADWAY. Mr. Chairman.

The CHAIRMAN. Mr. Treadway.

Mr. TREADWAY. Mr. Kent, this discussion with Mr. Vinson has to do with section 211, has it not?

Mr. KENT. Section 211? I was thinking of the law as it existed prior to the 1936 act, Mr. Treadway.

Mr. TREADWAY. I am referring to the 1936 act.

Mr. KENT. We have section 211-a and section 211-b in the 1936 act.

Mr. TREADWAY. This is the 1936 act, containing section 211.

Mr. KENT. Yes.

Mr. TREADWAY. That has to do with nonresident alien individuals. I understand that a treaty has been ratified by Canada and is now pending in the United States Senate making that rate definitely 5 percent. In case it is agreed to by the Senate, will there be any definite change or effect as to section 211?

Mr. KENT. Such a treaty was specifically authorized by the terms of the 1936 act. That is, in the case of contiguous countries.

Mr. TREADWAY. Yes; in the case of contiguous countries, that is right.

Mr. KENT. Authority was given to reduce the rate to 5 percent by reciprocal treaty provisions.

Mr. VINSON. That is, where our taxpayers received a reciprocal benefit from a contiguous country?

Mr. KENT. Yes; that is correct.

Moreover, the liability for taxes on capital gains derived by nonresident aliens from transactions within the United States was largely

theoretical by reason of administrative difficulties in the determination of such tax liabilities and the collection thereof which experience had shown to be virtually insuperable in the form imposed by the prior law.

It was believed that the changes made in 1936, which were based upon the idea of collecting a substantial tax on nonresident aliens at the source on types of income which lend themselves readily to the device of withholding, which taxes when collected would remain in the Treasury and not be subject to claims for refund, except in extraordinary cases, would result in a substantial increase in tax collections from this group of taxpayers. These expectations have been realized by the revenue returns under the 1936 act. I offer for the record a tentative analysis of fixed or determinable annual or periodical income paid to nonresident alien individuals and nonresident foreign corporations and reported on withholding returns, form 1042, for the calendar year 1936. These figures are based upon 5,535 withholding returns received in the Bureau of Internal Revenue as of June 18, 1937. It will be noted that the total amount of tax so reported is $14,950,684.21. It should be observed, however, that this figure does not include tax collections on resident foreign corporations, taxable at 22 percent on their American income, with respect to which no figures are yet available, nor additional taxes to be collected by returns from nonresident aliens carrying on trade or business in the United States. Nor does it represent a full year's collection of withholding taxes, since the withholding on dividends to nonresident alien individuals and the higher rates of withholding on other sources of taxable income did not become effective until July 2, 1936. Otherwise, the total collections at the source for the year 1935 would inevitably have exceeded the above figure by several millions of dollars.

With your permission, Mr. Chairman, I should like to offer this chart for the record.

The CHAIRMAN. Without objection that may be included in the record.

(The tabular statement entitled "Tentative Analysis of Fixed or Determinable Annual or Periodical Income Paid to Nonresident Alien Individuals and Nonresident Foreign Corporations and Reported on Withholding Returns, Form 1042, for the calendar year 1936, is as follows:)

Tentative analysis of fixed or determinable annual or periodical income paid to nonresident alien individuals and nonresident foreign corporations and reported on withholding returns, form 1042, for the calendar year 1936

[Number of withholding returns, form 1042, received in the Bureau as of June 18, 1937, 5,535]

Dividends	Amount of tax	Rate	Taxable income	
1. Paid to corporations by payor corporations (prior to July 2)	$540,447.66	1½	$36,029,844.00	
2. Paid to corporations by nominees (prior to July 2)	83,412.91	1½	5,560,860.00	
3. Paid to individuals and corporations by payor corporations (after July 1)	8,157,305.96	10	81,573,059.60	
4. Paid to individuals and corporations by nominees (after July 1)	2,370,801.12	10	23,708,011.20	
5. Paid by resident foreign corporations to individuals (prior to July 2)	11,224.61	4	280,615.25	
6. Paid by resident foreign corporations to corporations (prior to July 2)	12,960.37	15	86,402.40	
7. Paid by resident foreign corporations to individuals and corporations (after July 1)	14,120.36	10	141,203.60	
				$147,470,056.11

Tentative analysis of fixed determinable annual or periodical income paid to nonresident alien individuals and nonresident foreign corporations and reported on withholding returns, form 1042, for the calendar year 1936—Continued

