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The Hidden Logic and Simplicity of the Federal Income Tax Laws.

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THE HIDDEN LOGIC AND SIMPLICITY OF THE FEDERAL INCOME TAX LAWS

BY

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THE HIDDEN LOGIC AND SIMPLICITY OF THE FEDERAL INCOME TAX LAWS

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CHAPTER I

AIM OF STUDY AND DEFINITIONS

The Federal Income Tax laws, with their numerous sources and biblical-like wording, have always confused and irritated the American taxpayer, however, a careful study of their purpose and content offers the reward of a much clearer concept of the logic and interest embodied in them.

A subject as broad as the Federal Income Tax cannot be covered in a report of this nature. Only the very smallest phase of it can be given adequate treatement. It is necessary, therefore, that a clear outline of objectives be presented so that the topic can be read with more effectiveness.

The underlying theme of this report is the taxation of income by the Federal Government. Any tax other than the Federal Income Tax is not within the purview of this report. A discussion will be presented dealing with an evaluation of the income tax, pointing out the various issues involved, and how the present Federal Income Tax laws resolve these issues. Certain generally accepted standards of evaluation of any good tax will be listed and an attempt made to see whether or not the Federal Income Tax meets these tests. During this examination, the various taxable entities which are used by the Federal Government as the objects of our income tax laws will be pointed out. Arguments will be given for and against treating each of the present taxable entities as such. Finally the body of this report will deal with the complete set of laws applicable to a single type of business organization -- the Partnership. The Partnership was choosen as a means of illustrating the hidden logic and simplicity of our income tax laws because the laws applicable to a partnership are sufficiently brief to permit a complete coverage in a report of this size. It is not the purpose of this report to show in detail the income which is taxable to each entity. This would be impossible to do in a report of less than several thousand pages. The sole objective is to illustrate how the Federal Income Tax Laws are to be interpreted in a manner that will give to the student their correct meanings. The Partnership appears to have the necessary attributes to accomplish this objective. A summary will be given that should leave one with a clearer picture of the methods which should be used to determine the meaning of the Code. The Internal Revenue Laws are not a completely boring and incomprehensible set of rules. They have vitality and interest for the man who starts out in the right manner to understand them. The purpose of this report is to aid in the exposition of these qualities.

In the development of this topic, certain words and phrases will be used frequently. For purposes of clarity it is essential that the reader have a clear understanding of their meaning as used in this report. There will be presented at this point, certain words and phrases along with their meaning as used by the author.

Taxable entity. Any person or business organization that is recognized as having a separate existence by the Bureau of Internal

Revenue for the purposes of levying an income tax on such persons or business organization.

Individual. Any person upon whose income a tax is levied.

Partnership. Any association of two or more persons to carry on as co-owners a business for profit, and when this association is sufficient in law to make such persons file form 1065, the partnership return of income.

Corporation. Any group of persons which has formed a business for profit and which business would fall within the accepted definitions[1] of a corporation and which business must file form 1120, which is the corporation income tax return.

Trust. Any situation involving the separation of the legal and equitable title to property wherein the holder of the legal title (fiduciary) must file form 1041, which is the fiduciary income tax return.

Estate. Any situation where an executor or an administrator is managing and disposing of the estate of a deceased person and during such administration has realized income which must be reported on form 1041, which is the fiduciary income tax return.

Subject of tax "is the class of persons, category of property, act, privilege, or other circumstance upon which a tax is levied or the existence of which gives rise to a tax liability."[2]

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[1] See the classical definition of Chief Justice John Marshall in Dartmouth College v. Woodward, 4 Wheaton 518 (U.S. 1819).

[2] William J. Shultz and C. Lowell Harriss, American Public Finance (fifth edition, New York: Prentice-Hall, Inc., 1945) p. 170.

Measure of tax "is the unit to which the rate of tax is applied."[3]

These definitions are not intended to be scholarly in character. They were given to reveal the exact intended meanings of certain words which will be used frequently in this study.

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[3] *Loc. cit.*

CHAPTER II

BASIC PRINCIPLES OF INCOME TAXATION

History has proven that sound taxation is the most effective and equitable way for a government to raise the revenue so important for its continuance. In recent years, the Federal Income Tax has proven itself to be the most valuable fiscal weapon in the hands of the Government. In the year ended June 30, 1948, it produced $30,850,000,000.00 in revenue out of a total revenue from taxation of $42,290,000,000.00[4] It is a fair assumption that any fiscal measure which can produce such tremendous revenue has certain characteristics that any tax must have to be successful.

When a man is taxed on the real property he owns, he is being taxed on the right to own such property. Equally as true, is the case of a corporation paying a franchise tax, for this is a tax on the right or privilege which the corporation possesses to engage in business activities within a certain state. Thus it is possible to think of all the multitudinous forms of taxation, as a tax on the right to own or the right to do something. Now included in the numerous rights, which are taxed, is the most important one, from the standpoint of revenue-produced, this is the right to receive income. It is upon this right to receive income that our Federal Income

4 "United States Bureau of Internal Revenue," Annual Collection Division Report (Washington, D. C.: United States Government Printing Office, July 1948).

Tax Laws are based.

The question of what is and what is not income has contributed greatly toward making our present tax laws complicated. Income is a word used almost every day by mature persons, and yet its precise meaning is very doubtful to the experts.. Economically speaking it is an elusive concept, for economic theorists continuously offer many contradictory definitions of income.[5] Unfortunately for us, from a legal standpoint the concept of income is not much clearer. The Supreme Court has told us that "nothing (is) to be gained by the discussion of judicial definitions of income."[6] We shall heed the warnings of the supreme court and not become involved in the definition of income. Suffice it to say, that, for the purposes of this report, the only income which is under discussion is that which was considered as taxable under the 1949 Revenue Act, the Current Federal Tax Code, and the courts current interpretations of the Code.

Over one hundred and sixty years ago Adam Smith set forth four so-called "maxims" of sound Taxation.[7] These four read as follows:

> I. The subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to their abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.

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5 *Ibid.*, pp. 387-401.

6 Mr. Justice Holmes in, *United States v. Kirby Lumber Company*, 284 U.S. 1 (1931).

7 Adam Smith, *The Wealth of Nations*, (Book V), Chapter II.

II. 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.

III. 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 it.

IV. 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 and above what it brings into the public treasury of the State.

