1933

Some Historical and Economic Aspects of the Federal Income Tax in United States

Marguerite Lamar

Follow this and additional works at: https://digitalcommons.butler.edu/grtheses

Part of the Business Commons

Recommended Citation
https://digitalcommons.butler.edu/grtheses/107

This Thesis is brought to you for free and open access by the Graduate Scholarship at Digital Commons @ Butler University. It has been accepted for inclusion in Graduate Thesis Collection by an authorized administrator of Digital Commons @ Butler University. For more information, please contact omacisa@butler.edu.
SOME HISTORICAL AND ECONOMIC ASPECTS OF THE
FEDERAL INCOME TAX IN UNITED STATES

by

MARGUERITE LAMAR

A thesis submitted in partial fulfillment of the
requirements for the degree of Master of Science

Economics Department
Butler University

Indianapolis
1933
This thesis entitled "Some Economic and Historical Aspects of the Federal Income Tax Laws" with special emphasis on the 1928 Revenue Act, is divided into three main divisions, namely, first, historical development of federal income taxation in United States, second, income, as viewed by the economist, accountant, and the court, and lastly, the deductions permitted to be taken from gross income in arriving at net taxable income.

A brief introductory chapter is devoted to the presentation of various theories of taxation as held by the leading economists of the world. The purpose of this chapter is the preparation of a background of good taxation theory which may be borne in mind while reading the concept of taxation theory as viewed by the courts and Congress.

The method of approach has been mainly that of presentation of the facts as they now stand, and the theories as held by the economist, the accountant, and the decisions of the various agents of the government, together with my own critical statements. The method of approach in the last chapter was slightly different than in the two preceding chapters, due to the lack of available material regarding the economist's concept of deductions from income.

The most difficult problem encountered in the writing of this thesis was the discrimination between the essential and non-essential material available on the subject of federal income taxation.

I want to thank Dr. Bredenstine and Professor Camp for their assistance and encouragement during the period.
in which this thesis was written. Their valuable suggestions, together with the good books recommended to me on income by Dr. Beckner, aided me in the organization of the material amassed into a comparable form.
## CONTENTS

<table>
<thead>
<tr>
<th>CHAPTER</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. INTRODUCTORY THEORY OF TAXATION</td>
<td>1</td>
</tr>
<tr>
<td>I. HISTORY OF THE INCOME TAX ACTS OF THE FEDERAL GOVERNMENT</td>
<td>1</td>
</tr>
<tr>
<td>II. INCOME AS VIEWED BY ECONOMISTS AND THE 1928 REVENUE ACT</td>
<td>35</td>
</tr>
<tr>
<td>III. PERMISSIBLE DEDUCTIONS FROM INCOME AS VIEWED BY THE 1928 FEDERAL INCOME TAX LAW</td>
<td>85</td>
</tr>
<tr>
<td>CONCLUSION</td>
<td>102</td>
</tr>
</tbody>
</table>
INTRODUCTORY CHAPTER

LEADING THEORIES OF TAXATION

The first important theory of taxation to be mentioned is that of Dr. Taussig. His theory is as follows:

A tax is a compulsory levy. When a city maintains a fire department, improves the streets, maintains a police department and supplies several services free to everyone, everyone in turn is called on to contribute. It is immaterial whether the individual citizen is directly or indirectly benefitted a little or a great deal by the service. A tax is exacted from all alike and without any regard to the use made of the service by the individual.

It would be impossible to maintain these essential services by voluntary contributions. There has been in our history when the danger of peril combined the people's spirits so as to grant sums of money to the government, but under ordinary conditions, it would not be possible to secure the necessary funds by donations. "Men's willingness to support public service does not grow apace with their conviction of the need of the public service." 1

The question of the mode of apportionment is the prime question in the principle of taxation. In what manner shall the individual be compelled to contribute toward meeting the expenses of the public services? Is the system of paying in proportion to gross income more equitable or is the system of paying more than proportion to gross income the best? There are two answers to this question— one conservative and the other more radical. One is a system of proportionally taxation, while

the other is a system of progression.

The system of proportion is quite simple. An individual is compelled to pay only in proportion to his income, and this, of course, leaves the relations between the different incomes undisturbed. The wealthier pay in accordance with their income. The fact that some people are richer than others does not enter into the question. The taxes must be levied and the individuals are compelled to pay for the cost of the public service. Let all be treated alike and pay in accordance to the amount of income received. The social system is considered equitable, by the advocates of the conservatives, and the tax levied would not disturb the existing social order.

The advocates of the progressive system claim that the prevailing social order is not perfect, and that the taxing system is one of the factors which would aid in changing it. This system would compel the very rich to pay, not only in proportion to their income, but more than proportion. This movement has been claimed as socialist and the conservative group have as their argument the phrase of Mc Culloch's that when one you diverge from the rule of proportion, you are at sea without a rudder or compass. The argument that the rich should pay in greater proportion than their income is the mood of the people of to-day.

There have been other theories of taxation, such as, "according to ability" or as the German's express it "faculty"; another, "the equality of sacrifice, but neither system has offered any definite conclusion as to whether it would be more justifiable. The principle of ability does not draw any
definite conclusions on the question of progression. The question arises on the subject of ability as to how this is to be measured. Does the ability increase in proportion to the increase in income? The fact that the burden is not so great on the rich as on the poor, does not mean that the poor do not receive the public service in the same proportion. It is not possible to bring about an equality of sacrifice on the part of the taxpayer. All these problems of taxation lead back to the fundamental question of social justice and under the present system of private property it is impossible to attempt to apply the system of equality of sacrifice.

The second economist to be presented is that of Dr. M. H. Hunter, who defines a tax as "a compulsory contribution, exacted by public authority according to some general rule, the expenditure of which is presumably for the common good without regard to benefits to special individuals."

As regards the future of income taxation, Dr. Hunter, believes that each successive income tax law in the United States has shown progress in eliminating difficulties which were apparent in earlier laws. There are several advantages which have proven helpful in the later laws, such as information at source, in place of personal declaration in arriving at assessable income; corporations may make their return based upon their fiscal year, rather than the calendar year, and payment of the tax may be made in installments, rather than in a lump sum as previously required. The future looks more favorable upon income tax because it has proven so productive. The administrative defects have been eliminated to such a degree that it is the first ranking source of revenue in our federal fiscal system.
One of the most noted tax authorities in the world to-day is probably Dr. Edwin R. A. Seligman. One of his most interesting contributions is the evolution of the theory of "ability to pay." The stages taken are as follows:

1. Poll tax--result of primitive economic conditions
2. Property tax--developed as a result of the unequal distribution of wealth, the poll tax ceases to measure the ability to pay and gives way to the property tax.
3. Expenditure or Consumption taxes--this type of tax came into prominence toward the close of the Middle Ages, and in the sixteenth and seventeenth centuries. Due to the development of the economic order, the measurement of ability according to expenditure has been virtually abandoned.
4. Tax on Product or Produce--this tax was designed to tax only what was actually received. The product was to be measured by outward signs such as location of business, number of clerks, etc. The defects of this system lay in the failure to distinguish between product resulting from the bounty of nature; lack of distinction between the net produce of a piece of property and the net revenue of the owner; and the impossibility of providing a system of progression or regression.
5. Income tax--which is the final state in the evolution of taxation.

Dr. Seligman's final conclusion on income taxation is "there is no doubt that in the struggle for social and fiscal justice the income tax is assuming a continually more prominent part, and if we do not pitch our expectations too high, we can understand why this should be so. Under certain conditions the efficiency of the income tax administration
may gradually be improved, and under most conditions the addition to the tax system of the right kind of an income tax constitutes an undoubtedly step in advance. To ascertain what these conditions are, and what constitutes the right kind of an income tax, is therefore a study eminently necessary. 1

One of the most famous of the economist of the classical school, and perhaps one of the best known economist is Adam Smith. In addition to his contribution to the world of his laissez faire theory, Adam Smith also contributed something in taxation theory. He developed four canons of taxation which are quoted as follows:

1. "The subject of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectfully enjoy under the protection of the state.***

2. The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person***

3. Every tax ought to be levied at the time, or in the manner in which it is most likely to be convenient for the contributor to pay***

4. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over above what it brings into the public treasury of the state." 2

The federal income tax laws have followed the theory laid down by this famous economist many years ago, whether the lawmakers have

accomplished this fact consciously or not is not determinable at this time. The progressive rates of the revenue acts attempt to compel people to pay in accordance with ability and "in proportion to the revenue which they respectfully enjoy under the protection of the state." There is a definite trend in the four cannons that the 

According to Dr. Lutz, author and economist, the requirements for a good taxing system are seven in number and are as follows:

1. Fiscal adequacy—this is, must be high enough in order to secure sufficient revenues for the operation of the governmental functions.

2. Economy—it should operate in order to secure money for the government with the least expense upon the people.

3. Equity—the basis upon which the tax is levied should be fair.

4. Elasticity—the system should be one that adjustments may be secured easily.

5. Simplicity—the wording of the tax law should be expressed in such a manner that all who read it may understand the requirements.

6. Diversity—a number of different taxes collected to make up a whole taxing system.

7. Flexibility—the system should be so constructed as a change may be made with least possible friction.

Our taxing system should aim at social and economic justice. When the tax burden is increased, people began to look to the fair basis of the tax. A taxpayer should pay on the basis of ability or benefits received. It is rather difficult to measure the benefits received when we live, as we do, in a complicated
social and economic system. It is usually the individual who receives the most benefits who is the least able to pay. A sound taxing system should be one in which just sufficient funds are raised as are necessary in order to carry on the functions of the government.
CHAPTER I

HISTORY OF THE INCOME TAX ACTS OF THE FEDERAL GOVERNMENT

Income tax is the most recent form of taxation, and its modern aspect had its beginning in Great Britain in the Act of 1799 as a measure of the Prime Minister, William Pitt. The Pitt Act was amended by the Acts of 1803 and 1806, and was temporarily repealed in 1816. A new act, based upon the content and the experience of the old, was passed in 1842, and in 1869, Gladstone found in it a ready means of raising more revenue by the simple expedient of increasing rates. It was not until 1910 that Great Britain introduced, under the sponsorship of Lloyd George, the system of progressively increasing rates by means of a graded surtax.

Development of Income Tax in United States.

Income taxes in the United States date back to the colonial period. In 1646, a law was passed by the Court of Assistant of the Massachusetts Bay Company to tax produce from estates. The Assembly of Rhode Island in 1673 passed a law taxing the profits of merchants and tradesmen, and in 1684 a similar bill was passed by New Jersey. While these taxes were not fundamentally on income, they show definitely the trend toward income taxation as opposed to a land or property tax. Shortly before and during the Revolutionary War, taxes on the salaries of various professions were passed in Pennsylvania, Delaware, and Maryland. Massachusetts, in 1777, passed a law taxing all taxpayers on the amount of money accruing from business sources. Later several other New England States
adopted it, but abandoned the law before the end of the 18th century, except Massachusetts, who has not repealed it, but the law is not in force to-day.

The first suggestion of a federal income tax was made in January, 1815, by Secretary Dallas as a means of securing funds to finance the war which was going on at that time. Had the war lasted about two months longer, there probably would have been some taxation on incomes, as Secretary Dallas stated that income tax would prove to be a very fruitful sort of revenue.

There was no further consideration given this form of taxation until the outbreak of the Civil War. In order to trace the development of the Federal Income Taxation, it is convenient to divide the development into the following groups.

I. Acts passed during and immediately after the Civil War.

II. The Act of 1894, which was declared unconstitutional immediately after its passing.

III. The Corporation Excise Tax of 1909.

IV. The Income Tax Acts since 1913.

Each of these topics will be taken up in order given.

Acts passed during and immediately following the Civil War.

In order to meet the increased requirement for funds to carry on the Civil War, Congress, on August 5, 1861, passed the first income tax law which provided for a levy of three per cent on the annual income of every person residing within the United States, who had a net income from all sources, in excess of $800.00. The rate was five per cent upon incomes "Accruing upon any property, securities or stock owned in the United States" by citizens residing outside the United States.
The tax levied on incomes derived from interest on Treasury notes and other securities of the Government was fixed at only \( \frac{1}{2} \) per cent. Congress evidently believed that income tax was not a direct tax and could be applied without apportionment, and its constitutional rights were not questioned. Under this Act no funds were collected because the Act provided that the tax was not payable until June 30, 1862. By spring of 1862, a new revenue bill was prepared which was known as the Act of July 1, 1862. This Act was to go into effect on December 1, 1862, and to be in force for four years, thus no income tax was actually levied until 1863.

There were many features set forth in the Act of 1862, but only the income taxation section will be discussed. In this Act, the levy on the entire annual incomes of people residing abroad was five per cent, and three per cent on the annual income from all sources whatsoever of every person residing in the United States. A new feature of rate differentiation was introduced in this bill. The rate was five per cent on incomes in excess of $10,000.00 with an exemption of $600.00 for all people residing in United States. The one and one-half per cent rate on incomes derived from Treasury notes and Government Bonds was also a feature of the Act of 1862. Another exemption feature was introduced in this Act—that of Federal Government officials who were permitted to deduct the total amount of salary received from the Federal Government in excess of $600.00, in spite of the fact that they were specifically taxed at the flat rate of three per cent of their salaries above the specific exemption of $600.00 under another section of the same law. The tax on governmental officials' salaries was to be
deducted at time of payment of salaries. In addition to a tax on gross receipts of certain specified corporations, railroads were required to withhold and pay over to the government as a tax, three per cent on the interest of their bonds and the dividends of their stocks, likewise were banks, trust companies and saving institutions required to pay over a duty of three per cent on dividends and on assessments added to their surplus or contingent funds. The Act also had a provision whereby "all gains, profits on income derived from advertisements, or on any articles manufactured, upon which specific stamp and ad valorem duties shall have been directly assessed or paid" should be deducted. This provision could be interpreted to mean that all business income could be exempt as the tax on manufactured articles practically applied to nearly all commodities, and business incomes might be interpreted as meaning income derived from dealing in these commodities. Fortunately, this badly drawn up provision was not taken advantage of, and the Act of the following year removed all danger by the elimination of the words "or on any articles manufactured." This same amendment also provided for the deduction of rent paid for dwellings from a taxpayer's income.

The tax was to be levied for three years, beginning in July, 1863. Everyone was required to make a return on his income on a list or schedule to the assessor or assistant assessor. In case the income was not reported or the individual refused to report same, the assessor was to assess the income at his discretion. If the assessor felt that the income was understated, he was privileged to increase the
amount. If an individual, under oath, declared that his income was less than $600.00, he was exempt from payment of an income tax.