Dividends	Amount of tax	Rate	Taxable income	
FIDUCIARY				
8. Distributable shares of the income of estates and trusts (partly before and all after July 1)..... $1,058,888.11 Less credit for tax withheld on bond interest (reported on form 1013)................ 46,614.40	$1,011,773.71	10		$10,583,881.10
ROYALTIES				
9. Paid to individuals (before July 2)...............	30,618.60	4	$990,467.25	
10. Paid to individuals (after July 1).................	139,011.71	10	1,390,117.10	
11. Paid to corporations (entire year)...............	573,050.06	15	3,820,334.87	6,200,919.22
INTEREST				
12. Paid ot individuals (before July 2)...............	4,408.02	4	110,200.50	
13. Paid to individuals (after July 1).................	50,788.91	10	507,889.10	
14. Paid to corporations (entire year)...............	175,987.71	15	1,173,251.45	1,791,341.05
SALARIES				
15. Paid to individuals, including residents of Canada and Mexico (before July 2).................	24,010.80	4	600,270.00	
16. Paid to individuals, excluding residents of Canada and Mexico (after July 1).................	46,986.40	10	469,846.00	1,070,134.00
RENT				
17. Paid to individuals (before July 2)...............	3,216.19	4	80,404.75	
18. Paid to individuals (after July 1).................	16,239.37	10	162,393.70	242,798.45
COMMISSIONS				
19. Paid to individuals (before July 2)...............	3,510.74	4	87,768.50	
20. Paid to individuals (after July 1).................	3,453.44	10	34,534.50	
21. Paid to corporations (entire year)...............	14,637.81	15	97,585.40	219,888.30
ANNUITIES				
22. Paid to individuals (before July 2)...............	2,962.69	4	74,067.25	
23. Paid to individuals (after July 1).................	8,100.06	10	81,000.60	154,58[illegible].65
MISCELLANEOUS OR UNCLASSIFIED				
24. Paid to individuals (before July 2)...............	2,820.17	4	70,504.25	
25. Paid to individuals (after July 1).................	40,120.80	10	401,208.00	
26. Paid to corporations (entire year)...............	146,451.29	15	976,341.90	1,448,054.15
Total....................................	13,506,488.46	....		169,182,256.03

Corporate bond interest paid to nonresident alien individuals and nonresident foreign corporations as disclosed by 269,650 ownership certificates for the calendar year 1936, filed with the Bureau of Internal Revenue

	Amount of tax	Rate	Taxable income	
Paid to individuals and partnerships:				
(a) With tax-free covenant........................	$141,152.49	2	$7,057,624.46	
(b) With tax-free covenant........................	347,098.66	4-10	4,971,400.39	
(c) Without tax-free covenant....................	353,009.53	4-10	5,043,854.69	$17,072,838.54
Paid to corporations:				
(a) With tax-free covenant........................	20,000.97	2	1,000,048.58	
(b) With tax-free covenant........................	159,684.83	15	1,064,565.50	
(c) Without tax-free covenant....................	422,289.27	15	2,815,261.83	4,879,875.07
Total..	1,441,105.75	....		21,951,764.51

Total amount of taxable income reported on withholding returns for calendar year 1936...... $191,134,020.54
Total amount of tax reported on withholding returns for calendar year 1936................ 14,950,684.21

Mr. KENT. This figure may be compared with the figures representing the amount of income taxes collected in prior years from all nonresident aliens and all foreign corporations, as shown in the following table:

1933	$5, 218, 125
1934	5, 728, 854
1935	5, 753, 244

This comparison suggests that the changes made in 1936 looking to more adequate collection of taxes on foreign taxpayers represent a substantial improvement in a more equitable distribution of the tax burden between citizens and residents of this country and residents of other countries deriving income from United States sources.

The principal defect in the new system is that which is inherent in a flat rate of tax at a relatively moderate rate, viz, that there is imposed on foreign recipients of large incomes from United States sources a tax rate much lower than that under the preexisting law. This will generally be the case with individuals receiving a gross income from United States sources of $25,000 or more per year. The number of such persons is considerable, though much less than those whose American incomes are less than that figure.

It will be seen that the recipients of these larger incomes enjoy measurably and, in some cases, very substantial tax benefits under the rates prescribed in the 1936 act as compared with United States citizens and residents receiving the same amounts of income. This inequality could be minimized or removed and substantial additional revenue obtained by some readjustment of the withholding rates and/or the imposition of an additional tax burden by way of surtax upon the nonresident alien recipients of larger incomes.

In that connection I wish to say that I have here for the information of the committee and for such use as the committee may desire, two other charts, one of which contains a list. This is merely a sampling, you will understand. It contains a list of nonresident aliens receiving income for the taxable year 1935 in excess of $25,000. The purpose of the table is to show what the tax effects would have been, taking the 1935 income as their income for 1936, according to whether they are taxable under section 211–a or section 211–b of the act. I offer this for such disposition as the committee may see fit to make of it.

I have another chart, which contains the names of 132 foreign corporations and partnerships, including nominees, deriving income from United States sources, chiefly dividend income, the names and the amounts of the income which these corporations received during the year 1936, as shown by form 1042, which have been filed with the Commissioner of Internal Revenue.