These four maxims -- often referred to as the ability, certainty, convenience, and economic maxims -- have come down to us through the years as shining guideposts of good taxation. The United States Government as a beneficient sovereign appears to be following these concepts of Adam Smith in the levying of the Federal Income Tax. Whether such compliance is conscious or not we cannot say. Unfortunately the perfection embodied in these maxims is yet to be attained. However as each new inequity presents itself, the Congress, the Courts, and the Bureau of Internal Revenue, each in their turn, exerts influence to effectuate a just cure.

The purpose of the Federal Income Tax Laws is to extract a tax from those places in our economic structure where taxable income exists. With this purpose in mind, the Federal Government has decided that the following four taxable entities possess the ability to or can most readily pay an income tax: the Individual, the Corporation, the Trust, and the Estate. An attempt shall now be made to determine how closely the Federal Government follows the four postulates of sound taxation with the income tax.

Under the 1949 Federal Income Tax Rates on the Individual, the Trust and the Estate, the tax ranged from 16.6% to 77% of their respective net incomes subject to taxation. These percentage figures include the combined normal and surtax rates. These rates are progressive and result in the payment of a higher percentage of tax per dollar of income as the income of the taxable entity increases. In this manner income is used as the measure of a taxpayer's ability to pay. The basic idea being that the more income a taxable entity receives the more tax it is able to pay. This theory is not always sound. Under the 1949 rates of progressive taxation a married couple without any children having an income of $1725.00 will have to pay $60.00 in taxes. Another married couple without any children, having an income of $2925.00 will have to pay $240.00 in taxes.[8] The proponents of the progressive rates of income taxation argue that the payment of $60.00 by the first couple entails as much burden as does the payment of $240.00 by the second couple. It is obvious that this does not always result in an accurate equal burden on each taxpayer. There are a lot of external factors that will prevent the second couple from being equally able to pay four times as much income tax as the first couple. Whether the first couple owns or rents their home or whether they are forced to spend a greater proportion

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[8] These figures are based on the assumption that the married couples use the optional standard deduction, and file a joint return.

of their income for personal consumption than the second couple are all factors that tend to weaken income as a good measure of ability to pay. There are indeed numerous situations which arise under our present income tax laws which in particular instances make income a poor measure of ability to pay. A good example of this concerns taxpayers with fluctuating incomes -- actors, baseball players, boxers, and the like, professional people, and all other rendering personal service. These people, merely because they earn huge incomes in one year and nothing in the next year or years, are forced to pay a much higher percentage of their income in taxes than are people with their incomes apread out more or less evenly throughout the years. The fault here lies not with income as a measure of ability to pay, but with the application of the progressive principle of our tax rates. These people should be given some form of relief, possibly by allowing them to average their incomes over a period of years.[9] Another inequitable situation which exists when income is used as the measure of an individual's ability to pay a tax can best be understood by an illustration. Assume X and Y have taxable incomes of $1,000.00 and $1,000,000.00 respectively. Let us further assume that they are both married people with no other dependents and that they file a joint return. Under the 1949 tax rates X and Y would pay $166.00 and $770,000.00 respectively. Upon a superficial observation, it

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9 For an interesting discussion of this problem see: Thomas N. Tarleau, "Unjust Income Taxes," Fortune Magazine, 1: 69-70, January, 1950.

would appear that the taxes paid by X and Y were just. Let us look a little deeper and see what is really happening. After X and Y have paid their taxes they have $834.00 and $230,000.00 left respectively. Undoubtedly X has already spent the $834.00 and has saved nothing for the day when he can no longer earn an income. Y on the other hand could have spent $100,000.00 and still have $130,000.00 left to provide for him in his twilight years. Thus it is obvious that Y was far more able to pay his taxes than was X. Some provision should be made which would give the recipients of income from wages, salaries, and other professional services of less than, let us say, $5000.00 an additional exemption from taxation if they irrevocably appropriate some of their incomes to a plan that would provide them with income at such time when they can no longer work. An additional consideration that favors an exemption for these taxpayers is the fact that it would help them provide for their wives and children in the event a sudden death or accident stops their income. The fault again is not with the fundamental concept of income as a measure of ability to pay a tax, but is merely an example of the need for a slight revision of our tax laws as they apply to this particular situation. It is obvious that anything as all-inclusive as our income tax laws will produce some inequitable results. The fact that our democracy enables communists to influence others through public persuasion is not sufficient reason for abandoning it. The fundamental idea is still good. It merely needs a little brushing up around the edges. And so it is with the income tax laws, the underlying idea is as good as ever, but legislation is needed at a few points to make it even better. While it is very true that an individual has other possessions besides income that will give him ability to pay a tax, we must bear in mind that these other factors of an individual's ability to pay taxes are reached through property, estate, inheritance, gift, and other taxes too numerous to mention.

The preceding discussion should be considered to be equally applicable to a trust and an estate. The same rates of progression are applied to them as to the individual. Since it is the individual or beneficiary who must ultimately pay the tax levied on the income of a trust or estate, any consideration of ability to pay this tax would center on the individual. Should the trust or estate pay the tax, the beneficiary's income would be reduced by the amount of such tax. Hence it is that any tax which is paid by a trustee or executor can be considered as having been paid by the individual who receivesthe income

If income is not a true measure of ability to pay a tax, what is? Is wealth the best measure? Or consumption expenditure? Or savings? Or some other element? Or a combination of income, wealth, consumption expenditure, and savings? All these questions present very current problems. Before the framers of our tax policy make any rash or quick changes, they should bear in mind that the primary purpose of the income tax is the production of revenue. It is certainly desirable that a constant effort be made to promote tax justice. However, it should be bornein mind that our tax policy at present is functioning comparatively smooth and producing the needed revenue. Any change of policy which promises to reach desired theoretical goals may prove to be an utter failure as a revenue producer, because of the impossibility of good administration.

The corporation, however, must be considered alone since it presents a far different problem. It is a very important factor in our economy, since most of America's "big business" has the corporate form. The question of whether a corporation possesses the ability to pay the tax currently being levied upon its income is vital.

In 1909, the Congress passed a tax law which is commonly referred to as the Corporation Excise Tax of 1909. It placed a levy of 1% on the net incomes of corporations in excess of $5,000.[10] In 1932 the exemption was abolished. From 1935 to the present date the rates of corporate income tax have been progressive.[11] At the present time the rates of tax range from 21% to 38%, provided that all of a corporation's income is subject to the normal and surtax rates. With these high rates of tax being placed on a corporation's net income, the question of income taxes has assumed a more prominent place in American fiscal policy.

