PART TWO

Public Law: Government Regulation and Taxation

TAX POLICY ASPECTS OF THE CODE

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I DON'T know if my experience has been typical, but while the Internal Revenue Code of 1954 has taken me to many more tax institutes than usual, I have been asked very few questions about it at cocktail parties. The fact is that the new law, described as "the first comprehensive revision of the internal revenue laws since before the turn of the century,"[1] will affect the man in the street less directly than any other major tax bill in recent years. Aside from changes in rates and dependency allowances, the reforms that the average taxpayer has felt in the recent past have been the tax withholding system, the requirement of a declaration of estimated tax, the optional standard deduction, the splitting of income on joint returns, and the head-of-household provision. The only 1954 change of similarly widespread interest is the abolition of the $600 gross income limit for dependent children. The $50 dividend exclusion ought to be of general interest, but for many lower bracket taxpayers it merely legalizes a *sub rosa* exclusion, saving them from a twinge of conscience but putting no money in the bank. The deduction for child care expenses will probably disappoint more taxpayers than it will please; and the retirement income credit is granted only to taxpayers over the age of sixty-five[2] and even to this group it is less important than the 1948 grant of an extra personal exemption. Of the other 1954 changes, the modifications of the deductions for medical expenses and depreciation are each estimated to affect nearly ten million taxpayers, but skepticism of these claims is not unreasonable.[3]

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1 Sen. Rep. No. 1622, 83d Cong., 2d Sess. 1 (1954). A statement by President Eisenhower, issued Aug. 16, 1954, on signing the bill, called it the "first complete revision in seventy-five years."

2 Some taxpayers will qualify on reaching an earlier age. Int. Rev. Code § 37(c)(2) (1954).

3 The Senate Report estimates that 8.5 million taxpayers will be affected by the change in the medical expense deduction. Sen. Rep. No. 1622, supra ,note 1, at 3.

Just as the new Code embodies no tax reforms of the caliber of the tax withholding system or the split-income return, so too it reflects no fundamental economic decisions, except insofar as maintenance of the status quo is the result of a basic decision to stand pat. The only exception is the allowance of accelerated depreciation; but even if investment is stimulated as much as the proponents of the reform hope, it must be set down as an economic decision of a lesser order of magnitude than, say, a decision to impose or lift excess profits or excise taxes in lieu of income taxes. The most important economic decision in connection with the new Code was the defeat of an increase in the dependency deduction. The Eisenhower Administration's principal economic measures in the realm of taxation are embodied not in the 1954 Code, but in its earlier determinations to reduce excise taxes, to allow the excess profits tax to die on December 31, 1953, and not to rescind the 10 per cent individual income tax reduction promised for 1954 by the Revenue Act of 1951.

The 1954 Code, with its multitude of changes in details, then, is a practitioner's—rather than a taxpayer's or economist's—statute. In saying this, I do not mean to minimize its importance, still less to suggest a conflict of interest, but only to place it in proper perspective. It has been suggested that these changes in detail, though of minor individual importance, add up to a major reform, just as the removal of a great many little stones and small trees may give us a highway. Recognizing that this is a matter of judgment, not capable of exact proof, I dissent. If the new Code is better than the old, the proper analogies are not the Merritt Parkway and the Appalachian Trail, nor even the Merritt Parkway and the Boston Post Road.

This is a surprisingly high number, for in the tax year 1949, less than 10 million out of about 52 million individual returns itemized personal deductions, and only about 4.5 million claimed medical deductions. See Statistics of Income for 1949, pt. 1, pp. 5, 32 (1954). While the benchmark for extraordinary expenses has been lowered from 5 per cent to 3 per cent of adjusted gross income, the cost of drugs and medicines is now taken into account only to the extent that it exceeds 1 per cent of adjusted gross income. Moreover, the Senate Report states that "toiletries and sundries" may not be deducted. Id. at 219. If this restriction is applied to toothpaste, mouth wash, hair tonic, skin lotion, etc., it will disqualify items that many taxpayers have customarily deducted on the theory that they possess therapeutic value. "[I]t has been the practice of many taxpayers to deduct amounts spent for pharmaceuticals, which in many cases are not properly classified as medical expense items." Id. at 35. The net result of the 1954 change in the medical expense deduction, then, might be an increase, rather than a decrease, in tax liability.