The law was put into force in July, 1863, but it was some time before the machinery was in working order. The first two months of the fiscal year of 1863-64 yielded $173,700 on incomes below $10,000; $277,461 on incomes above $10,000; $1872 on incomes from abroad, and $3637 on interest on bonds. The Commissioner of Internal Revenue in his report on December, 1863, stated that "the present tax laws on the whole have been not merely endured, but welcomed by the people in a manner it is believed elsewhere unparalleled." 1

The Act of June 30, 1864, was enacted because of the increased demand for revenue to meet the expense of the war. This Act continued the $600.00 exemption feature, but changed several rates. The rate of five per cent was levied on incomes in excess of $600.00 to $5,000.00; seven and one-half per cent on incomes in excess of $5,000.00 and not exceeding $10,000.00, and ten per cent on incomes exceeding $10,000.00. The provision for deduction of house rent was limited to two hundred dollars, and that if a man lived in his own house, he was also permitted to deduct $200.00. Banks, trust companies, savings institutions, and insurance companies were taxed at a rate of five per cent on their dividends. Railroads, canals, turnpike and slack water companies were taxed five per cent on their dividends and interest on bonds, and the amount of the taxes were to be deducted from the sums due the security holders. Salaries in excess of $600.00 per year

1 Report of the Commissioner of Internal Revenue for the year ending June 30, 1863, Washington, 1864, pp 183-184
were taxed at five per cent. This tax did not make a distinction of rates as applied to people living abroad. The net profit from the sale of real estate or loss by sale of same, should be declared during the year the sale was made. A provision was made for the allowance of taxes paid by corporations for individuals. Allowance was made for repairs which was not to exceed the average for the five preceding years, but no allowance was to be made for any amount paid out for new buildings, permanent improvements, or any betterments to increase value of property or estate. The foreign council of another country was also to be exempt, provided that reciprocal privileges were granted by foreign governments. The tax on gross receipts of steamboat and canal companies, two and one-half per cent, while toll roads, ferries, and bridge companies paid three per cent, but this increase in taxation might be added to the rates charged. Express companies were taxed three per cent, insurance companies, one and one-half per cent, telegraph companies, five per cent, theatrical and similar enterprises, two per cent, lotteries, five per cent, advertisements, three per cent. All companies were compelled to send in statements of gross receipts annually. In case the firm neglected or refused to turn in a statement, ten per cent fine was to be added. Any attempt at evasion was to be punished by a fine of $1,000.00.

The Act of 1864 has served as a model for all future income tax acts. Before the Act was put into operation, several amendments were added which made up the Act of March 3, 1865, which increased the rates to five per cent on incomes in excess of $600.00 up to $5,000.00, and ten
per cent on incomes in excess of $5,000.00. The administra-
tive section of the Act was improved in several particulars.
The assistant assessor was required to secure the oath of
every individual making the return that the report was correct,
and if there was reason to believe it understood, the
officer had authority to increase same. In case an individual
failed to make a return, the assessor, or assistant assessor,
was required to make out a report to the best of his knowledge
and ability from the examination of such books and accounts
as available. A fine of twenty-five per cent was to be added
in this instance, and in case there was a fraudulent return,
the fine was to be one hundred per cent, and possibly a fine
of $1,000.00, or imprisonment for not more than one year, or
both. If the assessor increased the return of an individual,
the taxpayer might appeal to the assessor in the district
showing books of account or other evidence in order to prove
the case. The individual also had the right to appeal finally
to the Commissioner of Internal Revenue. This Act of 1864 was
to continue in effect up to and including the year of 1870.
In a report of December, 1864, by Secretary of Treasury, it
was stated that "from the results of experience, as well as from all the information received, the Secretary is
well convinced that much revenue fails to be collected
through an imperfect execution of the law, and more through a
fraudulent evasion of its provisions." Time and effort will, it
is hoped, remedy these evils in a great degree, and the
confident expectations of those who framed it be realized.
In the meantime, no effort should be spared to perfect the
as far as possible, and no experiment to increase its
efficiency, of which there is reasonable hope of success, should
be left untried."

The Commissioner of Internal Revenue, in his report of the same period discussed the improvements of that time. During the fiscal year ending July, 1864, the income tax yielded over $23,000,000.00. In this same report, the Commissioner called attention to the difficulties connected with the assessment of farmers' incomes and stated that "the best test of the yearly income derived from real estate is its rental value. A rule requiring such income to be assessed on that value would be conveniently practicable, and would obviate the necessity of the vexatious inquisition now required in ascertaining the comparative value of live stock at different periods of the year, the amount of butter, beef, mutton, pork, cheese, wool, hay, grain and other products sold or on hand. Estimates of these must needs be very unequal and returns incomplete, so that the burden of the tax is unequally distributed."  

With the close of the Civil War the question arose as to whether or not income tax should continue. The maximum amount collected in any one year during this period was $75,000,000.00 which was in 1866, while the total amount received under these Acts of the Civil War period was $375,000,000.00. There was a great deal of discussion after the close of the war regarding this system of revenue. Especially at this time there was a need for a system that would produce the needed revenue. In the winter of 1866-67,

1 Report of the Secretary of the Treasury for 1864 (p. 15)
2 Report of Commissioner of Internal Revenue for 1864 (p. 5)
the subject was brought up again to Congress who decided to impose a tax of five per cent on all incomes over $1,000.00. This was the Act of March 2, 1867. Income was decided to include the profits from the sale of real estate purchased within a year or two years previous. A tax was also placed on all premiums on gold or coupons, but the Act did not state whether such premium was to be taxed if only realized. The farmer's income also received some amendments. The new law provided that income from the sale of live stock was to be taxed. The previous laws had held taxable the amount of live stock. Deductions for losses sustained during the year were permitted. There were some administrative features which provided that the delay in payment was changed from ten per cent to five per cent with interest at the rate of one per cent. The penalty for failure to declare income was increased from twenty-five per cent to fifty per cent, and one hundred per cent for fraudulent returns. The date of assessment was also changed from May 1 to March 1, and the date the tax was payable was changed from June 30 to April 30. Mechanics or laborers employed by public works were exempt from payment of tax.

The income tax was to expire in 1870. The readiness with which people submitted to the taxation of income was not evidence and diminished each year. The Commissioner of Internal Revenue, in his report of December, 1869, declared his favor in the continuance of the Income Tax Law by stating that "whether we can part entirely with the receipts from this source of revenue, and if not, whether any substitute can be devised more just and equitable, and less burdensome.
My opinion is that, so long as a large internal revenue is required by the official necessities of the government, a portion of that revenue should be collected from incomes. The reasons for this seem apparent and forcible. This tax reaches simply the profits of trade and business, and the increased wealth of individuals from investments."

On June 1, 1870, Congress again took up the matter of income taxation. The Committee of Ways and Means had reported a bill to reduce the revenue by nearly thirty-four millions, but did not provide for the abandonment or reduction of income tax, giving preference of abolishment of inheritance tax, sales tax, gas tax, tax on gross receipts and many other special taxes. The important factor introduced in this bill was the exemption up to $15,000. After many heated debates, the House voted to continue the tax, increase the exemption up to $2000.00, and reduce the rate to three per cent. It was then taken to the Senate where it met with definite opposition. The Senate voted to strike out the House's income tax bill by 34 to 23. When the reports of the deficit came in the amount was larger than anticipated, and with the abolishment of the income tax, the situation reached a critical point. The problem was turned over to the Committee on Finance for further consideration. The problem was finally settled by imposing a tax for the years 1870 and 1871, at a rate of two and one-half per cent on incomes over $2,000.00. The Act also contained some important changes in administration, such as, only individuals receiving incomes in the excess of $2,000.00 were required to submit a report; that no official was permitted to publish in any
manner income reports except general statistics without the individuals' or firms' names; that the assessor could not increase an individual's return without first advising the individual who made the return; the last one was that no penalties were to be imposed upon individuals failing to make their return unless they were advised by the assessor and given reasonable time to appear and their case heard.

These changes mentioned above applied to the income tax proper. The tax as it applied to salaries and on government securities was confusing. The confusion arose regarding assessment dates. When the tax was first applied in 1862, the periods of assessment were different. The income tax proper was always assessed on income of the preceding year, while the taxes on salaries, interest and dividends were levied as they came due and were paid. When the law of 1862 went into effect on August 1st, interest, dividends, and salaries were taxed only from that date, while taxes on income proper received were assessed for the preceding year. This disparity was pointed out during the many discussions of 1870. Senate, as a result of this, voted that income tax proper to end on August 1, 1870, and that the tax on interest, dividends, and salaries, would continue until August 1, 1871, so that there would be equality between the two. When it was deemed necessary that the tax continue beyond the year of 1870, this disparity was lost sight of, and it was finally decided that tax on interest, dividends, and salaries should continue only through the year 1871. The final outcome was that the old five per cent tax on dividends and salaries continued until August 1, 1870, and the new rate of two and one-half per cent, was levied during
the year 1871. With the close of 1870, the tax on salaries and dividends ceased, while the rest of the income tax was still assessed in 1872, although it was on income received in 1871.

The fiscal condition of the country was improving very rapidly, and after 1872 no one ventured to vote the continuance of income tax. A motion was made in 1871 to discontinue it immediately, but it was not carried. The income tax was permitted to die a natural death in 1872 as it was not needed for revenue purposes.

The fallacies of the Acts of the Civil War period may be summed up under those which resulted as mistakes of theory, those which resulted in exaggerated exemptions, others may be characterized as laxity of administrative methods and defective provisions.

The theory of the tax was a mistaken one because so far as we know, there are only two kinds of income tax, stoppage at source and lump sum. The stoppage at source method of income tax was only slightly adopted by the Civil War legislators and this applied to the salaries of governmental officials and the securities of certain designated corporations. The other method of collection of income tax was the lump sum. There was no reason why the theory of stoppage at source could not have applied to all corporations instead of a designated few and also, why this method was not applied to all salaries of people employed in corporate organizations as well as to the income from corporate securities. Had the theory of the tax been applied to all, as a stoppage at source tax, the probable
The second shortcoming of the Civil War Income Tax Laws was the fact that exemptions were too high. This high exemption, especially after 1870, opened a way for much evasion and fraud.

The laxity of the administrative system was keenly felt. It is very essential to have good administration regarding the assessment of incomes. The fact that everyone was required to hand in returns necessitated good supervision. The greatest mistake in administrative activities was in the powers given to the assistant assessors. The assistants could ask questions and even could demand access to the books of the taxpayer. It is true that the question would not have to be answered, but a failure to answer might lead the assistant to believe that fraud was being attempted, and as it was not until one of the later acts that the taxpayer was protected from additional assessment without notifications, his tax could be raised without any recourse.

One of the grave mistakes of this period was the fact that, as these men were poorly paid, the ones employed were usually not prepared to attempt the work. In a number of cases the men were bribed and made any sort of bargains which were possible with the taxpayers. The publicity which were given the returns at first, also caused a great deal of evasion of the law as it was not until 1870 that any sort of secrecy was provided for.

There were mistakes in principle which caused no end of confusion as the law itself was confused and indefinite regarding certain aspects. The chief ones of this nature
were the uncertainty of the calculation of farmer's profits, the sale of real estate, and the rental value on homesteads.

The Civil War Income Tax laws accomplished a great deal regarding the fiscal returns as yielded at that time over one quarter of the entire revenue of the country at a time when funds were needed to meet outstanding debts. The fault of the tax lay in its administration and theory. Evasion was exceedingly common and during its last year, the income tax became thoroughly unpopular.

Income Tax Law of 1894

When Cleveland became President in 1893, the financial condition of the country was at a very low ebb. It was necessary that some sort of revenue be provided for the government, as it was facing a serious problem of eliminating its deficits.

The first indications of an income tax was made by Congress in December, 1893, which was to apply on corporations' income. This bill met with the favor of President Cleveland, but was opposed to by many of the leading members of Congress. There were many debates carried on regarding the pros and cons of income tax. It was finally made a law August 28, 1894, without the signature of the President. It was fashioned after the old Civil War Acts. Its chief features were:

January 1, 1896, was the date that tax was to begin. The rate was two per cent on an excess above $4000.00, and all "gains, profits, and incomes derived from any kind of property, rents, interest, dividends, or salaries, or from
any profession, trade, employment or vocations" were to be classed upon which the as income. The preceding calendar year was the period the tax was to be levied. It applied to people residing in the United States, or those who resided abroad, but received their income from the United States.

There was an important section of the act which was devoted to the explanation of income and what constituted income under the act. The chief points of the act were:

Income was to include all interest from securities except federal bonds and taxable as such. Profits from sale of real estate purchased two years previous was to be considered as taxable income. The farm was to include all fruit, produce, and any stock sold during the year, less expenses, and less his own consumption of goods. Any property inherited or received by gift was income. No improvement or betterment of real estate was considered deductible, although one would be permitted to deduct the expense incurred in carrying on an occupation, interest on indebtedness, losses actually sustained, and bad debts. The individual was not compelled to include taxes paid at source by other individuals or corporations. Salaries of state, county, or municipal officer were to be exempted from income taxation.

Included in this Act was a tax on corporations, companies, or associations operating for profit in the United States, but not including partnerships. The rate was to be the same, but abatements were not allowed. The income of corporations was decided to include profits after deductions of expenses, operating and business, interest on bonded or other indebtedness. The income was to include any amounts to which any funds were applied from
net profits. This tax did not apply to any municipalities, states, counties, building or loan associations, charitable institutions, religious or fraternal orders, mutual insurance companies, savings bank or societies under certain conditions.

Any person of lawful age, receiving income over $4,000.00 was required to make out a return of income to the Collector or Deputy Collector. The Collector or Deputy Collector was required to secure the oath of the individual filing the return that it was accurate. The amount of the return might be increased if there was doubt regarding the truthfulness of the report. Fraudulent returns were penalized fifty to one hundred per cent. These changes in the report were not to become final unless the individual was given sufficient time to plead his case. The Commissioner's judgment was final. If an individual refused to make or made a false return, the collector had the right to inspect the books and compel the individual to give information so that the correct or report be filed.

Every corporation or business association was required to make a return of its full profits even if such profits were more or less than $4,000.00. The books might be inspected also in this case if there was any reason to expect any fraudulent or refusal to make a report of income. Fraudulent reports were fined fifty per cent. Government officials' tax was to be paid at source.

July 1, was the date decided upon for payment of the tax beginning for a period of a year that ended the proceeding December 31st. Interest at twelve per cent and a penalty of five per cent was to be levied on all delayed payments.

The Act provided for the secrecy of returns. No official of the government was to divulge any fact contained in an income tax report or permit anyone to see a report of another individual
not authorized to by law. The law prohibited the printing of any material regarding the income return of an individual. The violation of these provisions was to be punishable with a fine of $1,000.00 or imprisonment not exceeding one year, or both.

The many defects of this law may be mentioned as follows:

1. The $4,000.00 exemption did not apply to corporations, thus, if a man received $3,000.00 from corporate dividends, it was taxable, while the same amount from another source would be exempt from taxation.

2. The tax applied to all personal property received from gifts or inheritance, and this was not fair because inheritances are not regular and are generally taxed by states. If a man received real estate as a gift there would be no taxation.

3. The act did not exempt the salaries of the President and Federal Judges.

4. There was no provision made for the collection at source except in the case of the Federal employees.

5. Farmers were permitted to deduct food consumed for their own use, therefore, it was not fair to all taxpayers.

6. No distinction was made between earned and unearned income, nor was there exemptions allowed for the size of the family.

This income tax law was rendered unconstitutional by decisions of the Supreme Court of the United States. There were several decisions rendered by the Supreme Court which had a bearing upon the Act of 1894.

These decisions are:-

1. Hylton vs. United States, 3 Dallas 171 (1796)
2. Pacific Insurance Co., vs. Soule, 7, Wallace, 433 (1868)
3. Veazie Bank vs. Fenno, 8, Wallace 231 (1874)
The clause involving each of these cases were "Representatives and direct taxes shall be apportioned among the several states which may be included within this Union according to their respective numbers, which shall be determined by adding to the whole number those bound to service for a long term of years, and excluding Indians not taxed, three-fifths of all other persons." "No capitations or other direct tax shall be laid unless in proportion to the census hereinbefore directed to be taken."

The first decision was in regard to a tax on carriages which could not be laid by the rule of apportionment without great inequality and injustice, and, therefore, the constitution could not have intended them, that an apportionment should be made. The Court held that the tax on carriages was an excise tax, therefore, indirect. Chancellor Kent made a remark of this case saying that, "The better opinion seems to be that the direct taxes contemplated by the Constitution were only two, namely, a capitation or poll tax, and a tax on land."