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10 Prentice-Hall, Federal Tax Course, (New York: Prentice-Hall, Inc, 1948), p. 1004.

11 Shultz and Harriss, op. cit., pp. 440-42.

Basically a corporation is taxed separately from its stockholders on the theory that the two are separate and distinct legal entities. This extension of the legal fiction of a corporation's separate being into the field of taxation has caused much disagreement among the scholars and theorists in the field. While it is true that a corporation and its stockholders are separate legal entities, is it not equally true that they are the same economic entity? When one speaks of ability to pay a tax he is not concerned with artificial legal distinctions. Under the present reasoning, an individual who has invested $100,000.00 in a corporation, has, from the standpoint of our income tax laws, doubled the earning power of his contribution. The $100,000.00 earns two distinct taxable incomes. The one income being attributable to the corporation, the other is attributed to the individual when he receives a dividend. Is it not clear that what we really have is a single economic entity -- the individual? Hence it follows that the $100,000.00 earns income only for the individual and should be taxed only to him. In 1936 Noel Sargeant, made the following statement:

> In considering the burden or ultimate incidence of taxes upon industry, the nature of industry as such is frequently entirely overlooked. Approximately 95% of manufacturing is done by corporations. It is estimated that there are approximately 11,000,000 separate industrial stockholders in the United States, and we cannot logically consider taxes upon the earnings or profits of corporations without considering their relation to the investment and earnings of these stockholders. "Industry" or "business" as such has no taxpaying ability; the taxpaying ability which exists is in reality the ability of

the stockholders in industry.[12]

Mr. Sargeant can find economists who will agree with him. They argue that ability to pay is a personal idea and cannot be very plausibly associated with a distinctly impersonal institution like a corporation. They contend that the best gauge of ability to pay is the stockholders and not the corporation. It is stated that the mere volume of corporate income with no regard to capital investment is a poor indication of ability to pay. The graduated tax upon corporate income taxes larger earnings at a higher rate without regard to the proportion of such earnings to investment, and this, some economists argue, discriminates against business efficiency and success. This discrimination is generally in favor of small corporations and against large corporations. It is further argued that a tax on corporate incomes is a part of the New Deal program of fostering "little" business in its struggle with "big" business.[13] This use of the income tax is against the principle that taxation should be used exclusively for revenue producing purposes or as an instrumentality to enforce powers specifically delegated to the taxing government. In 1937 the National Association of Manufacturers made the following comment in regard to a tax on corporate incomes:

> The income tax should be levied only on the income of individuals; since income taxes paid by corporations come

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12 Tax Policy League Symposuim, How Shall Business Be Taxed, (New York: J. J. Little and dues Company, 1937), p. 16.

13 Shultz and Harriss, op. cit., p. 442.

> out of some individuals earnings, either the stockholder, the consumer, the employees or perhaps all of them and since that individual may be a person of either large or small income, the principle of graduated rates is violated if the corporations income is taxed by progressive rates. However if corporations must be taxed they should be done so at a flat rate.[14]

They base their argument on the idea that those forms of taxes which fall directly upon the individual and are payable by him have the least harmful effects on the national economy and the economic machine. As far back as 1909, a noted tax expert foresaw the violation of the progressive principle of taxation by a graduated tax on corporate income when he said:

> A progressive corporation income tax does not necessarily mean a progressive tax on the individual shareholders. It may denote just the reverse. The application of the progressive principles to corporations is therefore of dubious expediency.[15]

Mr. Seligman's statement makes the very logical assumption that the large corporations with the large incomes are usually widely owned by numerous working men and women. Conversely the small corporations with the small incomes are usually owned by a family or a very small group of stockholders. Hence with the large corporations paying the higher rates of income tax, and the smaller corporations paying the lower rates of income taxes, you have the low income groups paying high rates of taxes and the high income groups, who own the small

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[14] Tax Policy League Symposium, *op. cit.*, p. 18.

[15] Edwin R. A. Seligman, *Progressive Taxation*, (second edition; Princeton: Princeton University Press, 1909), pp. 317-18.

corporations, paying low rates of income taxes. The conclusions that one may draw from Mr. Seligman's argument is that if corporations must be taxed at all, they should be done so at a flat rate. A flat rate would tend to eliminate several serious objections which are now offered against the progressive tax on the incomes of corporations.

It would appear from all the arguments which can be found against recognizing the corporation as a separate taxable entity and the few that favor it, that something should be done to rectify the situation. Numerous changes have been proposed, the most prominent of which are the following:

> I. Eliminate the deductibility of bond interest and other payments for capital such as rents under the income tax, so that the income tax system will not discriminate between stocks and bonds and leases as instruments for obtaining business capital.
>
> II. Reintroduce an undistributed profits tax at a rate that will approximate the average burden of the personal income tax on dividend income.
>
> III. Treat corporations as partnerships and tax each stockholder on his proportionate share of his corporation's total earnings whether distributed or not.
>
> IV. Allow stockholders a credit for the tax paid by the corporation on that part of its income distributed as dividends.
>
> V. Exempt dividend income from the low brackets of the personal income tax or to exempt part or all dividend income from all personal income taxation.[16]

Each one of the above plans has certain things that can be said in its favor. However, they all present certain difficulties of administration

[16] Shultz and Harriss, *op. cit.*, pp. 448-49.

and collection. All of the suggested changes in some way or other attempt to lessen the distinction now accorded to the corporation as a separate entity for tax purposes. The proponents of these changes realize that severe complications enter the picture when the legal fiction of a corporation's separate existence is carried into the field of taxation. The true solution appears to require a different change than any mentioned. It may eventually be found to be in the complete elimination of the corporation as a separate taxable entity.