The Senate Report estimates that 9.6 million individual taxpayers will be affected by the changes in the depreciation allowance. The basis of the estimate is not disclosed. If it constitutes the total number of taxpayers who *might* lawfully use the declining-balance or sum-of-the-years-digits methods, it is a poor guide, in my opinion, to the number who *will* use them. Id. at 3.

What we have, in my opinion, is a series of patches in the highway, with the old roadbed and pavement still carrying most of the load. I do not think many businessmen will feel that they have been unleashed by the 1954 Code. Moreover, I suspect that the new Code would not outsell the old if the new Code cost more. If a vote were taken among businessmen to decide between the old Code with a 3 per cent reduction in the corporate tax rate and the new Code without a reduction, I am confident that the old Code would be preferred. This would not prove that the old Code was better for business, or even that the voters were shortsighted, but it would put matters in balance: 875 pages may not speak as loudly as three little words.

The dividends-received credit, of course, is an important innovation, not so much for its present accomplishments as for the hope it holds out to the financial community for the future. Its immediate future, however, is less promising than it was before November 2, 1954, and in retrospect it may be that the possibility of any substantial adjustment at the individual level for corporate taxes has been greatly weakened by the partisan label that the credit now wears. Even those methods, like the partnership approach to corporate earnings, that take account of the stockholder's individual income, as the dividends received credit does not, have been jeopardized by the symbolic importance that the dividends received credit took on during 1954.

Partly because the future of the dividends-received credit seems wholly dependent upon the course of national politics, the relaxation of the depreciation rules by the 1954 Code seems to me to be its most important technical accomplishment. Aside from their effect on investment, the new rules, together with certain other provisions of the 1954 Code and of several other recent revenue acts, open up the intriguing possibility that the line of demarcation between capital expenditures and current expenses will in time be obliterated.

The first faltering steps in this direction were the accelerated amortization rules of World War II and the Korean War and the limited authorization of the declining balance method in 1946. These provisions, like the much earlier administratively created deduction for the intangible drilling and development costs of oil and gas operators, were confined to special situations and hence until recently did not carry any implications for the basic structure of our tax law. More promising as a growing point of the law was the administrative practice of allowing generous deductions for advertising and for research and development expenses, despite a theoretical basis for requiring many of such expenses to be capitalized. Next, we have the 1950 provision for the deduction of the cost of building up newspaper circulation and the 1951 provision for deducting mine exploration and development expenses. Finally, in 1954, along with the new depreciation rules, have come statutory deductions for research and experimental expenditures and for soil and water conservation expenses of farmers. To these must be added the provisions for amortization of corporate organizational costs and for the rapid amortization of grain-storage facilities.

What we have here, in my opinion, is not an agglomeration of individual items, but a trend that, though leaderless and planless, may become an almost irresistible movement for a taxpayer's option to deduct capital investments, either in the form of a deduction when the costs are incurred or as an allowance for amortization over a very short period. In the absence of some of these provisions, the capital investment would be recovered more slowly through depreciation; in other cases, it would be charged off only upon a sale or other termination of the enterprise. The next steps seem obvious enough: still faster depreciation or outright deduction for new investment by small businesses, for low-cost housing and slum rehabilitation, for construction in hurricane and other disaster areas, for selected industries or geographical localities, for enterprises that guarantee annual wages or high wage rates or new employment, for companies in bankruptcy, for purchased good will, etc. I have no doubt that pressure will build up for an option to deduct, amortize, or depreciate any capital investment. Moreover, the new provision for amortizing corporate organizational expenses suggests that the benefits of a rapid write-off need not be confined to items that would normally be recovered more slowly through depreciation: an obvious candidate for relief is the cost of professional training for physicians, engineers, and lawyers. It seems to me that we have here a device as fecund as percentage depletion and the capital gains concepts were a decade ago, sharing with them the power, for good or ill, to multiply in easy stages, without attracting political attention or opposition but always under the sponsorship of important sectional, industrial, or economic groups. Percentage depletion is now granted to everything but earth, air, and water, and capital gains can now be realized on items that by traditional standards are the quintessence of ordinary income. The write-off of capital expenditures may also spread like wild fire.