The second case was concerning the validity of tax on receipts of insurance companies from premiums. The court held unanimously that the taxes were not direct taxes, therefore, valid.

The third decision which was rendered by Chief Justice Chase, was that a tax of ten per cent upon the notes or circulation of state banks was not a direct tax, therefore valid.
The fourth case held that inheritance taxes were valid, that is, indirect taxes, under the Acts of June 30, 1864 and July 13, 1866.

The last decision concerned itself more closely with the income tax law, as it was held by Mr. Justice Swayne that, "The central and controlling question in this case is whether the tax which was levied on the income, gains, and profits, of the plaintiff in error, as set forth in record is a direct tax" and he added his decision with "Our conclusions are that direct taxes within the meaning of the Constitution are only capitation taxes as expressed in that instrument and taxes on real estate, and that the tax of which the plaintiff in error complains is within the category of an excise or duty." 1

There is same inconsistency in this decision in that a tax on real estate is a direct tax and a tax on income is a duty tax. This inconsistency was not overlooked because after the passing of the Income Act in 1894, Charles Pellock of Massachusetts brought suit against the Farmers Loan and Trust Company. He charged that the firm was going to pay a tax of two per cent on the income in excess of $4,000.00 which payment would lessen the profits to be distributed to the shareholders. It was held that the law was unconstitutional, null and void, for numerous reasons, and among others, because the income of the Trust Company was in part, from real estate, and from stock and bonds of states of United States and counties and municipalities.

1 Springer vs. United States, 102, U. S. 586 (1880)
At this same time, many other cases were being prepared regarding the problem involved in the case of Pollock vs. Farmers' Loan and Trust Company. Briefs were being prepared by prominent men for and against the validity of the income tax. Some attacked it on its lack of uniformity, others, its discrimination, and others still argued that it was a direct tax in accordance with the terms of the Constitution.

Those in favor of the tax asserted that it was not a direct tax, that the uniformity required by the Constitution was simply a geographical uniformity, that a tax on income was not a tax on land, especially since much land does not produce income.

The final decision regarding the Income Tax Act of 1894 was rendered by Chief Justice Fuller, who held that:

"A tax on rents or income of real estate is a direct tax within the meaning of that term as used by the Constitution of the United States. A tax upon the income derived from the interest on bonds issued by municipal corporations is a tax upon the power of the state and its instrumentalities to borrow money, and is consequently repugnant to the Constitution of the United States." 1 The Court also held that as much as the Act as provided for levying taxes on income derived from real estate or from interest on municipal bonds was invalid.

There were three questions upon which the court was equally divided, namely:

1. Whether the void provision as to rents and income from real estate invalidated the whole act,
2. Whether as to the income from personal property was to be considered a direct tax and render the act unconstitutional, and

3. Whether any part of tax, if not considered as a direct tax, was invalid for want of uniformity.

The Pollock case was rendered April 8, 1895, which definitely showed that no income tax could be levied without Constitutional amendment. On May 20, by a bare majority of one, the income tax law was held to be unconstitutional. The conclusion of the Court is summed up as follows:

1. "We adhere to the opinion already announced, that taxes on real estate being undisputably direct taxes, taxes on the rents or incomes of real estate are equally direct taxes.

2. We are of the opinion that taxes on personal property or on the incomes of personal property, are likewise direct taxes.

3. The tax imposed by section twenty-seven to thirty-seven, inclusive of the Act of 1894, so far as it falls on the incomes of real estate and of personal property, being a direct tax within the meaning of the Constitution, and, therefore, unconstitutional and void because not apportioned according to representation, all those sections constituting the entire scheme of taxation, are necessarily invalid."

Thus was the fate of the Act of 1894.

The Corporation Excise Tax of 1909

Section thirty-eight of the Act of Congress of August 5, 1909, entitled "An Act to provide revenue, equalize duties and encourage the industries of the United States, and for other purposes" provided that certain corporations, joint
stock companies, and insurance companies should be "subject to pay annually a special excise tax with respect to the carrying on or doing business by such corporation, joint stock company or association, or insurance company, equivalent to one per centum upon the entire net income over and above five thousand dollars received by it from all sources during such year."

This law was passed without the customary long debates and exceedingly hasty in the closing hours of a long session. Among its unusual features was the fact that this bill was never before the House for consideration or vote which was very different since all revenue bills are to originate in the House.

Some thought that since the Act, according to its title, proposed to "encourage the industries in United States" would not single out industrial corporations for taxation.

The corporation act grew out of the proposed "war tax" of 1898. This bill provided a right to tax the franchise of corporations on the basis of their gross earnings, or receipts, and it emanated from the Senate Finance Committee as an amendment to the revenue act. This bill met with so much opposition that Congress finally passed the "Sugar-Trust" and "Standard Oil Trust" Act in place of it. This act provided that every corporation or company which refine petroleum or sugar or controlled any pipe lines for transporting oil or other products, and whose gross receipts exceeded $250,000.00 such corporations would be required to pay annually a special excise tax of one quarter of one per cent on all gross receipts.
At once this bill was claimed to be unconstitutional and that it conflicted with all the principles laid down in the Pollock case. A case, the Spreckels Sugar Refining Company vs. Mo Olain, in which the law was deemed constitutional by the Supreme Court. The decision was very important because it not only retracted the decision in the Pollock case, but it provided a means by which the constitutional restrictions of direct taxes might be avoided. The corporation tax act of 1909 was not proposed and passed as a desirable addition to the fiscal system. Its purpose was to defeat the general income tax and raise money to meet a temporary deficiency.

The first and most important case brought to court under the new bill of 1909 was the case of Stella P. Flint, General Guardian vs. Stone-Tracy and Company. The Supreme Court held that this was an indirect tax and that assessment would include not only income directly from business, but also income from municipal bonds and from other property not directly or actively used in the corporate business. Mr. Justice Day stated that the difference between the Income Tax of 1894 and the Corporation Excise Tax of 1909, "is not merely nominal, but rests upon substantial differences between the mere ownership of property and the actual doing of business in a certain way. The tax directly on income from property has an element of absolute and unavoidable demand which makes it a tax on property merely because of its ownership. In taxes on privileges the element of absolute and unavoidable demand is lacking." 1

Before the Sixteenth Amendment, the cases which arose of the various taxes levied by the federal government, showed definitely that taxes on acts or occupations are excise taxes, which may be levied by the Government without apportionment among the States according to population. Excise taxes were not to be limited to the manufacture and sale of commodities, was in the trend of view at that time.

The Sixteenth Amendment to the Constitution was brought about by an urgent need for the right to levy a direct tax upon income of the people of the United States without apportionment according to population. The amendment marks an advance in the political history of the country, as it strengthened the power of the central government in time of war so that it could secure funds without increasing tariff.

Senator Brown, of Nebraska, proposed the Amendment on April 28, 1909, which was "Congress shall have the power to lay and collect taxes on incomes and inheritances, from whatever sources derived, without apportionment among the States, without reference to any census or enumeration." After some debate and discussion, the amendment was changed to read "Congress shall have power to lay and collect taxes on income from whatever source derived without apportionment among the several states, and without regard to any census or enumeration."

The Senate passed the resolution on July 5, 1909, by unanimous vote and the House a week later by a vote of 318 to 14.

1. Congressional Record, Vol. 44, pp 4109, 4120
The Amendment was then passed on to the States for consideration when the various legislatures convened. The Amendment was finally declared ratified by the States, February 25, 1913. This Amendment made constitutional the levying of income taxes by the Federal Government without apportionment. President Wilson, on October 3, 1913, signed the Revenue Act of 1913, the first of a series of income tax acts. It became effective on March 1, 1913. Although the law was passed October 3, 1913, retroactive to March 1, 1913, it was in effect only ten months of 1913. The Act provided for a normal and graduated surtax on individuals and a flat rate on corporations. Corporations paid for the entire year of 1913, so it can be said that the Excise Tax of 1909, was absorbed by the Revenue Act of 1913. The Act of 1909 provided for an exemption of $5,000.00 for corporations, but this exemption was discontinued by the new law, but the one per cent rate remained unchanged. Individuals were allowed an exemption of $3,000.00, and $4,000.00 if married and living with spouse. The rate was also one per cent for amounts above $3,000.00 or $4,000.00 depending upon the individual who made the return. The surtax was one per cent on incomes above $20,000.00 up to $75,000.00; three per cent over $75,000.00 to $100,000.00; four per cent on $100,000.00 to $250,000.00; five per cent on $250,000.00 up to $500,000.00; and six per cent on incomes over $500,000.00.

The Act included the stoppage at source clause and a self assessment system, which was a feature of the Civil War Acts and was practiced under the excise law of 1909. The
Government provided blanks for the self assessment feature, and the taxpayer filed information which served as the basis for the calculation of the tax.

The constitutionality of the graded surtax was attacked on the basis that it was repugnant to the due process clause of the Fifth Amendment, and that the maximum rates were confiscatory within the meaning of the same amendment. The Supreme Court declared the surtax of 1913 legal and constitutional.

The date, March 1, 1913, remains the basic date for calculating values of property up to the present date.

The Revenue Act of 1916, was passed on September 8, 1916, effective January 1, 1916, for the purpose of securing more revenues than obtained under the Act of 1913. This Act included specifically non-resident aliens. The provisions for deductions were extended to include those losses which occurred from activities entered into for a profit, and a loss resulted, even though it was not connected with the taxpayer's regular business. The normal rate for individuals and corporations was increased to two per cent and the surtax rate was also considerably increased.

The greater need for funds was the reason that the Act of March 3, 1917, was passed which increased rates over that of 1916. There were few taxes collected under this act, the only ones were those of corporations whose fiscal year ended in the spring and summer, such corporations paid taxes subject to the Act of October 3, 1917. This later Act was passed as an amendment to the Act of 1916 and effective as of January 1, 1917. The phrase "information at source" was substituted for "stoppage at source" except in the case of non-resident aliens and the case of tax-free bonds. At about this same time,
the Excess-profit Tax Act of March 3, 1917, was passed which taxed the "business income" of individuals, partnerships, and corporations. This was actually a war measure, as United States entered the World War on April 6, 1917. Normal and surtax rates were increased, and the excess-profit tax rates were as high as sixty per cent in some instances. Deduction of excess-profit tax was permitted against the income of an individual or corporation's income, both for normal and surtax purposes.

A complication arose which was difficult to solve due to the fact that the tax rates of 1917 were superimposed upon the 1916 levy. The Revenue Department was confronted with the problem of applying varying rates of two separate laws to the income of a given year. The normal and personal exemption for 1916 remained in force, but there was another rate of two per cent imposed upon individuals, with the exemption of $1,000.00 for single people, $2,000.00 for married persons living with spouse, or heads of families. An exemption of $200.00 for each dependent other than spouse was another feature of this Act under the normal rates. A rate of six per cent was levied upon corporations by adding a four per cent tax to the two per cent tax provided by the 1916 Act. Surtax rates, ranging from one per cent to five percent were superimposed upon those of the 1916 law. The maximum surtax rate for 1917 was sixty-three per cent; normal tax, four per cent, a total tax of sixty-seven per cent. This was the highest rate ever levied before.

The Excess-Profit Tax of the 1917 Act provided for an excess-profit tax on business income in excess of a certain
exemption. With the exception of a flat rate of eight per cent, the rates were graded and applicable to different brackets, each bracket being subject to a specified rate of excess-profit tax, and each bracket being dependent upon invested capital. For example, 20% of net income between excess-profit credit and 15% of invested capital, was the rate imposed upon the first bracket.

Domestic corporations were entitled to an excess profit credit of $5,000.00, and domestic partnerships, citizens, or resident aliens, were entitled to a $6,000.00 credit. Foreign corporations and partnerships and non-resident aliens were entitled to a credit of the same percentage of invested capital for the year in which the average annual net income of the pre-war period, (1911, 1912, 1913) was of the invested capital for the same period, was more than nine per cent. If the invested capital could not be ascertained, the credit was determined by taking the average credit for trade of industry involved. Where the invested capital was nominal or could not be ascertained, the rate was eight per cent of the net income in excess of the specified exemption mentioned above.

The war expenditures were so great that the revenues secured from the Act of 1917 was not sufficient, so this increased demand for funds necessitated the passing of the Income Tax Act of 1918. Before the President signed the bill, the war was ended, but the bill was passed and became effective as of January 1, 1918. It was unlike the law of 1917, it was a revenue act by itself. Congress had employed the services of many expert tax authorities in the construction of this law as well as the cooperation of the citizens who volunteered their services, in order to aid the important war measure.
There was some technical improvement in this law, but in spite of this, the Act merely promulgated the faulty Act of 1917.

The excess-profits on individuals and partnerships was discontinued, but the rates imposed upon corporations were as high as eight per cent. The same Act provided for reduction in 1919 and subsequent years of the income tax rate, which was twelve per cent, and the surtax, the maximum rate which was sixty-five per cent, but only a nominal reduction. The rates reduced were, income tax rate to ten percent, maximum surtax remaining at sixty-five per cent, while the excess profit rates were reduced to twenty per cent for the first bracket, and forty per cent for the second bracket. It is to be noted that the year 1917 was the only year that individuals and partnerships were subject to any excess-profit tax and that 1917 was the first year that partnerships were subject to any form of tax. All previous income taxes were levied on individual members of a partnership, but not the members as a partnership. The individual partners still paid taxes in 1917, but the partnership paid the excess profit tax, which was deductible from the income of the individual members of the partnership in the determination of their net income for tax purposes.

The Revenue Act of 1921 became a law with the signature of President Harding on November 23, 1921. The Act was effective as of January 1, 1921. The excess-profit tax on corporations was continued only for the year of 1921, but the rate was increased from ten per cent to twelve and one-half per cent. The law was, in the majority of its sections, similar to the Revenue Act of 1918. The effect of increasing the rate
two and one-half per cent on corporations was an additional burden upon the corporations earning a low rate of return on investment. The rates imposed upon individuals for the year 1921 were different than those which applied in 1922 and subsequent years. The maximum surtax rate for 1918 Act was sixty-five per cent, which continued through 1921, but in 1922, it was reduced to fifty per cent. There were some other important changes in the act. In order to discourage gifts as a means of evasion, the one who received the gift had to account for it in the same manner as the donor would have been compelled to if the property had been sold. Another provision provided for the inclusion of capital gain which resulted from the sale of property held for investment, by the taxpayer, for at least two years. There were also liberal provisions relative to the reorganization of corporations and to the transfer of property to a successor corporation.

The continued high rates of income taxation, which remained in force after the World War had ended, finally received attention by the enactment of the Revenue Act of 1924. This law did not reduce the rate on corporations, but it relieved the burden on other income taxpayers. In addition, many of the excise taxes and so-called "nuisance" taxes were abolished. Further relief was provided in the twenty-five per cent tax discount allowed noncorporate income taxpayers on their tax liability for 1923, and in the inadequately reduced rates applicable to the so-called "earned income."