In addition to the doctrine that a corporation possesses no taxpaying ability as such very grave economic problems arise by the taxation of corporate incomes and also the taxation of dividends to the stockholders. "An individual with a top-bracket income must be able to count on a secure 18 per cent earning rate on share value by a corporation in which he holds shares, to leave him as much after taxes as a 2 per cent tax-exempt, bond, assuming that the income of the corporation will be fully distributed."[17] The most obvious effect of the corporation income tax is to reduce drastically the profit potentialities of corporate stockholders. Recently a very careful study of the corporate income tax and its effects reached the following conclusion:

> Individual savers have increasingly entrusted their funds to safe forms of investment such as government bonds, life insurance companies, and other major savings institutions. Funds so invested are seldom made available to companies in

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17 Ibid., p. 447.

companies in need of venture capital.[18]

There can be no doubt that present income tax laws discriminate against stock as an investment. With most of American "big business" taking the corporate form, this is of doubtful propriety. At the present high rates of income taxes the individual investor has an easier decision to make as regards the type of investment he will make. He will, if he decides it will be more profitable, take his money out of stock and place it in other economically less important fields, where he is not subject to double taxation. It would appear to be a timely question whether or not the $9,850,000,000.00[19] obtained in 1948 from the corporate income tax, warrants the tampering with, and possible drastic consequences to, our American economic machine. The manner in which this question is answered may have effects that will reach farther than we can presently ascertain.

The second "maxim" of taxation laid down by Adam Smith stresses the need for certainty in a tax. It proposes that the tax which each individual is bound to pay ought to be certain as to: the time of payment, the manner of payment, and the amount of the payment. It is the purpose of this section to determine whether or not the income tax has the maximum amount of "certainty" embodied in it.

Simplicity in tax legislation is the first step toward tax

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[18] J. Keith Butters and John Lintners, Effect of Federal Income Taxes on Growing Enterprises, (Boston: Harvard University Press, 1945), p. 32.

[19] Shultz and Harriss, op. cit., p. 306.

certainty. Until a taxpayer understands the rules governing the income tax as it applies to him, there can be no certainty. The following statement is made in a book on elementary economics concerning this topic:

> Certain modern taxes, such as the property tax, the income tax, and the inheritance tax, are so involved with complexities that it is often difficult for the taxpayer to know just what his legal obligation is. For example there can be no doubt that, under the United States income tax many persons are paying more than their lawful taxes, through misunderstanding of the law or mere carelessness.[20]

The conditions referred to are deplorable and should be reduced to a minimum. The best way to eliminate this is to make the wording of our tax laws more simple and more direct and to the point. If all the criticisms that are offered about our federal income tax, none are more justified than the ones dealing with the phraseology of our present tax laws. Recently this situation was ably described by Judge Learned Hand as follows:

> In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception -- couched in abstract terms that offer no handle to seize hold of -- leave in my mind only a confused sense of some vitally important, but successfully concealed purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion; yet at times I cannot help recalling a saying of William

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[20] Fred R. Fairchild, Edgar S. Furniss, and Norman S. Beck, Elementary Economics, (Volume II, fourth edition; New York: The Macmillan Company, 1939), p. 18.

> James about certain passages of Hegel: that they were no doubt written with a passion of rationality; but that one cannot help wondering whether to the reader they have any significance save that the words are strung together with syntactical correctness.[21]

Judge Learned Hand in his able manner has expressed the opinion of some fifty million Americans who must comply with our income tax laws. Realizing this, the Treasury Department makes every possible attempt to simplify the average taxpayer's compliance with our tax laws. Each field office is staffed with trained men who are willing and able to give the average taxpayer all the assistance he needs to fill out his tax forms. The Treasury Department also distributes numerous instruction sheets and small books which bring out, in the layman's language, the hidden logic of the Code. One of the best of these is a book entitled, "Your Federal Income Tax," which can be obtained for twenty-five cents from the Bureau of Internal Revenue, Washington, D. C. Lawyers, accountants, "taxperts," and the tax departments of large corporations are aided in their endeavors to thread the complexities of federal and state tax law by the loose-leaf "tax services," published by Prentice-Hall, Commerce Clearing House, and other commercial organizations. These services and aids coördinate statutory administrative, and judicial tax law. The availability of these services mitigates the confusion which is partially caused by the fact that tax law has no less than six basic

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[21] Learned Hand in, (57 Yale Law Journal, 1947), pp. 167-69.

sources.[22]

There are numerous complicated situations which our tax laws govern. Hence we must realize that such subjects cannot be covered with the phraseology of a children's primer. Nevertheless, the substance and language of most tax statutes could be simplified without impairing the situation of those whose complex personal and business interests cannot be taxed justly under an elementary law. Congress would do well to direct its efforts toward a greater simplification of our tax laws. In a lot of cases complete re-wording will be necessary. It must be further realized that a certain amount of confusion is a healthy thing. This confusion is caused by the courts reviewing tax issues. We should regard this as the price we have to pay to protect individual liberties and rights from arbitrary encroachment by governmental action. With a revision of our present tax laws, all taxpayers could be far more certain of the amount of tax they are bound to pay, the manner in which they must pay it, and the time at which they must pay it. Once the taxpayers understand the tax laws, the Treasury Department will receive that passive acquiescence and grudging cooperation which is so vital to the successful administration of an income tax.

The third "maxim" of Adam Smith suggests that every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the taxpayer to pay it. The Federal

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22 For an excellent discussion see James M. Henderson, Introduction to Income Taxation, (second edition, Rochester, New York: The Lawyers' Cooperative Publishing Company, 1949), pp. 52-60.

Income Tax appears to be in direct compliance with this maxim.

One of the greatest improvements in the administration of the income tax was made by the Current Tax Payment Act of 1943. This act "placed individual income taxes on a 'pay-as-you-go' basis by requiring that (1) employers withhold the tax from wages paid to their employees, and (2) certain individuals estimate their tax, file a declaration of such estimated tax and pay it during the year the income is earned, instead of in the year following."[23] Prior to this act it had been the experience of the Treasury Department that a substantial minority of taxpayers consistently found themselves, on the fifteenth day of the third month following the close of their taxable years, unable to meet their tax payments. These people would often resort to tax evasion in an effort to avoid embarrassment. They would often be caught and needless irritation would result to all parties concerned. In the hope of improving this situation, the Congress hit upon the idea of the "pay-as-you-go" plan and the declaration of estimated taxes. The plan has met with overwhelming approval by all parties concerned. In actual practice, under the plan, every employer who pays wages to his employee must withhold a certain amount as tax. This amount is computed from tables furnished by the Bureau of Internal Revenue. In this manner the employee has a small amount deducted from his pay check each week, and the burden of paying the tax is eased. Any person who makes a salary in excess

[23] Prentice-Hall, _op. cit._, p. 1 or 7.