Beyond the dividends-received credit and the relaxation of the depreciation rules, in my opinion, the multifarious changes brought about by the 1954 Code neither fall into a perceptible pattern nor point clearly to any future developments. I do think, however, that at least two lessons of general import emerge from the welter of detail:

1. The "old" tax law was either better or more durable—probably both—than it was often credited with being. Again and again, old provisions have been retained or modified only slightly. The most notable of the drastic reforms, the House version of Subchapter C, was abandoned after it was subjected to the light of day. At other points, changes that now seem drastic may prove in practice to be less significant; obviously opinions will differ, but I would put in this category the reference to "reasonably anticipated needs" of Section 102, the mechanism for shifting the burden of proof under that section, the presumptions applicable to collapsible corporations and to acquisitions of "loss" corporations, and some others. There are also some sharp breaks with the past that I do not think will often be exploited, such as the power of partnerships to report as corporations. All in all, the new Code is much closer to the 1939 Code than might have been expected.

I do not attribute this to poverty of imagination, though one must not overlook the pervasive effect that long study of a detailed statute may have on a draftsman; civilized men may crumble under an injunction to strike out into unknown lands. But there seems to have been little or no effort to re-examine the basic premises of the old tax law. Intrafamily transfers, the exclusion of imputed income, the capital-gain-ordinary-income division, the annual accounting period, the uncoördinated transfer taxes on gifts and estates—these characteristics of our tax system are carried forward, with only an occasional change in detail. The function of the personal deductions, the relation of the corporate reorganization provisions to the national antitrust policy, the premium on debt in the corporate capital structure—all the host of troublesome policy issues were, so far as one can tell from the new Code and the committee reports, left untouched. The mechanisms adopted for revision—the questionnaires circulated by the staff of the Joint Committee on Internal Revenue Taxation, the House hearings in 1953 on the "40 topics," the multitude of drafting subcommittees—were ideally suited to correcting "tax loopholes, abnormalities, or anachronistic areas of Internal Revenue Code operation,"[4] but they were not conducive to the largeness of view that brings about fundamental reforms. An outsider cannot be certain, of course, that the basic questions were not taken up, but if they were, the revisers either found themselves in agreement with the so-

4 Silverstein, An Introduction to the Internal Revenue Code of 1954, N.Y.U. 13th Inst. on Fed. Tax. 7, 8 (1955).

lutions adopted during twenty years of Democratic administration or did not think the time was ripe to propose their own solutions. I am more inclined to think that the basic issues were set aside to permit concentration on details. Once the fundamental premises of the earlier law were, for whatever reason, accepted, we were bound to get a statute somewhat like the 1939 Code. Even the most objectionable provisions of that law were not drafted or enacted into law by men who were seeking to sabotage business enterprise. Their policy orientation, either at the outset or under the nudge of interested groups, was not fundamentally different from that of the 1954 revisers. Consequently, it should not surprise anyone that few of their solutions to the persistent problems of tax law have been cast aside.

2. Many virtues have been claimed for the new statute, including greater protection against military aggression,[5] but no one has seriously claimed that it moves in the direction of simplicity. There was, to be sure, "an attempt to express the internal revenue laws in a more understandable manner."[6] Passing the delicate question whether that attempt succeeded,[7] ease of comprehension does not necessarily mean simplicity.[8] There may be places where the new Code is simpler than the old (aside from points where it makes no difference, as in the merger of the normal income tax with the surtax and of the basic estate tax with the additional tax), but I cannot at the moment think of any; while additional complexities have poured out in a torrent.[9] That does not necessarily make the tax a better one,

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[5] See address of Secretary of the Treasury George M. Humphrey before Tax Institute, University of Texas School of Law, Oct. 1, 1954 (Treasury Dep't Press Release H-600, p. 5): "The tax reform law does one other thing which is generally overlooked by our critics. It helps the security of our nation against any potential aggressor. It does this by helping the modernization of our industrial base, upon which all our military strength ultimately rests."

[6] Sen. Rep. No. 1622, supra note 1, at 1.

[7] See address of Secretary of the Treasury Humphrey, supra note 5, at 4: "In addition, of course, we tried to see if we couldn't put more certainty into the law. Economic progress and clarity do have a real connection. As you gentlemen also know, many of our tax laws have been vague and ambiguous. This meant that an individual considering a new venture could not figure for sure just what his tax liability would be. Likewise, because of vagueness, the tax liability might be changed, subject to the personal judgment of a tax official. We feel that more certainty is going to permit hundreds of new ideas to be put into actual business practice."