The greatest achievement of this act was the creation of the United States Board of Tax Appeals. The Board assured everyone an impartial review of a contested tax liability prior to the payment of the tax. They reduced the arguments of "pay first and argue afterwards"
The constant pressure brought about by the people for the reduction of the tax rate and the simplification of the tax law, led to the passing of the Revenue Act of 1926, on February 26, 1926. Radical reduction on rates and many other changes were made effective as of January 1, 1925, so that the Act of 1924, was in reality in effect during that year, 1924. The principal changes were made in the rates in the Act of 1925. The law was not simplified to any extent, in spite of the intention to do so. The normal and surtax rates were reduced to one and one-half per cent for the first $4,000.00, three per cent on the second $4,000.00 and the balance taxed at five percent, as compared with two per cent, four per cent, and six per cent of the 1924 Act. Surtax rates ranged from one per cent on $10,000.00 to $14,000.00 to twenty per cent on incomes over $500,000.00, as compared with one per cent to forty per cent of the previous year. The rate on corporations was increased to thirteen per cent for 1925, and thirteen and one-half for 1926, and thereafter, as compensation for the loss of the capital stock tax. Personal exemption was increased from $2,500.00 to $2,500.00 for married persons living with spouse, or heads of families, and $1,000.00 to $1,600.00 for others. Earned incomes (maximum) was increased from $10,000.00 to $20,000.00, but the complications involved in the computation of incomes received in this manner were increased. The Acts of 1913 and 1916 failed to distinguish between the two classes of income. Through a legislative error
in the Act of 1917, the earned income was charged with a higher rate than unearned income. The Act of 1924, limited the application to maximum earnings of $10,000.00 and defined earned income in such a way that the income of all noncorporate taxpayers was taxed as though the first $5,000.00 was earned. The Act of 1926 was no improvement, except the maximum was increased to $20,000.00. It was Secretary Mellon who pointed out this discrepancy.

Installment sales were recognized by law and were to be accounted for in the report of income under the Act of 1926. The activities of the Board of Tax Appeals were more definitely stated, and its importance more fully emphasized. Estate tax rates were reduced from a maximum of forty per cent to twenty per cent, and exemptions were increased from $50,000.00 to $100,000.00. The gift tax was repealed as of January 1, 1926, while the rates for 1924 and 1925 were made the same as the estate tax rates for those years.

The 1928 Act became law May 29, 1928. It is different from the preceding acts in both form and substance. The arrangement of the income tax title is a direct result of the labors of the Joint Committee on Internal Revenue Taxation, which was created under the Act of 1926, to eliminate the complexities of repealing each prior revenue act and re-enacting most of its provisions with such changes as were deemed necessary. The income tax title is applicable only to 1928, and succeeding years. Prior taxable years are governed by the 1926 Act which is, in part, amended by the new law. The provisions which were not repealed nor restated, remained in force. The income tax title of the new act
contained a few introductory sections and the remaining sections were arranged under two classifications, general provisions and supplemental provisions. The general provisions were to inform the taxpayer about the ordinary problems of the taxpayer, such as rates of tax, computation of net income, credits against the tax, methods of accounting, returns, and payment of same. It is estimated that about eighty per cent of the taxpayers will find all that is necessary for the computation of the return in these sections. Special taxpayers will find all necessary material under the supplemental sections. One title covers amendments to the 1926 Act, another, the administrative provisions.

The same rate applied under the 1928 Act on individuals as before, but the corporate rate was reduced to twelve per cent, with exemption granted to corporations with net income of $25,000.00 or less, of $2,000.00. Such corporations were exempted from income taxation as real estate boards, not organized for a profit, voluntary employees' beneficiary associations, teachers' retirement fund associations of purely local character, cooperative marketing associations, and trusts.

A new retroactive provision protected trust against taxation as corporations for the years prior to 1925, if certain requirements were met. Certain provisions for deduction of depreciation were introduced which had not been mentioned before. The uncertainty which existed under prior laws as to the basis to be used by executors in determining the loss and gain upon sale of property provided in this act, was stated to be the fair market value of the property at the time of the decedent's death. All taxes for the years 1928, and subsequent years, were to be assessed within two
years after the return was filed, and no proceeding in court for the collection of such taxes, without assessment, could be commenced after the expiration of such period. There were many more additional features of the 1928 Act which are too numerous to give in the historical development of the Federal Income Tax Laws, but such features will be taken up in detail in the discussion of the 1928 Act which is to follow.
CHAPTER II.

INCOME AS VIEWED BY ECONOMISTS AND THE 1928 REVENUE ACT

The introductory chapter has as its purpose the introduction of the various theories regarding taxation as held by the leading economists of the world, which prepare a background upon which one may draw a comparison as to how the lawmakers have, or have not, followed what is considered good tax theory.

The historical information in Chapter I., was presented with the idea of showing how long it has taken the Congressmen and the courts of our country to evolve an income tax which meets the requirements of a sound and equitable taxing system for revenue purposes. The evolution was slow, but with each succeeding attempt, something new and desirable was added, which not only increased the revenue for the government, but aided the individual in cases of controversy or in the preparation of the income tax report.

It is now proper to take up the economic aspects of the 1928 Act along with the decisions of the courts. This chapter will deal entirely with income, first as viewed by the Act and the Courts, then by the accountant, and finally, by the economist. The subject of deductions has been reserved for the final chapter.
Definition of Net Income

The revenue acts of the Federal Government have as their purpose the taxation of what is known as net income of individuals, corporations, and certain trusts and estates. The definition of income according to the revenue acts is the balance left after subtracting from gross income certain deductions permissible under the law.

In the historical sketch of the development of the Federal income tax laws, it was pointed out that the Sixteenth Amendment made possible taxation without apportionment. As previously shown, this amendment was a necessity due to the decisions of the Supreme Court regarding the famous case of Pollock vs. Farmers' Loan and Trust Company, wherein the Court held that the 1894 Income Tax Law was unconstitutional on numerous grounds. The Revenue Act of 1913 and subsequent acts are directly related to the Sixteenth Amendment. The definition of income according to statutes, therefore, can be no broader than the Constitution will permit. It is necessary that the nature and scope of income as used in the amendment be understood in order that the limits of the term may be determined when used in the revenue acts. The background and history concerning the amendment will be discussed first, followed by the decisions of the courts of competent jurisdiction in an endeavor to establish a constitutional meaning of income.

The two decisions of the Pollock v. Farmers' Loan and Trust Company held that an income tax on municipal bond interest was unconstitutional, and that income tax was a direct tax within the meaning of the Constitution, thus it
could be levied only by apportionment. These decisions would not permit Congress to levy a tax on instrumentalities of states and political subdivisions thereof, nor could it impose an income tax without apportionment according to population without constitutional amendment.

In July, 1910, Congress submitted to the state legislatures the Sixteenth Amendment, and by February 25, 1913, it was announced, by formal proclamation, as adopted. The amendment read as follows:

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The Income Tax Law of 1894 was held unconstitutional on two grounds,

1. taxation of municipal bond interest and
2. absence of apportionment.

One can readily see that the phrase "from whatever source derived" was intended to meet the first objection, and the remainder of the amendment, to meet the second.

Economists' Concept of Income

In economic discussions of income it is net income, not gross, that the economist has in mind. How this is to be defined depends chiefly upon the problem before the economist. Sometimes it may be correct to refer to income as "the flow of material goods and of personal services" that one receives or consumes during a definite period of time. In other instances it is necessary to look to the "satisfaction" which is derived from goods or services.
When "money income" is mentioned, it is understood to include not only the money cost or money value of our income of goods and services, but also the amount of the investments of other savings made during the year. One's total income includes numerous things which are not bought with money and on which money prices are not even put. Personal services which members of a family render one to another, is perhaps the best example. For practical purposes it is not convenient to take into consideration this kind of service, thus income items include only such goods and services as are ordinarily sold for money prices. Some recognition must be made of a general class or type of goods or services which are ordinarily bought and sold, such as food produced on a farm and consumed by the farmer and his family, therefore, this consumed food constitutes a part of his income. By the following discussions it can be seen that the courts cannot be said to have adopted the economist's views of the nature, scope and meaning of the term "income."

Income under the Sixteenth Amendment

Taxable income does not fall into any groups of income as defined either by the economists, accountants, or by any other group of professionals. What the courts have decided income to be, is law. The first instant in which the courts had an opportunity to pass on the meaning of the term "income" in connection with the present series of tax laws, was under the Corporation Excise Act of 1909. In the two leading cases arising under the 1909 Act, the Supreme Court expressed itself most conclusively. The first case was Stratton's Independence, Ltd.,
v. Howbert, in which income was defined as "the gain derived from capital, from labor, or from both combined." The second case was Doyle vs. Mitchell Bros. Co., in which income is so defined as to include the profit gained through a sale or conversion of capital assets. This definition was deemed so important as to be included in Article 21 and 41 of the 1928 Federal Income Tax Law.

One must note the fact that "income" is not the amount received upon the sale or conversion of property, but the profit gained as a result of the transaction. This is distinctly brought out in the case of Doyle vs. Mitchell Bros. Co.

Thus, the conclusion is drawn, as a result of the decisions handed down by the United States Supreme Court, income is what the courts decide it to be. The legal concept of income coincides more closely with that of the accountant than that of the economists.

It is not a simple matter for the layman to comprehend and grasp the full significance of revenue acts, such as the Revenue Act of 1928, which is a great improvement over the previous acts, without some aid. The interpretation of the revenue laws by the courts is oftentimes very different from the layman's conception. In the final analysis, one must realize that it is the court's decision which gives the solution to any question at hand.

The language of the Sixteenth Amendment is such that one would hardly think that it would require any explanation, but this is not the case.

The first official interpretation of a revenue act is in the form of a Treasury decision known as one of the "Regulations." These regulations are issued in accordance with the provision of the Sixteenth Amendment.
of the 1928 Act, Section 62; 1926 Act, Section 1101; 1924 Act, Section 1001; 1921 Act, Section 1303; 1918 Act, Section 1309; 1917 Act, Section 1005. The provisions authorize the Commissioner, with the approval of the Secretary, to "prescribe and publish all needful rules and regulations for the enforcement" of the acts. The various parts of the Regulations are known as "Articles," and are numbered consecutively. Such regulations are generally cited as follows:

"Reg. 69, Art. 8"

This means, Article 8 of Regulation 69.

The Commissioner amends or even repeals articles of the Regulations from time to time. These decisions are known as Treasury Decisions, and are designated by the letters "T. D." It is a well established law that whenever there is a case of doubt existing in the taxing statute, the decision is always handed down in favor of the taxpayer. A famous case under this ruling is Gould vs. Gould in 1917. The ruling handed down was that "in case of doubt they (statutes) are construed most strongly against the government and in favor of the citizen." 1

The function of the Treasury Department in interpreting revenue laws is to merely give their interpretation and nothing more. Their decision is of little value if the statute is clear and well constructed. The basic rule in handing down a decision is the one given above—that rulings must be handed down in favor of the taxpayer, if there is any doubt in the case.

Accounting for Income Tax Purposes

To know that the federal income tax is levied on net income and how to determine this income is not sufficient. The tax is imposed on the net income of a certain period known as the "taxable" year. One can see that this differs greatly from the economist's idea of net income, which does not take into consideration definite periods of time in arriving at what net income is of an individual. In accounting for income tax purposes, it is not sufficient to know what a "taxable" year is, but also the determination of the taxable year to which a given item of gross income or deduction belongs. There are two principal methods of accounting for income tax purposes, namely,

1. Cash receipts and disbursement basis, and
2. Accrual basis.

The method of accounting used merely determines which taxable period an item belongs. Under certain circumstances, returns are required for fractional parts of a year, such as, if a person becomes of age, or is emancipated during the calendar year, or in case of death, the return is made out by the executor. Under such conditions as these, the return is made out for a period less than a year.

The statute provides for two types of "taxable years." One is the calendar and the other, the fiscal year. The calendar year is the consecutive twelve-month period ending on December 31, while the fiscal year is any twelve-month period ending on some other day than December 31. The general rule laid down the law is "the net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year
or calendar year, as the case may be) "1. The return by an individual or corporation must be made by either one or the other two systems of basing income. This rule developed because of the fact that many corporations closed their books at other times than the end of December. This date was provided for in earlier income tax laws. The rule is now that whatever system the taxpayer employs in keeping a record of income, it is that system upon which he must base his income tax return. It is to be borne in mind that a return must not cover a period longer than twelve months.

Various systems of bookkeeping are known, but the most common are single and double entry bookkeeping. In any case, where the least complications arise, single entry bookkeeping does not fit the requirements for calculation of net income. Double entry bookkeeping is the only system in which the calculation of net income is made easy.

From the viewpoint of income tax, it is not the system of bookkeeping used, but the basis on which the items of income, deductions from income and credits are computed. The two main divisions were mentioned previously, and at this point an endeavor is made to distinguish and explain the cash basis and the accrual basis.

Income under the cash basis has been defined through a recent court decision as "in order to keep books on the basis of actual receipts and disbursements, credits yet to become due or obligations yet to be paid, would have to be ignored." 2 Briefly, in computing net income on the cash basis, the only items contributing to net income are those for which cash, or its equivalent, has been received or paid.

1. 1928 Act, Section 48 (a)
Income under the accrual basis has also been defined through the court decision in the same case and the following is quoted: "The books are kept on an accrual basis whenever entries are made of credits and debits as the liability arises, whether received or disbursed." 1

The important thing in this method is not the receiving or paying of cash, but the incurring or accruing of an obligation and the incurring or accruing of a right. For example, a sale of goods on credit instantly creates an obligation on the part of the customer to pay at some future date, and the right on the part of the seller to receive compensation. Income computed by the accrual method requires that all charges are deemed to result in income immediately, without consideration of time of payment. This applies likewise to expenses or deductions from gross income. They are deducted when incurred, not when paid. The Revenue Commissioner recommends that taxpayers who have inventories to use the accrual basis for computation of income, as it more truly reflects income because it gives effect to sales and other accruals of income in the year in which the business was actually done. This is also applicable to deductions.

Neither the Commissioner or the statute demand that any one system be used. The general rule laid down by the statute is that "The net income shall be computed in accordance with the method of accounting regularly employed in keeping the books of such taxpayer." 2 This rule developed gradually because prior to the 1916 Act only the cash basis was recognized for income tax purposes. The 1916 Act permitted

1. Alm
2. 1921
corporations, joint stock companies, associations, and insurance companies the option of reporting income on other basis than actual cash received and disbursed provided such system showed true income.

While the statute does not say what system to use, it does give the Commissioner the authority to compel the taxpayer to keep his books in such a manner to clearly reflect the income. This is done in order to insure a full collection of taxes. Otherwise one could evade tax payments by keeping books badly or by not keeping them at all. The Commissioner is also permitted to compute the income of an individual in case of poorly kept books, or none at all. In an instance where the individual does not keep books, it is necessary to have the report made out on a cash basis.

When a taxpayer uses the cash receipts and disbursements method in keeping his books, and this system is sufficiently complete and all items are treated with reasonable consistency, he is compelled to compute his taxable income on that basis. The only exception is that the Commissioner might rule it unsatisfactory because it does not show true income.

In computing income on cash basis, only items which are affected by cash transactions are included. There are several statutory exceptions, such as depreciation and losses by bad debts which are allowable deductions to a taxpayer on the cash basis. Unless there has been the actual transfer of cash, or its equivalent, the taxpayer cannot take the item into consideration in computing his net taxable income. A sale or purchase of goods is not an income item until the taxpayer makes or receives payment for it, as the case may be.
The opposite of the proposition is not true. Not all cash received is income, and not all cash paid out is deductible from gross income.

The method of accounting bears only on the question of when—what taxable period—the item in question is to be considered in computing net income, and not whether a given item is taxable as income or allowable as proper deduction from income due to the method of accounting employed. The cash basis considers a sale at the time when payment is received for it. The accrual basis accrues it immediately, regardless of when the payment is to be made. The common point is—the two methods consider the sale at some time in computing income.

The general rule laid down by the cash basis is that, an income item is considered as such for the taxable period within which it was actually received. If the item is of the income type, it is considered income in the year in which it was received.