of $500.00 plus $600.00 for each exemption -- that is, a single man with no dependents would have to make in excess of $5100.00 -- or any person who has income in excess of $100.00 from which no tax is withheld, provided his total income is expected to amount to $600.00 or more, must file Form 1040-ES. This is the Declaration of Estimated Tax liability for the coming year. When the tax is estimated, the individual can then divide his total estimated tax liability into four equal parts. A quarterly payment is then made every three months during his tax year. Thus it is that business men, professional people, and all others from whose income no tax is withheld,[24] can distribute their tax burdens evenly throughout the year. Corporations are given similar relief by allowing them to pay their tax in four equal installments as follows: On or before the fifteenth day of the third, sixth, ninth, and twelfth months following the close of the taxable year. Farmers are also allowed, but not compelled, to pay their tax liability in four equal installments. Thus it should be noted that the convenience of the taxpayer is given careful consideration. The Bureau of Internal Revenue realizes that the extent to which the details of a tax law conform to the convenience of the taxpayer, they contribute to popular acquiescence in the tax and ease the problems of its administration. No small corps of officials, however well intentioned and well trained, could successfully levy

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[24] Unless a wage-earner makes in excess of $4500.00 plus $600.00 for each exemption.

and collect a tax from a population stubbornly resisting them at every phase of their task. The various plans, whereby taxpayers distribute the burden of paying their taxes throughout the taxable year, is one of the many features of the Federal Income Tax that helps make it the leading revenue producer it is today.

The final "maxim" of sound taxation advanced by Adam Smith proposed that there should be "taken out and kept out of the taxpayers' pockets as little as possible over and above what revenue finally goes into the public treasury." Adam Smith, in effect, suggested that the costs of collecting taxes should be kept at a minimum. There is hardly a taxpayer who would disagree with this proposal. It is unfortunate that the degree of efficiency in the administration of the income tax cannot be measured by the amount of administrative costs incurred in collecting the tax. We must remember that there are huge sums of money involved in the collection of the income tax. Whenever this is true, the human mind will be forever trying to devise methods and schemes which will reduce the tax or even eliminate it. This being the case, a low ratio of tax costs does not necessarily indicate an efficient tax administration. A tax office which makes no attempt to check evasion and avoidance of a tax will incur a small amount of costs. Such an office will merely satisfy itself by accepting whatever revenue is paid by voluntary contributors. Another office which makes a serious attempt to collect all the taxes which are legally owing, by auditing returns and making sample checks, will collect much more revenue, but it will have much higher administrative costs. One of the primary reasons any tax is successful is due to the fact that all people who are liable for it are forced to pay their taxes. If John Doe feels that everyone else is evading the tax he will be far more likely to do likewise. Obviously, it is much more desirable to have machinery set up which is capable of intensively enforcing the law. "Low tax costs resulting from administrative indifference are as much an indication of injury to the taxpayer as high costs resulting from inefficiency."[25]

It is clear that the required amount of administrative costs, necessary to collect a tax, depend upon the type of tax being levied. A specific tax on legal documents involves small administrative costs if it can be collected by the sale of stamps which must be affixed to the documents. An income tax, on the other hand, which requires detailed audits and reviews of complicated returns, is expensive to administer properly. An important factor which helps reduce the ratio of costs to revenue is the minimum exemption. A personal income tax return submitted with a three or four dollar payment costs that much or more to audit, file, and possibly check. Hence the exemption of $600.00 eliminates the filing of thousands of returns that cost as much or more to audit as the revenue they produce. Another cost-reducing practice is the withholding of income tax from the wage-earner

25 Shultz and Harriss, _op. cit._, p. 283.

at the source of his income. This practice, while it reduces the administrative costs to the Treasury Department, increases certain "compliance" costs to the employers. "On the average each corporation, in 1934, filed 39 federal and 152 state and local primary tax returns and approximately 1000 information reports, at an average compliance cost of 2.3 per cent of the taxes paid."[26] This survey was made of 163 business corporations and included all forms of compliance costs, not only those incurred in connection with the withholding of income tax at the source. Nevertheless an idea of the problem can be gained from these statistics. It is generally agreed that the good produced by the withholding compliance costs far outweigh the evils to the employer. The main thing to note is that the Treasury Department is attempting to reduce the cost of administering the federal income tax to a minimum. However, in so doing they are keeping in mind that low costs of administration is not good *per se*. They fully realize that there is a certain point at which the income tax can be most effectively administered. So long as an intelligent effort is being made to discover the ideal ratio of administrative costs to revenue, we cannot condemn the income tax because of its high cost of administration. There are a lot of other things in addition to administrative costs which warrant consideration.

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26 Robert M. Haig, *The Cost to Business Concerns of Compliance with Tax Laws*, (New York: American Management Association, 1935), p. 42.

CHAPTER III

ILLUSTRATED METHODS OF CODE INTERPRETATION

The previous discussion has dealt with the basic principles upon which our tax laws are founded. Much more could be said about this subject, but to do so would be deviating from the objective of this report. It is essential to the understanding of our Income Tax Laws that the rationale behind them be understood. Once the fundamental concepts have been grasped, the student can then proceed toward the understanding of the Tax Laws themselves. An attempt will now be made to show the methods which must be used to grasp the true meaning of a section of the Internal Revenue Code.

As was mentioned earlier, there are four taxable entities for federal income tax purposes. They are: the Individual, the Corporation, the Trust and the Estate. Each of these entities has too many sections of the Code applicable to them to be suitable for use in accomplishing the purpose of this report. However there remains a form of business organization which is not a true taxable entity but which is recognized as a basic accounting entity by our Federal Tax Laws. As such there is a section of the Code called Supplement "F" which deals solely with the Income Tax Laws applicable to the Partnership. Supplement "F" is sufficient in length to permit an adequate discussion of all its sections. By doing this a complete picture can be obtained of the workings of our Federal Income Tax Laws as they apply to a particular type of business organization. The Partnership will be used as a vehicle for illustrating how accurately and how seriously the Internal Revenue Code must be read before one can extract from it its true meaning.

Section 3797 (a)(2) of the Internal Revenue Code defines a partnership as follows:

> The term 'partnership' includes a syndicate group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term 'partner' includes a member in such a syndicate, group, joint venture, or organization.