[8] See address of Undersecretary of the Treasury Marion B. Folsom before American Management Association, Aug. 19, 1954 (Treasury Dep't Press Release H-564, p. 12): "One fact which emerged clearly from our work is that objectives frequently conflict with one another. For instance, clarity is not always consonant with simplicity or brevity, and at many points our efforts to make the new law clear and easy to work with have necessarily resulted in more detailed provisions than those contained in the 1939 Code."

[9] Judge Elbert P. Tuttle, when general counsel of the Treasury Department, said:

but it does show that the revisers, for whom simplicity was originally an aim, soon gave up even lip service to this idol. And rightly so, because a "simple" statute is a forlorn hope; so long as the income tax must raise tens of billions of dollars, we could not tolerate a simple tax law for one day. Without complexity, there could be none of the exceptions, modifications, qualifications, adjustments, and distinctions that temper the blade for the sheep who are about to be shorn. A forthright recognition of this fact would have been salutary, however, and it is a pity that the committee reports say nothing to dispel the myth of simplicity. There may be a lingering suspicion that with more time, or diligence, or talent, or supervision, the revisers would have produced a more simple tax law. If the suspicion exists, it is rooted in fantasy, not in fact.

Closely allied to the hope of achieving simplicity, and equally fated to disappointment, is the hope of ousting the courts of jurisdiction in the construction of tax statutes. The House version of the 1954 Code sought to insure in one area, for example, that "literal compliance" with the statute would be sufficient to achieve a specified tax result,[10] but the Senate Finance Committee was far less enthusiastic about mechanical rules:

> The House bill, in the opinion of your committee, contains several important provisions which, by spelling out detailed rules in an attempt to achieve almost mathematical certainty, would make it difficult for necessary business transactions to be carried out with a minimum degree of interference from the tax laws. . . . Your committee believes that any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks and securities will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments.[11]

The new Code has preserved most of the issues that in the past have had to be repeatedly referred to the judiciary: what is a "reasonable" allowance for salaries; what is "interest . . . on indebtedness"; when does "boot" have "the effect" of a taxable dividend; when is a redemption of stock "essentially equivalent to a dividend"; when do

"The Federal tax system has for some time been called the tax practitioners' paradise. What is meant by this is that our laws are so complex that taxpayers find it necessary to employ professional tax counsel. I have no doubt that tax practitioners can prosper without this kind of artificial subsidy provided at the expense of the taxpaying public." Speech before Sixth Annual Conference on Federal Taxation, University of Virginia Law School, June 24, 1954 (Treasury Dep't Release H-518, p. 6). Artificial subsidy or not, the new Code threatens no tax practitioners with technological unemployment.

10 H.R. Rep. No. 1337, 83d Cong., 2d Sess. A116 (1954).

11 Sen. Rep. No. 1622, supra note 1, at 42.

a number of "steps" make up a single transaction; and many others. In addition, some of the 1954 Code's important innovations require the drawing of lines whose proper location will never be removed from the area of controversy: what is a "substantial improvement" to real estate and when is its value "substantially enhanced" thereby;[12] how does a "fellowship grant" differ from a "gift";[13] when is the receipt of preferred stock in a corporate reorganization "substantially the same as the receipt of a stock dividend";[14] what is "a" trade or business and when is one "actively conducted";[15] what are "rights (contractual or otherwise) to payment for . . . services rendered or to be rendered";[16] and others.

In suggesting that certainty is illusory, I do not mean that whirl should be king. In many areas, the statute can provide stringent rules with profit to all, and there are no doubt times when the administrative and judicial functions should be confined to ascertaining whether there has been "literal compliance" with the statute. The peril is that in the quest for certainty, we will overlook the importance of flexibility. The 1954 Code as enacted has on the whole escaped the sirens of formalism, but here again its lesson is implicit rather than explicit. If the 1954 revisers, with an obvious penchant for statutory rules, found it desirable to leave ample room for judicial judgment, it may be fairly concluded that literalism has no future—at least not while the federal income tax plays the leading role on the federal fiscal stage.

12 Int. Rev. Code § 1237 (1954).
13 Int. Rev. Code §§ 117, 102 (1954).
14 Int. Rev. Code § 306 (1954).
15 Int. Rev. Code §§ 346, 355 (1954).
16 Int. Rev. Code §§ 312, 341, 751 (1954).