The regulations state, in regard to the receipt of income in property, that "items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money." 1 For instance, if an individual receives living quarters provided for by the employer, for his convenience, such valuation as may be set upon the quarters is not to be considered as income by the employee. The regulations also state that if a note is given in payment

1. Reg. 74, Art. 321; Art. 22. Reg. 69, 65, 62, and 45
that it is to be considered at its fair market value, and if, when the note is eventually paid, payment is made for more than its fair market value, this additional payment is to be considered as income.

The consideration of capital expenditures under the cash basis is the same as under any other good accounting system. There must be a distinction made between capital and revenue expenditures. The Commissioner laid down in Regulation 74, Article 124, that "Repairs which neither materially add to the value of the property nor appreciably prolong its life** may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures" and such has been approved by the Board.

A summary of the general rule for reporting income and deductions therefrom, under the cash basis, is that all true income items must be reported in the year in which they are received, actually, and that all allowable deductions must be reported in the taxable year in which they were paid.

The next system to be considered in reporting income for taxing purposes is that of the accrual basis. When the books of the taxpayer are kept on the accrual basis, and the system clearly reflects income, the taxpayer must report on that basis. It is sometimes difficult to determine on what basis the books are being maintained. In cases of doubt, the system which is predominately employed in the books is the one which is used.

The general rule for a taxpayer reporting income under the accrual method is, that gross income is considered to be income earned during a taxable year, regardless of the year in which
it was received or receivable. In deciding the result of the case of Owens-Ames-Kimball Co., the Board of Tax Commissioners decided that "The accrual method of accounting requires that at the end of every accounting period all income which has been earned during the period must be accounted for as income accrued in that period, though perhaps not collected, because it is not due and will not be collected until some future date." 1

In considering items for deductions on the accrual basis, the general rule is that accruability is not affected by the time the payment is made or to be made, but when the expense or deduction was incurred. Under the accrual method, deductions from gross income consist of deductible expenses, losses, which were incurred or accrued during a taxable year. For instance, a firm agrees to contribute to a charitable institution, and it was held that the amount was to be deducted in the year in which the promise was made, and not the year in which payment was eventually made.

The Commissioner has in practically all instances refused to recognize accounting reserves as proper deductions. This opinion has been upheld by the Board, who in a recent case, that of the Mead Construction Co., stated "While the claim must be taken to represent a future cost of carrying on business, and from the standpoint of cost accounting is entirely reasonable, and it would seem that any prudent business man or organization should provide for such estimated cost and set aside and maintain a reserve for that purpose in order that his or its account may properly represent the annual or periodical gains or losses, we are nevertheless faced with the

1. 5 B. T. A. 921, 928
situation that under the Revenue Act of 1918 it is provided that net taxable income shall be the gross income less certain specific deductions provided by the statute. We have held in the Uvalde Co., 1 B.T.A. 932, that the taxing Act had made no provision for the deduction of future expenses, however accurately the same be estimated, and the rule laid down in that case will be followed in the instant cases."

The fault of this ruling lies in the fact that the Board has constantly refused to allow deductions clearly accruable from the accountant's viewpoint as being entirely reasonable. If the Board's attitude was limited to situations where the entire liability is dependent upon a contingency which may or may not happen, the ruling is entirely justified. The Board has an extreme distaste for reserves and future liabilities and will not permit them to be considered in accruing net income.

A system of accounting which is particularly adapted to the needs of dealers in personal property who sell on the installment method is the installment sales method. This system has become popular not only in this line of business, but has extended into various other types of business.

The 1926 Revenue Act had a provision which permitted that the installment sales section of the 1926 Act shall be retroactively applicable to 1916 and all later years. Prior to the 1926 Act, there was no authorization for the use of this method in reporting income for taxing purposes.

There are certain problems which are common to all bases. The most common one is that of accounting for depreciation and depletion. The law provided for a reasonable deduction for

1. Mead Construction Co., 3 B.T.A. 438 and Harris-Emery Co., 10 B.T.A. 297
depreciation and depletion of property used in business. The accrual system provides an easy problem. Under the cash receipts and disbursements basis, the Department insists that the depreciation claimed should be shown in the books of account. It is, therefore, necessary for the taxpayer who keeps his books on the cash basis that appropriate book entries must be made in order that he might be able to claim the deduction.

Another common problem is that of accounting for losses from bad debts. All individuals and firms are subject to bad debts. This item is permitted to be deducted from the gross income. The individual reporting on the accrual basis, reports gross income on the basis of accounts receivable resulting from sales and not cash received from sales. The individual who reports on the cash basis reports income only as he receives cash for sales. Thus, if a taxpayer sells goods to an individual who in turn does not pay for it, he does not report this sale because he never receives cash for it. The individual who reports on the accrual basis, is permitted to deduct accounts which have proven to be bad accounts.

There is no section in the law which deals with the changing of the taxpayer's method of accounting, or basis of computing income. Anyone who wishes to change their method of accounting for taxing purposes must first obtain written permission from the Commissioner, who is the only one who has authority to grant this request. This ruling applies also to anyone who desires to change both the method of accounting and the basis of computing income.

The purpose of discussing the subject of accounting for
income is to, first, determine the period in which an income tax is levied, and, second, the proper method of accounting which may be used in determining the net income. It has been clearly pointed out that the method of accounting does not change or affect the nature of income.

The economist viewpoint of income accounting is somewhat different. According to Irving Fisher, who uses the concept of income in the sense of services and disservice, the theoretically correct bookkeeping of income consists of crediting and debiting the plus and minus items of income to their proper capital sources as services or disservices rendered by those sources. The true amount of income received by an individual is derived by a patient study of each item of income flowing from each item of source. The total amount of income from a given source is found by adding together the values of all its services and subtracting the value of all its disservices. The individual must go through all the income receiving property, or property of any nature, such as bonds, real estate, automobiles, and other properties and debit and credit service or disservice.

Irving Fisher claims that the greatest cause of confusion in the determination of net income lies in the failure to relate each item of income to its source, and the failure to credit an item of income when at the same time the item may be a negative income to some other kind. He illustrates this idea with plowing. The money value of plowing is credited to the plow, but the debit entry is to the field being plowed. The name given to this debiting and crediting of two related items of
income is called "interaction."

The entire productive process is linked together hence, an interaction. Every interaction implies income and simultaneous re-investment. Fisher gives this implication the name of double entry bookkeeping.

One can readily see that such an analysis cannot be carried into the field of practically accounting. The true income for revenue purposes could not be secured. The economist's concept of income accounting would not be readily adaptable to the use by an individual in preparing a statement of income for Federal Income Tax purposes.

Exempt Income.

The concept of income has been briefly given in the preceding pages, covering the accountant's, economist's, and the court's viewpoint regarding this item. There are certain items which are regarded as income by both the accountant and the economist, but are considered by the law and court to be non-taxable as income. It is necessary that these items be understood thoroughly before income as conceived by the Federal Income Tax Law may be further analyzed and discussed. These items have been exempted under the statute because it has been deemed advisable due to good public policy.

The following items are excluded from taxation under the Federal Revenue Act:

1. Amounts received under life insurance policies upon death of insured.

This exemption applies both to individuals and to corporations. If the policy holder or the beneficiary decided to let the sum payable under the policy s
this interest is considered as a gain, therefore, taxable.
The payment is not taxable as long as it is proceeds from
the policy.

2. Amounts received under life insurance policies other than
upon the death of the insured.
Under the statute the proceeds of a life insurance, endow-
ment, or annuity contract, are excluded from gross income
up to an amount equal to the aggregate premiums paid: any
excess is to be included in gross income. In the case where
the one who receives the annuity is other than the one who
paid, the law does not give any ruling. When the insurance,
enowment, or annuity contract, or any interest therein, is
assigned or transferred for any valuable consideration, only
the actual value of such consideration and the amount of
the premiums and other sums subsequently paid by the
transferee shall be exempt from taxation under the law. Any
excess paid to the transferee is taxable.
The entire cost of insurance on life is tax exempt upon
their return to the insured. All life insurance premiums
returned to the insured are not income. Only such proceeds
in excess of premiums is taxable income. For example,
interest permitted to accumulate on a policy for the benefit
of the beneficiaries, is not exempt from tax.

The statute provides for the exemption from income taxation
this form of property, but any income from such property
is to be included in gross income. The first test of a
gift is that it has been given as a result of the donor's
own volition and that no consideration is paid for the
transfer of property. There must also be intent to make
a gift as given in Vlohek, that "A gift involves more than a delivery of the property. There must be present intention that the property delivered shall be the property of the donee." 1

In the question of gift from parents to children, employer to employee, or other close relationships, the Department has studied the cases with careful scrutiny. There must be proof that such a transaction was a gift, with intention for it to be of that nature before such transfer will be recognized as non-taxable income.

4. Compensation for injuries or sickness

The statute of 1928 provides that "Amounts received, through accident or health insurance or under workmen's compensation act, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement or account of such injuries or sickness," 2 are permitted to be excluded from calculations of net taxable income.

5. Tax-free interest

The statute states that the following types of property shall be tax free if interest is paid on such securities as listed below:

a. "The obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia;

b. Securities issued under the provisions of the Federal Farm Loan Act, or under the provisions of such Act as amended;

c. The obligations of the United States or its possessions.

1. Vlohek, 7 B. T. A. 1244
2. 1928 Act, Section 22 (b)
4. Every person owning any of the obligations or securities enumerated in clause (a), (b), or (c) shall, in the return required by this title, submit a statement showing the number and amount of such obligations and securities owned by him and the income received therefrom, in such form and with such information as the Commissioner may require. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit), the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt to the taxpayer from income taxes. 1

The revenue laws since 1913 have specifically exempted interest upon the obligations of a state, territory, or a political subdivision thereof. The taxing power involves the power to destroy, and if the Federal Government was able to tax the instrumentalities of the various subdivisions of the same, it would not be equitable.

The regulations state definitely that any securities issued by a state or territory or a duly organized political subdivision acting by constituted authorities shall be for public purposes if such interest on securities is to be tax exempt. Even if the security is issued for public purposes, but financed by a private corporation, such securities are not tax exempt. In dealing with tax exempt securities, the gain or loss resulting from the sale of such securities are treated the same as any other gains or losses. Tax exempt securities bought at a premium and held to maturity, such premium is considered to be a loss, therefore, deductible.

Prior to 1918, the securities of the District of Columbia and other obligations of the United States and territories were given the same exemption privileges as were accorded to

1. 19.
the securities of the various states. There is only one exception to be kept in mind, and that is, the provision previously stated on page 54, in sub-section 5-d.

Income from securities issued by the Federal Farm Loan Act and under Federal Reserve Act are entitled to special tax exempt privileges.

An individual who is in the employment of a state or political subdivision is exempt, not because of the source of revenue, but because such service is rendered by an officer or employee of the state or a political subdivision. The Department has defined what constitutes an "employee" and "officer" as "An officer is a person who occupies a position in the service of the state, or a political subdivision, the tenure of which is continuous and not temporary and the duties of which are established by law or regulations and not by agreement. An employee is one whose duties consist in the rendition of prescribed services and not the accomplishment of specific objects and whose services are continuous, not occasional or temporary." 1

The Supreme Court of the United States has also added information on the definition of "officer" and "employee" in the case of Metcalf and Eddy vs. Mitchell by stating

1. "An office is a public station conferred by the appointment of a government. Their term embraces the idea of tenure, duration, emolument, and duties fixed by law.

2. A contract between a state and a person to perform services does not create an office and does not give the contractor the status of officer. Such a person is frequently an independent contractor:
(a) who takes no office
(b) who is free to accept any other concurrent employment
(c) whose engagements are not of a permanent or continuous character but whose period of employment is prescribed by contract rather than statute

3. Certain basic distinctions are implied between an employee of a state or political subdivision thereof and an independent contractor:

(a) the services of employees are subject to direction of control of public boards or officers (who engage employees, experts, etc.)
(b) independent contractors, unlike employees, are held responsible for the use of judgment, discretion, and professional skill in the bringing about of an agreed upon result.
(c) independent contractors have that requisite liberty of action which is excluded from the idea of employer-employee relationship." 1

There have been various decisions handed down by the taxing commission regarding income which has been received by individuals who have rendered services to the state, but held taxable. In the majority of the cases it was held that the services rendered were not essential to the function of the government. The decisions are too numerous to list, but it is essential to note that the fact that governmental income is not always tax exempt.

The exempt income of the Federal Income Tax laws definitely shows that the concept of income by the courts does not agree with either the economist or the accountant as various types of income included in the exemption division would constitute income by other methods of calculations.

**Income from Personal Service**

Income as construed by the Constitution has been

1. Metcalf and Edy vs. Mitchell 269 U. S. 514
discussed as well as gross income and its permissible deductions given in statutes or by the courts. The methods of accounting for income by various basis has also been thoroughly analyzed and the two most important methods, accrual and cash basis pointed out. It is now proper to take up the subject of gross income in detail, and the first division is that of income from personal services, or earned income, which is usually accounted for by the cash receipts and disbursement basis.

The distinction between earned and unearned income is based on the principle that the income in one case is derived from personal exertion, and on the other hand, the income is secured without this personal exertion. Gladstone expresses it by the words "industrious" and "lazy" incomes. It is not always an easy thing to draw a sharp line between such incomes because the owner of property income is often required to exert much effort in order that such property will produce any income.

According to Taussig, the real difference between the two types of income is that the holder of earned income is in many instances under a moral obligation to save a considerable portion for various purposes. The individual savings who sets aside a portion of his income for his dependents, such is not a part of his present income, but a part of the future income of his dependents. If this income is taxed now and taxed again when the income reaches the dependents, there is a double taxation. The property holder may also do the same thing, but it is not likely that a portion of such income
would be put aside. It is on this idea that the government permits a deduction of insurance premiums from gross income.

Income from personal services may be taxed due to the Sixteenth Amendment, and as a result of this statute, all revenue acts since 1918 have contained the following:

"The term 'gross income' includes gains, profits and income derived from salaries, wages, or compensation for personal service*** of whatever kind and in whatever form paid, or from professions, vocations*** and income derived from any source whatever***."

By the phrase "'gross income' includes*** income from any source whatever" Congress meant that no income except that expressly exempt should escape taxation. Personal services embraces salaries, wages, commission, fees, bonuses, percentage of profits, pensions, etc., provided only that such income is direct or indirect compensation from personal services.

It has been a recognized condition in modern times when many people are able to amass a large fortune in securities and other property that there should be a different rate of tax than that which is applied to an individual who secured income from personal exertion. Property has become to be looked upon as a means of securing a livelihood without the who own property exertion of energy and the fact that such people do not directly contribute anything to the community's resources are the main reasons why such incomes secured through the ownership of property should be taxed at a different rate.

1. 1928 Act, Section 22 (a)
The Federal Income Tax Law recognizes the fact that there are certain types of personal services which should be exempt from the payment of taxation on income and these two types are:

(a) citizens, bona fide non-residents of the United States for more than six months during the taxable year, and
(b) those entitled to the benefits relating to people who reside in territories or possessions of the United States.

All other individuals must account for their income. An alien resident, like a citizen, must account for his income from sources both within and without the United States.

There are certain exemptions from the personal service clause, which are listed in detail in the revenue law. These exemptions came about as a result of the type of service rendered by the individual. The exemptions permitted are stated either in the law or in a court decision. The most notable of these exemptions are:

1. Salaries of Federal Judges and the President of the United States.
2. Employees of a state or political subdivision thereof.
3. Soldiers and sailors under various allotment acts.
4. Teachers in Alaska and Hawaii.
5. Clergymen who turn over property to churches in excess of expenses, such property held is not taxable. Houses furnished for pastors are not taxable.

In accounting for taxable income from personal services, the recipient who reports on a cash basis, must report it in the year in which it was received regardless of the year.
in which it was paid. If the taxpayer fails to receive commission, wages, salaries, due entirely to his own control, such income must be accounted for in reporting on the cash basis.