It should be noted from this definition of a partnership that one can be a member of a partnership for tax purposes and not be a member under the law. The term "Partnership" is defined largely by eliminating from its meanings any form of business which would be classified as a trust, an estate or a corporation under the revenue laws. Generally speaking before a business organization will be classified as a partnership, the following conditions must exist:

> To constitute a partnership there must be (1) an association or joining together of the parties to carry on a business enterprise, which requires, of course, express or implied consent to the arrangement by all the parties who are to be partners, (2) a contribution by each of property or services, and (3) a community of interest in the profits.[27]

The rules just given have been formulated through numerous judicial decisions and within their broad confines are closely followed.

[27] Prentice-Hall, op. cit., p. 2901.

It should be noted that under the Internal Revenue Code, the term "Partnership" includes joint ventures, and similar unincorporated organizations, such as syndicates and pools. For example, if X and Y buy some land for later sub-division, they are joint adventurers, and the joint venture being classified as a partnership, must file a partnership return each year. Regulation 29. 3797-4 (2) defines an association as distinguished from a joint venture by the following example:

> A, B, and C contribute $10,000. each for the purpose of buying and selling real estate. If A, B, C, or D an outside party (or any combination of them as long as the approval of each participant is not required for syndicate action), takes control of the money, property and business of the enterprise, and the syndicate is not terminated on the death of any of the participants, the syndicate is classified as an association.

This is an important distinction to note between an association and a joint venture because if tax law designates one business as an association and the other as a joint venture they are taxed as a corporation and a partnership respectively. The important difference between the joint venture and the association as illustrated by the Regulations is the charasteristic of permanence the association enjoys. A limited partnership is classified as an ordinary partnership or as an association taxable as a corporation depending upon its characteristics. The main thing to watch out for is the number of characteristics which the partnership possesses that are usually found in corporations. For example, if the organization is not interrupted by the death of a member, or by a change in ownership of a participating interest, and the management is centralized, it is taxable as a corporation. One cannot enjoy the tax advantages of a partnership and the business advantages of a corporation.[28] A business organization will be classified as either one or the other.

The family partnership has produced the most litigation in the field of partnership taxation because the Commissioner of Internal Revenue often challenges the validity of a family partnership. The Commissioner, in short, refuses to recognize it as a Partnership for tax purposes. The so-called "family partnership" is usually challenged on the ground that the partnership relationship is not bona fide and is merely a device for splitting the partnership income among the various members of a family. At the present time, since husbands and wives are now permitted to split their incomes under the income tax laws, fewer husband and wife partnerships are being created.[29] However sufficient incentive remains for the type of transaction to make it a current problem. Business and professional people still find it advantageous to split their incomes with sons, daughters, brothers, and sisters. If they create a partnership with such other members of their family it does not necessarily mean that an attempt will be made to tax the entire income to a single member of the partnership. It is very likely, however, that an investigation will be made as to the

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[28] John M. Maguire and Roswell Magill, _Topical Law Reports_, p. 8493.

[29] Prentice-Hall, _op. cit._, p. 2902.

bona fides of the partnership.

It is possible today to determine with reasonable certainty whether a proposed family partnership will be recognized for tax purposes. The problem has run the gauntlet of judicial decisions and the Supreme Court has given us the following factors to consider:

> (1) did the members of the family (for example, father and son) truly intend to carry on the business as a partnership;
>
> (2) if so, who actually earned the income?[30]

To answer the above question the Supreme Court applied the following tests:

> (1) did the relative (for example, son) invest capital originating with him;
>
> (2) or did the relative (for example, son) share in the management or control of the business;
>
> (3) or did the relative (for example, son) perform vital additional service?[31]

The Bureau of Internal Revenue is cognizant of the confused state of affairs which exists. In an effort to clarify the family partnership picture, the Bureau has issued a ruling in which it outlines its policy toward such partnerships. In this ruling the Bureau sets forth four criteria to determine the validity of a family partnership. They are as follows:

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[30] Commissioner v. Tower, 327 U.S. 280 (1946).

[31] To see how these tests are applied see the following cases: Goodman, 6 T. C., 987; Shulak, 1946, P-H; T. C. Memo, 46101; Paransky, 1947, P-H., T. C. Memo, p. 47038; Evans, 1946, P-H., T. C. Memo, p. 46106.

(1) The rendition of services by the family member alleged to be a partner, in the regular conduct of the business, to a degree and quality commensurate with the status of a partner in that kind of business;

(2) The nature and extent of the alleged partner's participation in the control and management of the business;

(3) The capital and credit contribution to the business (subject to its risks) originating with the contributor, which is needed for and not already available to the business;

(4) The reasonableness of the relationship between (a) the proportionate share of the profits of a partner and (b) the services he renders or the amount of capital originating with him.[32]

When the Bureau is confronted with the necessity of determining a partnership's validity it will first apply the above tests. Once having done this they will conclude that (1) the organization is a bona fide partnership and recognize it as such or (2) that the whole thing is but a scheme to avoid taxes and not recognize it as a partnership or (3) that the question of whether or not the organization is a bona fide partnership is doubtful. In the last case the Bureau will litigate the matter if it feels it can win the case. The main question will be the division of profits. Whenever the merits of the case favor the taxpayer the Bureau will recognize the division of profits. The reason the division of profits is the main question in a family partnership is owing to the fact that this is the great chance for tax avoidance under our progressive principle of income taxation.

[32] I. T., 3845, 1947-1, Cumulative Bulletin 66.

Now that the question of whether or not the business organization in question is or is not a partnership and taxable as such has been studied, an examination will be made of Supplement F of the Internal Revenue Code to determine the meaning of the provisions applicable to the partnership.

Section 181 of the Internal Revenue Code provides: "Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity." The Regulations do not enlarge on this section. All this section really means is that the partnership itself is not subject to the income tax. The tax liability originating from the carrying one of a business in partnership form is borne by the individual members of the partnership. The partnership is not a taxable entity under our income tax laws. The statute recognizes the partnership as a basic accounting entity, and as a result of this, an information return must be filed by the partnership.

Section 182 is concerned with the income which is taxable to the partners. It states: "In computing the net income of each partner, he shall include, whether or not distribution is made to him..." the following things:

> Section 182 (a) As part of his gains and losses from sales or exchanges of capital assets held for not more than 6 months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than 6 months.
>
> Section 182 (b) As part of his gains and losses from sales or exchanges of capital assets held for more than 6

> months his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for more than 6 month.
>
> Section 182 (c) His distributive share of the ordinary net income or the ordinary net loss of the partnership computed as provided in Section 183 (b).