Mr. VINSON. Have you copies of that?

Mr. KENT. I just had this one copy.

The CHAIRMAN. It is hardly necessary to put that in the record, unless someone specially requests it.

Mr. VINSON. Let us see if I got this picture. In 1933, 1934, and 1935 the total revenues derived from nonresident aliens and from foreign corporations is $5,000,000 plus, annually? Is that correct?

Mr. KENT. Yes.

Mr. VINSON. The figure of approximately $15,000,000, which has already been paid into the Treasury under the 1936 act, is the revenue paid only by nonresident aliens?

Mr. KENT. And nonresident foreign corporations, nonresident aliens and nonresident foreign corporations. It is that tax which has been caught at the source.

Mr. VINSON. What do you mean by a "nonresident corporation?"

Mr. KENT. Nonresident foreign corporations.

Mr. VINSON. Having a place of business here, or not having a place of business here?

Mr. KENT. Not having a place of business here.

Mr. VINSON. In other words, $15,000,000 is the amount of revenues obtained from nonresident aliens and the nonresident foreign corporations not having places of business here?

Mr. KENT. That is correct.

Mr. VINSON. The revenues from the resident alien or nonresident alien having a place of business here and the foreign corporations having places of business here are not included in the $15,000,000?

Mr. KENT. That is right, except to this extent, Mr. Vinson, that the withholding taxes, the withholding rates apply to all nonresident alien individuals. Therefore there may be a few of them. There will not be many of them. There may be a few of them who will be filing returns because they are carrying on a trade or business in the United States, who will have paid that same small amount of tax at the source.

Mr. VINSON. Is that included in the $15,000,000?

Mr. KENT. That is included in the $15,000,000.

Mr. VINSON. What tax then upon the foreigner, whether he be an individual or a corporation, is not included in the $15,000,000?

Mr. KENT. There is the income of foreign corporations carrying on trade or business in the United States, and having an office or place of business therein, that is taxable at the 22-percent rate.

Mr. VINSON. But that is not in the $15,000,000?

Mr. KENT. That is not in the $15,000,000.

Mr. VINSON. Can you estimate the amount of taxes that it is reasonable to expect that will be added to the $15,000,000 for the taxable year 1936?

Mr. KENT. I really cannot make an estimate on that, Mr. Vinson. I can give you this figure, however. I can give you a breakdown of these preceding years showing the amount of income collected from foreign corporations filing returns in those years.

Mr. VINSON. I do not want the foreign corporation filing returns, where that money is included in the $15,000,000.

Mr. KENT. Yes.

Mr. VINSON. In short, here is what I want? In 1934 and 1935 you had $5,000,000 plus annually from non-resident aliens and foreign corporations. I want to know how many million dollars will be collected from those two sources under the 1936 act.

Mr. KENT. I will get that for you if I can. I do not know whether it is possible just at this time to get even an approximate estimate on that, because that is information which is gathered from a statistical analysis of the returns filed in March.

Mr. VINSON. In any event we are $10,000,000 better off annually than we were before the 1936 act?

Mr. KENT. That is correct.

Mr. VINSON. I am wholeheartedly in agreement with you that the foreign taxpayer who will make an income-tax return here should pay the same rate of taxes upon the income derived within the

United States as a domestic taxpayer. The trouble was, I think you will agree with me, that in the case of the smaller foreign taxpayers they were not making returns. Is that correct?

Mr. KENT. That is correct.

Mr. VINSON. And this withholding tax picks up $10,000,000 additional, and picks up money from many nonresident aliens who were not paying any taxes at all?

Mr. KENT. That is undoubtedly true.

Mr. VINSON. Now assume that you would take a figure of $25,000, which is the figure you used in your statement, and you would apply the withholding tax to all income of nonresident aliens and to nonresident foreign corporations not having a place of business here, and require the making of a return by those foreigners who have an income of more than $25,000, and make applicable the domestic rates to that income, and then credit the tax when computed with the amount withheld, would that meet the situation you have in mind?

Mr. KENT. Approximately; yes.

Mr. VINSON. How many taxpayers would fall in that category, who will be compelled to make the return?

Mr. KENT. I do not have a figure on that. I think I could get that figure for 1935.

Mr. VINSON. Approximately, have you got any idea?

Mr. KENT. There would be, I should say, a thousand or more of them. I think a thousand would be a conservative estimate.

Mr. VINSON. And, of course, that would pick up several added millions of dollars?

Mr. KENT. That is true.

Mr. VINSON. And, of course, the foreigner who has his place of business here is now upon the same plane as the domestic taxpayer and subject to the same rates and the same surtaxes?

Mr. KENT. That is right.