The Federal Income Tax Law recognizes many different types of income because it states that "income from any source whatever" should be taxed. The following discussion will cover the major types of compensation and how the courts and the law look upon such income.

1. Excessive salaries taken by owners.

In some firms, certain officials receive salaries in return for services rendered because they are stockholders. The question is whether the payment should be treated as salary, subject to both normal tax and surtax, or whether it should be treated as dividends, subject only to surtax. The Treasury Department's attitude has not always been consistent. The earlier decisions held that salaries received in excess of normal salary or higher than the usual compensation for such services, such payment was to be construed as "constructive dividend" and subject to surtax only. Later, the Department held that all compensation received by a stockholder should be regarded as salary, and to be subject to both rates of tax. The only exception, was if such salary was in proportionate to holdings in the firm, the amount received could be held to be "excessive" payments and subject to surtax only.
2. Commissions

A very large proportion of the taxpayers who receive income from personal services receive such income in form of commissions. A salesman's commission is usually a certain percentage of sales, based upon an optional basis, such as gross sales, net sales, sales actually paid up, or some other familiar system. Some salesmen have a drawing account which is merely a claim upon future earnings.

There are certain complications which occur in connection with the computation of salesmen's earnings. The expenses which are incurred by a salesman in his carrying out of duties are deductions from his gross income, and therefore, decrease his taxable income by such amount. If, in addition to commissions received, an allowance for traveling expenses is granted, the taxpayer should add such allowances to income and deduct from this total amount his actual expenses. In the long run, the traveling expenses usually exceed the amount allowed for such purposes.

3. Fees

There is no actual tax difference between the salaries and wages of employees, commission of salesmen, and the fees of professional men and women. In all instances the taxpayer is required to account for income on the accrual or cash basis, and for a fiscal or calendar year. Lawyers, contractors, engineers, and some other group of professional people often account for their income on a contract basis due to the fact that during a single
year they account for income earned over a period of years. This is not an unusual situation. In the case of Jackson vs. Smietanka, it was held that the recipient must report the total fee for such services as income in the year received, unless he had reported on the accrual basis the estimated amount of compensation earned during each separate year of the life of the case. 1

4. Bonuses

In some instances, employees receive bonus in addition to salary. If such bonus is a gift, it is not taxable income to the recipient. In the majority of cases it was found that the bonus consisted of payment to the employee of work actually done by night work or some extra hours. Such bonuses secured in this matter were held to be taxable income.

It is oftentimes difficult to distinguish between bonus and salary. It is held that bonuses are distinctly gratuitous payments. Such gifts must, according to the Treasury Department in the Decision of the Daly case show "An intention to give, a transfer of title or delivery, and an acceptance by the donee." 2

Officers of corporations are many times presented with sums of money as a token of appreciation for services rendered, but the question arises whether it is bonus or salary. Delivery and acceptance are present, but the intentions are not so easily decided upon. It is

1. Jackson vs. Smietanka 267 Fed. 932
2. Daly, 3 B. T. A. 1042, 1044
generally settled by whether such donation was done under orders from the board of directors or in the ordinary course of the affairs of the corporation. If the stockholders have authorized the gift, then such payment is not considered taxable. Each individual bonus case requires separate consideration.

Bonuses may sometimes take the form of profit sharing. An employer may give each of his employees a certain percentage of the profits made during a definite period, such payment is considered to be taxable to the recipient.

Another form of income which falls under the bonus classification is tips. Many types of employment are wholly dependent upon tips as wages, the most common are waiters, porters, and similar types. Such form of income is taxable, and the only exception is in the instance where the award far exceeds the value of such services. This payment is looked upon as a gift and non-taxable.

5. Pensions

Pensions are oftimes looked upon as bonuses or additional compensation rather than as a gift. Pension payments may also be looked upon as a deferred payment for services rendered in the past. Beginning in 1921, the law exempted from taxation "pensions from the United States for service of the beneficiary or another in the military or naval
forces of the United States in time of War." 1 Commencing in 1924 another type of pension income was considered non-taxable. This was pensions paid to other people than the one who rendered the service. This type of pension would ordinarily be exempt because it would be looked upon as a gift. There are, however, certain pensions which are taxable:

1. "The pension paid to a retired clergyman by the governing body of his denomination, on the ground that it was paid by a former employer." 2

2. "Pensions paid by one of the Confederate states to Confederate veterans of the Civil War." 3

Further pensions have been held to be tax exempt by rulings of the Department, such as, pensions received by retired teachers and widows of teachers paid by the Carnegie Foundation for the Advancement of Teaching, retirement pay of former judges of the federal court, and two months' salary to an officer of a corporation.

6. Sick Payments

Payments made to sick employees are closely related to pensions. Whether or not such payment is regarded as compensation is decided by business custom. Usually it is considered as taxable income.

7. Vacation Payments

It has become a universal custom to pay employees while absent on a vacation. The amounts so received are considered to be taxable income on the ground that they are so made due to an expressed or implied agreement.

1. 1928 Act, Section 22 (b) (6)
2. I. T. 1157, C. B. I-I, 69
3. O. D. 902, C. B. 4, 112
8. Supper Money

Such money received by employees due to over-time work and called "supper money" is held to be exempt whether or not the entire amount is spent for the supper. The only ruling published regarding the subject of supper money holds that such money is not taxable if the employee voluntarily performs the duty after regular hours and the employer does not charge the disbursement to the "salary account."


The taxing of gambling income falls under the phrase of "income derived from any source whatever." Only the net winnings are taxable. By rulings of the Commissioner, the gambler's losses are not permitted to be deducted, therefore, income is based on net winnings. All winnings resulting from illegal betting on the results of commodity and stock market operations are taxable. Such income received by any illegal manner is considered taxable.

An examination has been made of the various types of earned income which are usually received in cash, and now it is proper to consider the type of income which is not necessarily made in cash in return for personal services. The determination of the "fair market value" is the principle problem involved in this type of compensation.

Types of Income not Paid in Cash.

Board and Lodging.

By a decision of the office department, the board and lodging received in addition to cash compensation is considered taxable income, and valuation must be placed upon such quarters
in accounting for income.

The exception to this ruling is that the employee is compelled to use the quarters provided because it is an advantage to the employer. If this is the case, such board and lodging is not considered to be taxable. The employee is constantly subject to the call and convenience of the employer. On the other hand, if the taxpayer, because of his employer's wishes, lives in a place provided for him, for which he would otherwise have to pay were he not so fortunate, such lodging is considered taxable.

The question arises now as to the valuation placed upon such board and lodging where it is not compulsory. The ruling handed down in this case is what the recipient of this income would have to pay were he required to furnish this accommodation—not the market price or the price charged by a hotel.

**Light and Heat**

In some hotels and apartment houses, the janitors in addition to the furnishment of quarters for themselves and their families, are often furnished with light or heat, or both. This necessity is considered to be taxable at the fair value of the heat and light received.

**Luncheon, Vacation Homes, Sales to Employees.**

Luncheons furnished to employees at cost or without cost are taxable only if the luncheon is furnished free, not if furnished at cost.

**Sales to Employees below Market Price**

Employees are often permitted to purchase merchandise substantially below the market price, and the general rule
applying to such cases is that the employee must include such difference between the market price or value and the price paid for the commodity.

Compensation in the form of Promissory Notes.

The Bureau has held that a promissory note constitutes taxable income to the recipient while the oral promise to pay is not taxable. The basis for making the return is the fair market value of such note.

Compensation in Capital Stock

The employee who receives any shares of capital stock of a corporation as compensation for services, such stock is taxable income to the recipient to the amount of the fair market value. This same ruling applies to other securities such as bonds or collateral notes.

In the instance where the employee was permitted to purchase stock under the market value, the difference between the market value and the purchase price was considered taxable income to the taxpayer.

Transportation

Transportation furnished to employees and members of their families does not constitute taxable income as it has been construed to be a gift. Such transportation was not contracted upon at any time during employment, therefore, it is regarded as a gift.

The statute provides for the exemption from taxation various types of compensation for personal services. In the determination of compensation, regardless of the form paid, it has been shown that such compensation resulted in taxable income, unless otherwise exempt. The valuation of compensation not paid in cash was taken on the basis of "fair market" value.
It was not until the 1924 Revenue Act that Congress acknowledged the difference between earned and unearned income, and made a provision for the difference in taxation. In the 1917 law, through a legislative "error," earned income was taxed at a higher rate than unearned income. Former Secretary Mellon once said in advocating a lower tax burden on earned income:

"The fairness of taxing more lightly incomes from wages, salaries and professional services than the income from a business or from investment is beyond question. In the first case, the income is uncertain and limited in duration; sickness or death destroys it and old age diminishes it. In the other, the source of the income continues; it may be disposed of during a man's life and it descends to his heirs." 1

The economist, Taussig, states that any conclusion in favor of progressive taxation and of higher taxation of property incomes lies in the frank admission of the undesirable features of our present society and a definite realization of social reform. The question then arises whether this particular mode of reform, through taxation, would bring about the desired results.

Certain kinds of property are marked off more sharply as not essential for the working of the individualistic system, and, therefore, peculiarly fit for taxation. A progressive tax is generally based upon the amount of income, rather than the kind of income. Progressive taxation of large property incomes can be advocated if one admits the undesirability of large amounts of wealth in few hands and

to secure the funds in the hands of many through taxation is justifiable.

The Revenue Act has accepted the fact that income received by individuals, corporations, partnerships, or other associations, not as a result of the exertion of personal energy, is also taxable and under a different rate. It is at this point that this type of income will be discussed, and the various rulings and court decisions be presented.

The first division of income from other than personal service, or earned income, to be taken up is that from corporate businesses---dividends. The statute permits the taxation of dividends in the same way that it permits taxation of income from personal service. All the revenue acts since 1913 have included a phrase which specifically states that dividends from corporations are taxable.

In order to know what constitutes a dividend under the revenue act, a definition is given which states that "any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913" is considered to be a dividend.

Regardless of the fact that a firm may claim that an agreement was made to pay interest on investment, instead of calling same dividend, such a payment is taxable income. Any amount paid out of earnings constitutes a taxable right. Any distributions to stockholders by a corporation, whether in cash or in other property, constitutes a statutory dividend, provided such earnings represent earnings since February 28, 1913.

1. 1928 Act, Section 115 (a)
In order to prevent corporations from distributing earnings made prior to February 28, 1913, there were certain restrictions placed upon the distributions by law. The 1928 Act provides that when a corporation makes a distribution, it must be regarded not only as a payment which tends to exhaust available earnings or profits, but as having been made "from the most recently accumulated earnings or profits." Ever since the 1913 Act, Congress has attempted to compel corporations to distribute all or a large portion of their corporate earnings.

The taxability of a dividend depends upon the status of its recipient and the status of the distributing corporation. The recipient may be either an individual, partnership, corporation, or co-operative group, etc. The recipient may be classified as a citizen, a resident alien, or a non-resident alien. A complication arises if the corporation is foreign or of some peculiar nature.

If the recipient is an individual and receives dividends from an ordinary corporation and the dividends are of an ordinary nature, such dividends are not subject to a normal tax and the sur tax applies only when the amount so received exceeds $10,000.00. The theory underlying the tax exemption of dividends from domestic corporations is that income taxes were paid by the domestic corporation on its net income before surplus, out of which the dividends were paid, became available.

In the case of a resident alien, the situation is the same except that

1. Resident aliens are not subject to provisions of the China Trade Act

1. 1928 Act, Section 115 (b)
2. Nor treatment accorded to citizens of United States.

The non-resident alien who is the recipient of dividends from ordinary corporations, are taxed only upon the amount of dividends at a surtax rate.

If the recipient is a corporation, such dividends are taxable under the revenue act.

The taxability of those individuals reporting on the cash basis account for dividend when received. Under the accrual basis, the recipient reports dividends in the same manner as the recipient does who reports on the cash basis. This is due to the fact that dividends do not accrue by the mere passage of time which is characteristic of interest.

In the case where the dividends take the form of a distribution of stock of another corporation due to the merging of two corporations, such dividends as may result from the merger are considered taxable.

When dividends are given in the form of salary when no service has been rendered, it was held by the Department that such income was taxable. A circuit court of appeal has held that the Government could question whether part of a payment made to a stockholder-officer as salary was in fact a distribution of profits, and approved reference to a jury to decide what portion of the compensation was a dividend. This question was brought up in the case of United States vs. Philadelphia Knitting Mills Company.

Stock dividend is not a distribution of profits and not taxable. Because stock dividend is not taxable, it becomes necessary to define what is a "stock dividend." It may be defined as a distribution by a corporation of its own capital
stock to its stockholders. This ruling was made by the Treasury Department. The definition of stock dividend would exclude the distribution of one corporation's stock to another as in a merger.

Liquidating dividends are not true dividends. In the case of complete liquidation, the statute has adopted the rule that the amount received by the stockholder as a liquidating dividend represents the selling price of the stock. The computation of a gain or loss under this transaction is computed in the same manner as in any other transaction. There was much controversy prior to the decision of the Supreme Court in the case of Hellmich vs. Hellman, which finally decided that liquidating dividends involved capital transaction and that gain resulting from such "dividends" was taxable in the same manner as profits resulting from dealings in all types of property.

Dr. Edwin R. A. Seligman in his work "Studies in Public Finance" discusses the economic nature of stock dividends and comes to the conclusion that a cash dividend is indisputably income even if the proceeds are subsequently lost. A stock dividend is not income as this distribution is regarded as capital.

Even though the Sixteenth Amendment amply provided for taxation of dividends of corporations and other business organizations, all the revenue acts since 1913, have included a phrase for their taxation. The economist considers all revenue from stock shares as income, while the courts and law specifically exempt certain dividends from taxation. The accountant also considers the receipt of dividends as income.
Interest

The second type of income which individuals, partnerships, corporations, and other co-operative groups receive is that of interest. Interest is a form of unearned income. It differs from dividends in that dividends are distributions made by corporations or associations, while interest is paid by individuals, corporations, partnerships, associations, or others, as the price, in one form or another, for use of capital. The business man's point of view regarding interest is that it is a charge or payment for the use of money.

The economist defines interest as the price paid for the services of capital, and appears in two forms: loan interest and imputed interest. The value of the products of industry which is attributed or imputed to the services of capital goods, as distinct from the services of land and labor is called imputed interest. The first type of interest, loan interest, is self-explanatory. Interest must be paid if capital is to be used in production, and it is possible because capital goods are used under the direction of entrepreneurs. Interest is necessary in order to induce saving.

The income tax laws have adopted the business man's idea of interest, and the Sixteenth Amendment justifies the taxation of interest income. All of the Revenue Acts have specifically included interest as a part of taxable income. The classification of interest according to the Revenue Acts is divided into three parts, while the economist is concerned with only two. The three groups are:

1. Interest which is totally exempt
2. Interest which is partially exempt

3. Interest which is entirely taxable.

Interest which is totally exempt.

There are certain incomes in the form of interest which, by reason of statutes or by law, have been held tax exempt. The major instances are:

a. Interest on obligations of a state or political subdivision thereof.

b. Interest on securities issued under the provisions of the Federal Farm Loan Act.

c. Interest on obligations of possessions of the United States.

d. Interest on obligations of the United States issued prior to September 1, 1917.

Interest which is partially exempt.

Under this classification the type of interest which is exempt is divided into two divisions because the amount received is under a definite amount and interest is paid which is subject to surtax rates only. Liberty Bonds issued after September 1, 1917 were exempt from taxation up to a certain amount to encourage people to purchase them. All Liberty and Victory Bond interest, if not entirely exempt, is held to be taxed only at a surtax rate. Interest paid on certain types of bank deposits by foreign corporations and legations are held to be tax free. Interest paid on bank deposits of a non-resident alien beneficiary, in the case of an estate, is held to be taxable.