It will be noted that all the income is to be divided among the partners in their respective "distributive shares." A partner's "distributive share" may be defined as his proportion of the partnership profits and losses as determined by the partners profit sharing ratios. For example, if A, B, and C divide a partnership's profit in the ratio of 30%, 30%, and 40% respectively, C's distributive share of the partnership's profits and losses is 40%.

Section 182 (a) should be interpreted to mean that each partner should include his distributive share of the partnership's short-term capital gains and losses in his own income tax return. These amounts should be included in each partner's return irrespective of whether the partnership has actually distributed the amounts to the partners.[33] In computing a partnership's short-term capital gains and losses the same rules apply as in the case of the individual. Section 117 is the code section that governs capital gains and losses. The total partnership short-term capital gains and losses should be shown separately on Form 1065, the Partnership Information Return, in the first section under Schedule G. Each partner's distributive share

[33] Joyce Stanley and Richard Kilcellen, The Federal Income Tax, (The Tax Club Press, New York, 1948), p. 277.

of the partnership short-term capital gains and losses is shown in Schedule I on page 4 of the partnership return.

Section 182 (b) means the same thing as Section 182 (a) does except that the latter is applicable to a partnership's long-term capital gains and losses. Each partner should take into account his distributive share of a partnership's long-term capital gains and losses in computing his individual income tax liability. The total long-term capital gains and losses are shown in the second section of Schedule G on Form 1065. Then the amount of the long-term capital gains and losses applicable to each partner is shown in Schedule I on Form 1065. Regulation 29.182-1 (b) provides that if separate returns are made by a husband and wife, living in a community property state, and if the husband only is a member of the partnership, then the husband's share of the partnership's gains and losses from the sale or exchange of capital assets should be reported by the husband and wife in equal proportions. This gives people living in a community property state a tax advantage over those who do not live in a community property state.

Section 182 (c) provides that a partner must report his distributive share of the partnership's ordinary net income or loss in Schedule E of Form 1040. His share of the ordinary net income is taxed at ordinary income tax rates or if there is a partnership loss, then the ordinary net loss offsets his other income received in his individual capacity.[34] A partner must

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[34] Ibid., p. 277.

include his distributive share of the partnership's ordinary net income or loss in his own return whether such income was distributed to him or not. It has been decided that a partner cannot escape taxation on his distributive share of the partnership's ordinary net income by an assignment of a part or all of such income.[35] The ordinary net income of a partnership is shown in total at Item 26, page 1, on the partnership return. The distributive shares going to each partner of such ordinary net income or loss is shown in Schedule I on page 4 of Form 1065.

Section 183 (a) gives the general rule that "the net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual, except as provided in subsections (b), (c), and (d). This section is very simple and to the point. Nothing can be said about the general rule just stated.

Subsection (b) of Section 183 deals with the segregation of items and further clarifies section 182 (c). It provides as follows:

> (1) Capital Gains and Losses -- There shall be segregated the gains and losses from sales or exchanges of capital assets.
>
> (2) Ordinary Net Income or Loss -- After excluding all items of gain and loss from sales or exchanges of capital assets, there shall be computed --
>
> (A) An ordinary net income which shall consist of the excess of the gross income over the deduction; or
> (B) An ordinary net loss which shall consist of the excess of the duductions over the gross income.

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[35] Rabkin and Johnson, Federal Income, Gift, and Estate Taxation, (Matthew Bender and Company, Inc., New York, 1949) p. 10,056.

Capital gains and losses under Section 183 (b) (1) must be segregated from other partnership income or loss. As was previously mentioned the partners must include in their individual returns their distributive shares of the partnership's capital gains or losses. This breakdown enables the partners to set off otherwise unallowable individual losses against their share of partnership gains, or to set off their share of partnership losses against their individual gains.

Regulation 29. 183-1 (1) states that partnerships are not allowed the benefit of Section 117 (c) -- the capital loss carry-over. However, the individual partners may avail themselves of Section 117 (e) and use the net loss carry-over available to them under that section.

Section 183 b (2) (A) means what it says and can be interpreted literally. The partnership net income is defined in this section as the excess of the gross income over the deductions. The partnership ordinary net loss is merely the excess of the deductions over the gross income. This net income or loss is computed after the capital gains and losses have been excluded. When computing the total deductions for a partnership, any payments made to partners for services rendered are not deductible. Likewise, any interest paid to partners for their capital contributions is not deductible. Both partners' salaries and interest on invested capital are not deductible on the theory that they are in substance a division of partnership profits.

However if a partner is unable to perform his partnership duties and hires another to work for him such expense will be offset against such partner's distributive share of the partnership income. Where members of a liquidated partnership continue to make pension payments to former employees, under a plan inaugurated during the esistence of the partnership, they are allowed individual deductions for such payments.[36] A partner is permitted to set off individual gambling losses against his distributive share of partnership gambling gains, and the reverse is also true.

Section 183 c states:

> In computing the net income of the partnership the so-called 'charitable contribution' deduction allowed by section 23 (o) shall not be allowed; but each partner shall be considered as having made payment, within his taxable year, of his distributive portion of any contribution or gift, payment of which was made by the partnership within its taxable year, of the character which would be allowed to the partnership as a deduction under such section if this subsection had not been enacted.

Section 23 (o) provides that a taxpayer may deduct the amount of his charitable contributions up to a maximum of 15 per centum of the taxpayer's adjusted gross income. Section 183 (c) in effect disallows the deduction to the partnership itself. The charitable contributions of a partnership are excluded, as are capital gains and losses, from the computation of the partnership's ordinary net income or loss. The partnership can contribute 100 per centum of its income from all sources to charity. However, each member of the partnership

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[36] *Ibid.*, p. 1007.

is allowed to deduct, up to a maximum of 15 per centum of his adjusted gross income, his distributive share of the partnership's charitable contributions. In other words, each partner is considered, for tax purposes, as if he contributed his distributive share of the partnership's charitable contribution. This is a fine illustration of how completely the partnership is not recognized as a taxable entity. As was mentioned earlier, it is merely a basic accounting entity, for income tax purposes.

Section 183 (d) concerns the standard deduction dealt with in Section 23 (aa) of the Internal Revenue Code. It states:

> In computing the net income of the partnership, the standard deduction provided in section 23 (aa) shall not be allowed.