Under Secretary MAGILL. There is one little thing you may want to do there. I think the law now reads "If he has office or place of business in the United States." I think probably that word "office" wants to be taken out.

Mr. VINSON. At one time I do not believe it was in the statute. I am not just sure about that. It seems to me as if at one time we had "place of business" without "office."

Mr. COOPER. Mr. Chairman.

The CHAIRMAN. Mr. Cooper.

Mr. COOPER. Mr. Kent, the second chart referred to by you was not put into the public record?

Mr. KENT. Yes.

Mr. COOPER. You spoke of it as being only a sample that you made some reference to?

Mr. KENT. Yes.

Under Secretary MAGILL. I understand that what has gone into the record is the statement of the tax gained by virtue of the 1936 tax provisions.

Mr. COOPER. That is the first chart referred to?

Under Secretary MAGILL. That is the first chart he offered.

Mr. COOPER. But the last two?

Under Secretary MAGILL. The last two are not in the public record.

Mr. COOPER. That is right.

Mr. CROWTHER. Mr. Chairman.

The CHAIRMAN. Mr. Crowther.

Mr. CROWTHER. As I understand, Mr. Kent, the nonresident alien carrying on a trade or business, or foreign corporation having a business in the United States or a place of business, they are both subject to the capital-gains tax?

Mr. KENT. Yes.

Mr. CROWTHER. But the nonresident alien is not? He is not subjected to the capital-gains tax?

Mr. KENT. That is right.

Mr. CROWTHER. I wonder why.

Mr. KENT. Our experience had been, as I have stated in my statement, that the liability was largely theoretical; that it was extremely difficult, and in many cases impossible, to determine the amount of his gain in the first place, to locate the transaction, to identify the nonresident alien living abroad as the person who was the party to that transaction, and after determining the liability, where that was possible, to collect the tax.

Mr. CROWTHER. Have you gentlemen given any consideration to the repeal of the capital gains and loss sections?

Under Secretary MAGILL. We have been working on this problem off and on I suppose for 6 or 8 months. The difficulty is, as you can readily appreciate, that the certificates of stock in American corporations are said to circulate freely abroad as bearer certificates. That is, the certificate is issued in the name of a foreign brokerage house, for example, and is by it endorsed in blank, and then the certificate is sold all around in the foreign countries.

Mr. CROWTHER. I am talking about the repeal generally of the capital gains and loss section.

Under Secretary MAGILL. I beg your pardon. I thought you meant this.

Mr. CROWTHER. Yes. I do not mean in reference to this.

Under Secretary MAGILL. Yes; that has been also a matter of major consideration with us. That is one of the various problems that we expected to present to you in the fall when you go into the other program.

Mr. VINSON. Mr. Chairman.

The CHAIRMAN. Mr. Vinson.

Mr. VINSON. Mr. Magill, if we are going to have legislation at this session, do you not think that the question of capital gains and losses and the question of depletion, and the question of community property ought to be passed over for the time, for a comprehensive study?

Under Secretary MAGILL. Your judgment on that would be better than mine as to the legislative situation.

Mr. VINSON. You are acquainted with those three problems, and they are major problems in our taxing law. If we are going to have legislation at this session, do you think it can be gone into thoroughly enough to take action?

Under Secretary MAGILL. As far as capital gains are concerned, I would quite agree with you, I do not see how you can go into that at this time.

Mr. VINSON. When you get into depletion you have a very complex situation, have you not?

Under Secretary MAGILL. Yes.

Mr. VINSON. Of course the legal problems connected with community property that we have already ascertained are quite complex.

Under Secretary MAGILL. Quite difficult.

The CHAIRMAN. I think we all realize that those controversial questions will require more time than we have at our disposal, to get legislation on this immediate proposition we have been considering at this session of Congress. I am thoroughly in accord with Mr. Vinson in that respect.

Under Secretary MAGILL. We are anxious to get legislation on some of those matters that we have presented at this time. That is the reason for presenting them.

The CHAIRMAN. Have you finished for today, Mr. Magill?

Under Secretary MAGILL. The other matter that I had in mind here, subject to your pleasure, is this information that Senator Harrison spoke about that Senator LaFollette wanted and asked for at one of the earlier meetings, in respect to certain personal holding companies that were included in another discussion which had occurred before one of the committees. We have that information ready for presentation if you want it at this time.

Senator HARRISON. I would suggest that the material called for not be filed today, but at our executive session meeting we can determine what if anything further along that line is desired.

Mr. COOPER. Then, Mr. Chairman, I move that we recess until 11 o'clock Tuesday morning, to meet at that time in executive session.

(The motion was agreed to; whereupon, at 11:20 a. m., the committee adjourned until Tuesday, July 6, 1937, at 11 a. m., to meet in executive session at that time.)

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