Interest which is entirely taxable.

Ordinary interest is subject to both normal tax and surtaxes. This type of interest usually arises as a result
of loans and investments. It may be reported either on the accrual or cash basis, and upon the calendar year or fiscal year basis, depending upon the system used by the taxpayer. Any income resulting from ordinary interest cannot escape taxation under the Federal Revenue Acts.

Interest secured from the result of selling stock on the deferred payment plan was held to be taxable interest. If a stockholder received interest as a result of prepayment of subscription, such interest is taxable and should not be treated as a reduction of the cost of the stock.

The payment of interest is ordinarily made in cash, but in instances where the payment is in other forms, such payment is to be considered at a fair market value.

The economist concept of interest is broader than the one accepted by the Federal Income Tax Laws. It was necessary for the courts and Congress to adopt a simple means of determining interest and to state definitely what types of interest income were taxable, partially taxable, and wholly taxable.

**Income from Rent and Royalties**

This is the third type of unearned income to be reviewed for the purposes of securing some of the economic aspects of this form of income, rents and royalties.

For income tax purposes rent is not restricted to the payment for the use of real property. Income tax rent included the price paid by an individual or corporation for the use of an automobile, boat, machinery, or other personal property. It is not always easy to distinguish between rent and royalties in their simple aspects. The rent received by an owner of real
property is hardly distinguishable between the royalties received from an individual or corporation for removing oil, gas, or other minerals from rented land. Payments made to authors, playwrights, artists, and inventors, as well as owners of mineral lands are considered as royalties for the right to exploit the product of either the brain or of the soil. Just as in the case of all other income, rents and royalties may be received either in cash or in other forms of property, may be reported on the cash or accrual basis, and may be received directly or indirectly.

The economist defines rent as the price paid for the services of land. "Rent means only an income derived from the ownership of land." What one pays for the use of a durable good of any kind owned by another may also be called rent.

The Sixteenth Amendment provides simply for the taxation of rent and royalties, but to make sure that royalties and rentals are definitely taxed, the statute defines income as including "gains, profits and income derived from dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property**also from gains or profits and income derived from any source whatever." 2

Beginning with the 1921 Act, income from sources within the United States is described as follows, "Rentals or royalties from property located in the United States or from any interest in such property, including

1. "Outlines of Economics" Richard T. Ely p. 402
2. 1926 Act, Section 22 (a)
rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property." 1

Not only is the income from rentals and royalties taxed in the hands of individuals, but corporations, trusts, and estates, are taxed in the same fashion.

True rents and royalties are never exempt because they are rents and royalties. Saving as a result of income from rent and royalty is not taxable. Whenever an organization, which is tax free, receives income in this form, such income, of course, is tax free also. Indians are exempt from the tax on lands allotted them from the government because they are wards of the government.

Ordinary rent for the use of real property is generally paid in monthly installments according to the desires of the property holders. Taxpayers who account for income on the cash basis should account for it in the year in which it was received, and the taxpayers who account for income on the accrual basis should report such income in the year in which it was earned.

Rent does not necessarily have to be paid in cash in order to constitute income. The owner of farming land often rents out part of his farm in return for a share of the crops. The value of such crop is the taxable income when the commodities have been sold for cash. This is necessary due to the fact that it is difficult to estimate the fair market

1. 1928 Act, Section 212 and 119 (a) (4)
value on farm products. Sometimes a tenant may pay rent in the form of merchandise which is accounted for on the basis of fair market value. In such instances the amount of merchandise is generally agreed upon before the contract is complete. If the rent is paid with a promissory note, such note constitutes income on the basis of market value. If the note is discounted, the discounted value is the basis for taxable income. When the note is paid, if paid for more than it was discounted for, the excess amount collected over the previous reported amount, is also taxable income.

Ordinary income from royalties is as simple in the computation for income tax purposes as ordinary rent. The simplest example is that of the author who receives from a publisher royalty income for his book. The author accounts for his income as it is received, except in unusual cases where the author accrues his income. A payment made outright for a story is considered more in the light of a compensation for personal services, but it has been recently held that royalties derived from "the sale, leasing or renting of the intellectual product" of an author are not for personal services, but for the use or sale of property, thus are excluded from earned income. Income from the sale of cartoons, articles, etc., to a publishing syndicate, may be either regarded as compensation or royalties because payments are based upon the result of the operations of the syndicate.

The cost of copyrights, patents, and similar property are returnable to the owner free of tax. For simplicity purposes, the law has set the rate for tax exemption at $1,000.00, thus, if an invention cost $1,000.00 to develop,
the first $1,000.00 received in royalties are tax free.

The author who spends money for research material, stenographic services, etc., may deduct same from the first royalties provided they reach $1,000.00, but he is not permitted to deduct the amount of his living expenses while writing the book.

The true owner of the income is taxable, regardless of who actually receives the royalties or the rent, provided the recipient is specified by the owner.

According to the economist, rent, like interest, is a return for the use of a capital good. The rent of a farm or store includes a return for the use of buildings and improvements as well as the land. The economist does not consider royalties or merge them along with rent as it is found in the revenue acts or in the court decisions. There is no distinction made between the rent of a house or a boat or some other real property in the revenue acts. The economist generally considers rent from a narrow standpoint.

**Income from Dealings in Property**

This is the final type of income which is considered taxable. Income from dealings in property results in trading operations. The first type of income considered was that from personal services or earned income, which was followed by unearned income, which included dividends, interest, rents, and royalties. The most common type of income under this final classification, is that which arises as a result of a sale of product by the manufacturer, the disposition of the wares of a shopkeeper, and the sale by a non-trader of a share of stock or a bond, at a price higher than cost. It is the
Purpose of the following discussion to determine how the amount of taxable income is realized from transactions in various types of property.

The basis for the determination of the gain or loss realized in the transaction or sale of property according to the 1928 Revenue Act, is the excess of the amount realized therefrom over the basis provided in the adjusted basis, and the loss shall be the excess of such basis over the amount realized.

When other types of property are given in exchange for a different type, it is more difficult in ascertaining the gain or loss from such transaction. The law compels a taxpayer to include income from this type of transaction although the proceeds are not represented in cash. It may be stated generally that under the 1924, 1926, and 1928 Acts, every transaction involving a sale or disposal of property results in taxable gain or deductible loss unless the law provides for its exclusion. The basis of a sale has a practical element only when associated with the proceeds of the transaction, and it is not necessary that such proceeds be in cash in order for same to be considered taxable.

The general basis for the computation of gain or loss as a result of a trading transaction is the cost, and if such property is acquired after February 28, 1913, the basis must be cost. Property acquired prior to March 1, 1913, would be considered at the market value at that date.

Another basis which may be used to compute cost is the adjusted basis. For example, if an individual buys a wagon for $50.00, but must spend $10.00 for repairs, the basis for the computation of gain, if sold it for $80.00 is not
$60.00, but $60.00, thus the net income would only be $20.00. If the individual did not sell the wagon immediately, but used it for a year, and charged off to depreciation $20.00, then sold the wagon at the end of the year for $50.00, he would account for income of $10.00, because anything over $40.00 would be considered income to the owner of the wagon. Most of the problems arising from the proper basis arise in connection with the adjustments necessary in order to find the cost of the property at the time of the sale. The 1928 Act provides that the determination of net gain or loss, "proper adjustment shall be made for any expenditure, receipt, loss, or other item properly chargeable to capital account" and "proper adjustment shall be made for any expenditure or item of loss properly chargeable to capital account." 1 It was also added in the same act that "The basis shall be diminished by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion, which have since the acquisition of the property been allowable in respect of such property under this Act or prior income tax laws." 2

The gain or loss which may result from the sale of property is based generally upon cost and that the proceeds of a sale or other disposition of property must be compared with the basis. This cost must be adjusted both upwards and downwards in order to establish the basis for income tax purposes. The adjustment is necessary because there may have been various improvements added which increased the cost of the property, while on the other hand there may have been various

1. 1928 Act, Section 11 (b) 1
2. 1928 Act, Section 11 (b) 2
decreases, such as depreciation, which lowered the cost of the property.

**Inventories**

A business which has been organized for some time generally has a stock of goods on hand which constitutes inventory, and the value of such unsold merchandise must be taken into consideration, both at the beginning and at the end of the year, in order to determine the true profit. The subject of inventories will be discussed, first, under the extent to which Congress has recognized the need of inventories, and second, the methods employed in the determination of the value of such inventories.

The statutes provide that "Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income." 1

It was not until December 1911, that a Treasury Decision was made that the basis of inventory should be "cost or market, whichever is lower" instead of compelling the taxpayer to report on cost basis.

True income cannot be determined without the aid of inventories and if income rates are based upon net income, it is necessary that the true and fair income basis be reported.

1. 1926 Act, Sec. 22 (c)
There are various types of computation of inventory, and the most common are:

- cost basis
- basis of cost or market, whichever is lower
- market basis
- book inventories
- basis known as the "retail method"
- basis of average cost
- basis for livestock raiser and other farmers
- basis for miners and oil producers
- basis of appraisal

It is very essential that the correct type of basis be chosen for it would be a bad policy to adopt one basis one year and a different one the next, only to find out that neither plan would be suitable to the type of business engaged in. A plan must be adopted to suit the needs of the business, and this basis followed consistently.

There are two tests which an inventory basis must conform, and they are:

1. the basis shall conform "as nearly as may be to the best accounting practice in the trade or business" of the taxpayer, and
2. the basis shall be the one which "most clearly" reflects the income.

Inventories are to be taken only when the Commissioner deems it necessary in order that true income may be shown. The Commissioner has ruled that inventories, both at the beginning and at the end of each taxable year "are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor." 1 The small neighborhood shops are not required to keep inventories as the value of their stock is:

1. Regulation 74, Article 101.
of goods does not vary a great deal from year to year. If the small shop-keeper was compelled to keep books it would involve a greater amount of expenditure for clerical work. Farmers are not required to take inventories because they are permitted to report on the cash basis.

The Regulations state that: "The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption, or use in productive processes, together with all finished or partly finished goods. Only merchandise title to which is vested in the taxpayer should be included in the inventory." 1

The general rule laid down is that the inventory must include all merchandise owned by the taxpayer. Items are not to be included in the taxpayer's inventory unless title to the merchandise is vested in him. Real estate dealers are not permitted to take inventory.

Inventories are generally taken by actual physical count by a means of listing all goods on hand. The list also contains a description of the goods, the cost, and the number.

The purpose of discussing inventory was to present the necessity of correct determination of net income which cannot be accomplished in some types of business without the listing of merchandise on hand.

1. Regulations 74, Article 101
CHAPTER III.

PERMISSIBLE DEDUCTIONS FROM INCOME AS VIEWED BY THE 1928 FEDERAL INCOME TAX LAW

The third chapter of this thesis has as its purpose the presentation of the permissible deductions from net income as viewed by the 1928 Federal Income Tax Law. In the previous chapter, it was attempted to present some of the economic problems involved in the determination of net income.

It was shown that net income was the amount which remained after subtracting from gross income certain items called allowable deductions.

It was deemed necessary to determine what constituted net income before attempting the analysis of deductions. Income may be both earned and unearned, and may be received either in cash or in some other form, in which instance, the determination of fair valuation is the prime factor. The determination of income is a complicated problem, constantly subject to the supervision of the Commissioner of Internal Revenue and the Treasury Board's decisions.

One must bear in mind that the purpose of this thesis is to present first, a background of good taxation theory as held by the leading economists of the world, second, to compile a historical development of the Federal Income Tax laws in United States, and lastly, to deal with some of the economic problems involved in the determination of taxable income as viewed by the 1928 Revenue Act.
The statute provides for the deduction of "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession for purposes of the trade or business of property to which the taxpayer has not taken or is not taking title or in which he has no equity." 1

Under all the Revenue Acts, Corporations are permitted similar deductions as individuals. Beginning with the 1918 Act, the provision dealing with these deductions permitted corporations the same allowances as individuals, except for the special provision dealing with traveling expenses which is omitted in the case of corporations. The Department, however, does permit a corporation to deduct traveling expenses.

It has been necessary for a limitation to be placed upon the term "business expenses." Personal, family, and living expenses are not deductible under any of the revenue acts, but it sometimes difficult to distinguish between the various kinds of expenses. The reason why personal expenses are not deductible is that single people, as well as married people or heads of families, are permitted to deduct a certain amount each year which is supposed to cover this type of expenditure. Capital expenditures are never allowed as deductions under any of the revenue acts.

1. 1928 Act, Sec. 23 (a)
The Treasury Department has taken the stand that if an expense is to be an allowable deduction, it must meet three tests, namely,

1. the expenditure must be for an expense in connection with the maintenance and operation of the taxpayer's business or business properties,
2. it must be an ordinary expense, and
3. it must be a necessary expense.

All three of these requirements must be present before the taxpayer will be permitted to claim the deduction. The Solicitor has held that "Construing the phrase 'ordinary and necessary expenses' then in the connection in which it is used, having constantly in view the purpose of congress to raise revenue, there seems no room for question that the deduction intended to be allowed is only of the usual or common and essential or reasonably necessary expenses in the case of a corporation doing a similar kind and volume of business, and, by implication, that extraordinary or unnecessary expenditures in the maintenance or operation of the business or properties are excluded."

In order to claim the deductions, the business expense must be incurred by the taxpayer who claims the deductions. A person who owned the entire stock of a corporation was refused permission to deduct these expenses of the corporation from his own account even though the individual advanced the funds necessary for the payment of the expenses. In the case of partnerships, no individual partner may deduct any expense incurred in the operation of the partnership from his personal income tax return.

1. C.C.R. 1045, C.B. 2, 133
The amount of money expended for "ordinary and necessary" expenses has a controlling factor in the deduction for returns. Any large amounts which seem unusually are not permitted to be deducted. This ruling was made necessary in order to prevent the incurring of expenses in large amounts so that the income for the year may be materially reduced for income tax purposes.

In each case the problem of deductions depends upon its own facts and circumstances. In some instances a deduction may be permitted, while the same kind of expense under other circumstances would not be allowed. The Solicitor has held "expenses derive their character not from the funds out of which they are paid, but from the purposes for which they are incurred." 1

Expenses which are incurred in illegal transactions are not permitted to be deducted as expenses. The Board has held "We doubt if business men generally would concede that bribery and lying are ordinary and necessary business acts. If they are not, then the costs of bribes and lies are not ordinary and necessary business expenses. We do not believe that it is in the interest of sound public policy that the commission of illegal acts should be so far protected or recognized that their cost is regarded as a legitimate and proper deduction in the computation of net income under the Revenue Acts of the United States." 2 In order that deductions may be properly taken, it has been held that such deductions are to be taken in the year in which the expenditure occurred. The same ruling applies when the accounts are kept on the cash or accrual basis.

1. S. O. 88, C. B. 4, 119
2. Backer, et al., 1 T.B.A 214; 1 B.T.A. 542
It is sometimes difficult to distinguish between personal, family, and living expenses from business expenses. The distinction is based upon the circumstances that give rise to it. Rent is neither a personal nor a business expense. Its deductibility depends upon the purpose for which the expenditure was incurred. Rent paid by a taxpayer for his residence is not deductible, but if the taxpayer uses part of the residence as his office, such portion of the rent as may be attributed to the office is considered deductible.

By way of summary, only such business expenses as are ordinary and necessary are included in the provision for deduction. It is essential to differentiate between expenses of business and personal expenses and between business expenses and capital expenditures.

Deductions for Interest

The business man who pays interest on borrowings considers such an item as business expense, and, therefore, deductible from the gross income of his business. It can be said, in general, that the revenue acts have adopted the business man's conception of interest paid on borrowings. It has been shown that the taxpayer may decrease his gross income by the deduction of necessary and ordinary business expenses, and if there had not been a provision for the deduction of interest in the revenue acts, the provision made for expenses would justify the inclusion of interest in this category.

The 1928 Act provides "All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States
issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title." 1

All interest paid on indebtedness, with one exception, is considered deductible. It is not necessary that such borrowings be made for business purposes in order that they can be deducted. An individual may borrow money to make a trip for pleasure purposes, or household furniture, and the interest paid on such amount is considered deductible. The exception previously mentioned, it that interest paid on money borrowed to purchase tax free securities is held taxable.

It has been held that the taxpayer must report the interest paid or accrued in accordance with the system of bookkeeping used. The taxpayer who changes the system of bookkeeping from the cash to the accrual basis during the taxable year, may not deduct interest which accrued in a prior year, but which was paid during the present year. This ruling came about as a result of the fact that the Department did not want taxpayers to change their system of accounting without permission, and if such changes were made, the taxpayer must be required to pay the cost for same.

Discount may be looked upon as prepaid interest, and, therefore, considered deductible.

The Revenue Acts have accepted the business man's viewpoint of interest expense, and have permitted its deduction from gross income. There is only one exception, however, and that is, if interest is paid or accrued in order to purchase or carry tax-exempt securities.
It is now proper to consider the third type of deductions which are permitted to be deducted from a taxpayer's gross income. It has been shown that business expenses are not the only class of expenditures that the taxpayer may use in arriving at net taxable income.

Deductions for Taxes

It is first necessary to understand what is meant by taxes. Taxes are generally said to be assessments which are imposed to meet general governmental demands, and which go into a general tax fund.

The provision in the 1926 Act for the deduction of taxes for individuals, corporations, partnerships, estates and trusts, are

1c) "Taxes Generally.--Taxes paid or accrued within the taxable year except:

(1) Income, war-profits, and excess-profits taxes imposed by the authority of the United States;

(2) So much of the income, war-profits, and excess-profits taxes imposed by the authority of any foreign country or possession of the United States as is allowed as a credit against the tax under section 121; and

(3) Taxes assessed against local benefits of a kind tending to increase the value of the property assessed;***

For the purpose of this subsection, estate, inheritance, legacy, and succession taxes accrue on the due date thereof, except as otherwise provided by the law of the jurisdiction imposing such taxes, and shall be allowed as a deduction only to the estate.

(d) Taxes of Shareholder Paid by Corporation.--The deduction for taxes allowed by subsection (c) shall be allowed to a
corporation in the case of taxes imposed upon a shareholder of the corporation upon his interest as shareholder which are paid by the corporation without reimbursement from the shareholder, but in such cases no deduction shall be allowed the shareholder for the amount of such taxes."

All "taxes paid or accrued within the taxable year" are permitted to be deducted except:

1. Income and profit taxes of the United States.
2. Such income and profit taxes of a foreign country or of a United States possession as are allowed as credits against the tax.
3. Assessments for local benefits.

The phrase "paid or accrued" has been inserted in order to make the taxpayer account for his taxes paid in accordance with the method of accounting used.

Ordinarily, the deduction for taxes may be taken only by the person upon whom the tax is imposed, if such person pays the tax. For convenience, the classification of taxes is generally made into three divisions, namely:

1. Taxes paid to a foreign sovereignty or to a United States possession;
2. Federal taxes;
3. State and local taxes.

**Foreign taxes.**

Taxes imposed by a foreign government or by a possession of the United States on a citizen, resident, or domestic corporation are, except for local benefits, considered deductible.

**Federal taxes.**

Federal taxes may be considered as deductible or non-
deductible. The statute permits the deduction of all federal taxes except income and profit taxes. Interest paid on delinquent taxes is also deductible, but this amount would be considered deductible under interest if the interest were not permitted to be an expense in this instance.

State and local taxes

As regards state taxes, it may be generally stated that all state taxes may be considered deductible. There is only one exception as regards local tax exemption, and that is, the case where the tax is imposed for a "local benefit". In all other instances, local taxes paid or accrued are considered deductible.

By way of a short summary, taxes are permitted deductions from gross income except in three instances, federal income and profit taxes, assessments for local benefits, and lastly, such income and profit taxes payable to foreign countries or to possessions of the United States as may be taken as credits against the amount of income tax due the United States. There are some taxes which are in reality only fees, and a fee is not considered as deductible as tax, but if it is incurred as a result of a business activity, such may be deducted as business expenses. In general, it may be stated, that all taxes are usually permitted to be deducted from gross income.

Deductions for losses

Due to the fact that some people engaged in business suffer losses as a result of their activity, or that individuals who own some real property may have same stolen, the Revenue Acts have recognized such losses as expenses and the amount of such losses may be deducted from gross income. Such losses are part
Revenue acts have recognized them as such. Under this discussion of losses, only the ordinary losses are considered at present, losses for bad debts, depreciation and others are reserved for future reference.

The 1928 Act states that an individual may deduct

"losses sustained during the taxable year and not compensated for by insurance or otherwise--

(1) if incurred in a trade or business; or
(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or
(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft."

In order that a noncorporate taxpayer be permitted to deduct a loss it must have arisen or been incurred

1. "in trade or business, or
2. in any transaction entered into for profit (even though not connected with taxpayer's trade or business); or
3. in connection with property not connected with trade or business, if the loss resulted from fires, storms, shipwreck, other casualty, or theft."

The question now arises as to whom may be permitted to take the deductions for losses. The statutory provisions are:

(a) individuals (citizens and residents)
(b) domestic corporations, joint-stock companies, and associations.

1. 1928 Act, Section 23 (a)
2. 1928 Act, Section 23 (e) (1)
3. 1928 Act, Section 23 (e) (2)
4. 1928 Act, Section 23 (a) (3)
5. 1928 Act, Section 23 (e) (3)
6. 1928 Act, Section 23 (f)
(c) Nonresident alien individuals. 1

(a) Partnerships. 2

(e) Estates and trust 3

Losses which are not compensated for by insurance or otherwise, may be deducted in the taxable year in which they occurred. The deduction for business expenses, taxes, and interest must be taken in the year in which it was paid or accrued. Losses are seldom "paid", and it is difficult to decide when a loss was sustained or incurred, especially in cases involving litigation. The accounting method or basis of computing income affects the time as of which losses may be taken. Very often the Commissioner permits losses to be deducted in periods other than which they were sustained.

Deductions for Bad Debts

The revenue acts make special provision for the deduction of bad debts rather than include them with deduction for losses. The provision reads as follows:

"In computing net income there shall be allowed as deductions:

"Debts ascertained to be worthless and charged off with in the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part." 1

The requisite for the deduction of bad debts must be that such a debt exists. The fact that a taxpayer considers a debt to exist does not constitute its deduction, there must be some enforceable personal legal obligation existing. There

1. 1928 Act, Section 23 (j)
rests upon the taxpayer the responsibility for the attempt to collect a debt by taking reasonable and ordinary steps to collect, and the taxpayer must be prepared to present some evidence of an attempt to meet this responsibility. The failure to attempt to collect may be regarded as a voluntary discharge of the debt, or as a gift to the debtor.

Bad debts must be distinguished from losses. This is important for two reasons, namely,

1. Bad debts are deductible only in the year in which they are charged off, while losses are deductible in the year in which they are sustained, and

2. The deductibility of bad debts is closely related to the accounting system, while the deductibility of losses is quite independent of this fact.

In the case of the Electric Reduction Co., vs. Lewellyn, the Court held "Congress doubtless had in mind the distinction between a loss and a worthless debt. Every worthless debt is a loss, but not every loss is a worthless debt. Every worthless debt is allowed as a deduction if it is ascertained to be worthless and is charged off within the taxable year. So far as allowance as a deduction is concerned, a loss and a worthless debt amount to the same thing if the latter is charged off in time."

The voluntary cancellation of a debt is regarded as a gift and may not be deducted as a bad debt to the creditor nor reported as income by the debtor.

In order that a bad debt may be deducted as such, in addition to it being definitely determined as a bad debt, in the books of account, same must be charged off. The actually
writing off of the debt must be done in the year in which the credit is to be taken. The Board has held that only items which have been charged on may be permitted to be charged off. When the taxpayer keeps books of regular account, the evidence of this charging off should be shown in books of proper account.

The 1928 Act permits a deduction for reserve for bad debts at the discretion of the Commissioner. This step is a rather belated one in the opinion of accountants, who have held that reserve for bad debts is in line with good accounting practice. In determining the amount of the reserve for bad debts, the individual experience of the firm is usually followed.

By way of summary, bad debts are deductible in the year when they are ascertained to be uncollectable and written off the books of the taxpayer. Difficulty is sometimes encountered in determining whether a debt is really deductible. Debts secured by collateral may not be written off until the collateral is sold and the difference between the two is determined. It may be said that the revenue acts have realised the necessity for the deduction of bad debts because of good business policy and the fairness of ascertaining net income for taxation purposes.
It has been previously pointed out that net income is the result of certain statutory deductions from gross income. With certain exceptions, deductions consist mainly of business expenses and losses. The deductions presented before have been of this nature, and it is now proper to deal with permissible deductions due to the decline in value of property employed in the taxpayer's trade or business, such decline being due to physical deterioration, wear and tear through use in such trade or business.

The 1928 Act contains a provision permitting deductions for depreciations:

"Depreciation.—A reasonable allowance for the exhaustion, wear and tear of property, used in the trade or business, including a reasonable allowance for obsolescence*** 1

The depreciation provisions of the statute are not intended to cover all causes for decline in valuation of business property. Declines which are ordinarily gradual are covered by depreciation allowance, but sudden changes in the manufacture of machinery which would necessitate the destroying of present equipment and selling same as a loss, such would be deductible as a loss, not as depreciation.

The determination of the property subject to depreciation as viewed by the statutes is not to be restricted to any one kind of property, but to both tangible and intangible property. In order to claim depreciation deduction, the tangible property must be of such a nature that "it is subject to wear and tear". Intangible property which has a definite duration of potential usefulness is entitled to the depreciation allowance.

In the determination of the amount of depreciation to be

1. 1928 Act, Section 23 (k)
allowed, the Department has stated: **The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate) whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the basis of the property.***

There must be two known factors in the determination of the amount, namely,
1. The "basis" or capital sum to be replaced,
2. The length or duration of the useful life of the asset.

The basis does not necessarily have to be cost. If the property was acquired before March 1, 1913, the 1928 Act provides that the basis shall be the cost or the value as of March 1, 1913, whichever is greater. If the basis is unknown, there can be no permitted depreciation deduction. The adjusted basis is the capital sum, over and above scrap value, which remains intact during the depreciable asset's useful life in the business.

The Department, in the determination of the length or duration of the useful life of the asset, stated: "The term 'useful life' is interpreted to mean the period of time over which an asset may be used for the purpose for which it was acquired." 2

Depreciation allowance grew out of the fact that many assets employed in trade or business become less valuable as a result of their use in the trade of business. The measure of depreciation depends upon the type of asset, but such depreciation must be reasonable. The object of the allowance is to enable the taxpayer
to recoup himself of the loss secured while using the asset in a trade or business.

Closely related to depreciation is that deduction known as depletion. The theory of allowance for depletion is that capital represented by natural resources embraces a certain quantity, and this quantity is reduced by exploitation or removal, the production of capital is correspondingly reduced. The 1928 Act deals with depletion allowance thoroughly, and the general purpose of the depletion deduction is well stated in the Regulations: "The essence of these provisions of the act is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either the cost of his property, or the value of his property on the basic date plus, in either case, subsequent allowable capital additions but not including land values for purposes other than the extraction of minerals." 1 Depletion allowances are granted to individuals and corporations alike.

The basis upon which depletion is allowed in provided for in the 1928 Act, which states "The basis upon which depletion is to be allowed in respect to any property shall be the same as is provided for the purpose of determining the gain or loss upon the sale or other disposition of such property." 2 The cost or fair market value are the two bases which may be used in the determination of depletion allowance.

Depletion allowances are permitted in businesses which deal in the exhaustion of natural resources, such as mines, oil and gas property, and timber property. The problem of depletion is

1. Regulations 74, Article 221
2. 1928 Act, Section 114 (b)
in the determination of valuations upon which depletion may be measured.

The last type of allowance to be considered is that of donations made to charity. Charitable contributions are not deductible by corporations and associations unless the donations are considered "ordinary and necessary" business expenses. The rule governing the amount of donations permitted to be deducted is that the contributions must not exceed 15% of the donee's net income before the amount of contributions is taken into consideration. The time of deduction is governed by the accounting methods regularly employed by the taxpayer. The Commissioner hands out rules regarding the deductions of this nature in order that evasion of taxation may not occur.
Conclusion

The purpose of this thesis has been to present some of the economic problems involved in the 1928 Revenue Act based upon a background of the historical development of the federal income tax laws in the United States.

The Civil War Revenue Acts, covering a period of several years after the war, were the first federal income taxes to be levied in this country. Their failure was due chiefly to the poor administrative system, and the fact that the people did not realize that it was a more equitable and just taxation. The failure of the Civil War income taxes point out that if an income tax is to succeed, it must be supported by a strong administrative system so that the tax evasion will not be too great. The series of Civil War income taxes were later repealed due to the improved financial condition of the country and the unfavorable attitude of the people toward this form of taxation.

Later on, when the Federal Government realized that it must find a new source of revenue other than that of tariffs, it again turned to the income tax. This was in 1894. This law was held to be unconstitutional because it was a direct tax and therefore could not be levied without constitutional amendment. Congress then began the work for the ratification of the Sixteenth Amendment, which occurred in 1913.

With the ratification of the Sixteenth Amendment a series of revenue acts have been passed which have prepared the way for the highly developed system of revenue return which our country has today. Each succeeding act has added improvements, explained what may be income, what constitutes income under laws, and how the concept of deductions may be
conceived in order that a true basis for net income for taxation may be secured.

The conception of income by the economist is different from that of the accountant or that type of income as held by the courts or through the revenue acts. Income, under the revenue acts, is what the courts have decided it to be. The courts, the Commissioner of Internal Revenue, the Board of Tax Appeals, all have agreed upon income and what constitutes income under the revenue acts. Their decisions are often very narrow, but it is necessary for the rules to be rigid so that people will not attempt to evade the taxation of their income. Certain penalties have been created for the evasion of federal income taxation which have caused people to be extremely careful in reporting their net income for taxation.

The unfavorable attitude of the people which existed after the Civil War toward the taxation of incomes has practically disappeared due to the fact that the people have become conscious of the desirability of the taxation of incomes in preference to property taxation. The growing favor of income taxation is evidenced by the fact that many states in the union have adopted or proposed some form of income taxation. The fact that the rates of taxation may be varied according to the requirements of the governmental unit is one of its most favorable features. The amount of revenue secured by this means is constantly increasing in importance. The property taxation requires the reassessment of property frequently, while there is no need for this administrative feature in the levying of income tax.
The future of income tax appears to be favorable because of its elasticity, its productivity, its diversity, its ease of administration, and lastly, its justness.
I. BOOKS


II. ARTICLES

Fisher, Irving, *The Income Concept in the Light of Experience*. Revenue Act of 1928 enacted by the Senate and House of Representatives of the United States

Regulations 74 of the Revenue Act of 1928.

Report of Commissioner of Internal Revenue Washington, 1864, and 1869.