Section 23 (aa) states that if an individual's adjusted gross income is over $5000.00 he may take in lieu of his "other deductions" and "optional standard deduction" of $1000.00 or 10 per centum of his adjusted gross income whichever is less. In the case of a married person filing a separate return the limit is $500.00. If an individual's adjusted gross income is less than $5000.00 his optional standard deduction is 10 per centum of his adjusted gross income. Section 183 d in effect does not allow the partnership this deduction. However, each member of the partnership is still permitted to take the optional standard deduction if he desires to do so.

Section 184 is concerned with credits against a partnership's net income. "The partner shall, for the purpose of the normal tax, be allowed as a credit against his net income, in addition to the credits allowed to him under Section 25, his proportionate share of such amounts (not in excess of the net income of the partnership) of interest specified in Section 25 (a) as are received by the partnership. If the partnership elects under Section 125 to treat the premium on bonds, the interest on which is allowable as a credit under Section 25 (a) (1) or (2), as amortizable, for the purposes of the preceding sentence the partner's proportionate share of the interest received by the partnership shall be his proportionate share of such interest (determined without regard to this sentence) reduced by so much of the deduction under Section 23 (v) as is attributable to such share."

Here at last is a typical section of the Code. One could read the section many times and still not know its meaning. An attempt will now be made to illustrate the correct procedure to follow in the interpretation of the Internal Revenue Code.

In interpretating Section 184 it is necessary that the readers know the meanings of the other sections of the Code referred to in Section 184. Section 25 a (1) and (2) allows a credit against an individual's net income for the purpose of the normal tax, but not for the surtax, of interest income received on obligations of the United States or its instrumentalities if the interest is included in gross income but is exempt from the normal tax. The next section referred to in Section 184 is Section 125. This section gives the rules for the amortization of premiums on bonds. It states that when bond interest is wholly or partially taxable the amount of the bond premium amortizable for the year shall be allowed as a deduction. It further provides that no deduction shall be allowed for a bond premium when the interest on such bond is wholly tax exempt and is not includible in gross income. Finally Section 125 a (3) states that when interest on a bond is partially tax exempt then there shall be allowed as a deduction from the credits allowed in Section 25 the amount of amortizable bond premium applicable to such credit. This last mentioned Section of 125 is the one which is referred to in Section 184. The last section referred to in 184 is Section 23 (v) which simply is the authority for deducting the amount of amortizable bond premium from interest income. In short whenever a taxpayer has taxable interest income he can always deduct the amount of amortizable bond premium applicable to such interest income.

Now that all the sections referred to in Section 184 have been examined it is best to turn to the regulation applicable to Section 184 and see if it adds anything not already known. Regulation 29. 184-1 explains that the credits against net income provided in Section 25 are not applicable to the partnership. An individual partner, however, is entitled for the purpose of the normal tax only, to a credit against his net income, not in excess of the net income of the partnership of interest income specified in Section 25 (a) that is received by the partnership. Such credit is in addition to the credits allowed a partner under Section 25 (a) in his individual capacity. All such interest on Government obligations not wholly exempt is reported in the income part of the partnership return. Such interest is also shown in Schedule I on page 4 of Form 1065 allocating such interest among the respective partners.

Now that Section 184 is fairly well understood, an illustration will be given to show exactly how it works. Let us suppose that a partnership agreement provides that Jones is to receive 40% of net income or loss. The partnership owns 1½% U. S. Treasury bonds issued prior to March 1, 1941 in the face amount of $20,000.00, on which it received interest of $300.00. In his personal income tax return Jones will assume that he owns directly $8000.00 of the bonds on which he received $120.00 interest. If, in addition to the above bonds, Jones personally owns 3% U. S. Treasury bonds issued prior to March 1, 1941 in the principal amount of $10,000.00 on which he received interest of $300.00, Jones would include in gross income $345.00 ($420.00 total interest received less $75.00, the interest on $5000.00 of the 1½% bonds which is excluded). However on his separate return, Jones would be entitled to an adjustment of $10.35 (3% x $345.00) for the normal tax on such interest included in gross income. If a joint return is filed by Jones and his wife, the adjustment allowable is $5.175 (3% x $345.00 x ½) for one-half the normal tax on such interest included in gross income. Now if the partnership had paid a premium on the bonds and elected to amortize such premium the interest allowable to Jones on his proportionate share of the bonds would be reduced by his proportionate share of the amortization deduction.

One text,[38] in summarizing Section 184, states:

> ... that each partner shall be allowed in his individual income tax return, as a credit against net income, his proportionate share of the partially tax-exempt interest of the partnership.

This is an over-simplification and is dangerous for the man who has a limited insight on the meaning of the section. Nevertheless an idea can be gained of how a man with a thorough knowledge of a particular section of the tax code can crystallize its meaning down to the bare essentials.

Before leaving Section 184, which deals with "Credits Against Net Income", the distinctions between a credit against net income and deductions and credits against a tax should be pointed out. Deductions are the items which are subtracted from gross income to arrive at net income. Thus business expenses are a deduction from gross income. When the Code uses the term "net income" it is the net income which is left after deductions are subtracted from gross income that is meant. Once net income is determined Sections 25 and 26 set forth certain items which are deducted from or are a credit against net income. There is a real reason for calling the latter a credit against net income instead of including them among the deduction items. The reason being that only certain credits are allowed in connection with certain taxes. Credits against net income should also be distinguished from credits against the tax itself. For example, a credit allowed against a tax for taxes paid to foreign countires, Section 131. The

[38] Stanley and Killcullan, *op. cit.*, p. 279.

main difference is that the credit against the tax is deducted directly from the tax, rather than from the net income, and therefore in most instances a credit against the tax gives a greater tax benefit.

Section 185 of the Internal Revenue Code was repealed by Section 107 (a) of the 1943 Revenue Act and will not be discussed in this report. However, Regulation 29. 185-1 will provide any interested person with its meaning.

Section 186 is concerned with taxes paid by partnerships to a foreign country and possessions of the United States. It provides:

> ... the amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of the member of a partnership to the extent provided in section 131.

Section 131 a provides that when a citizen is a member of a partnership he is allowed his proportionate share of the taxes paid or accrued by the partnership to a foreign country or possession of the United States. If the member of the partnership is a resident alien, then different rules apply and Section 131 should be read to determine the proper method of handling his taxes. Subsection 131 b (1) and (2) gives two different rules for determining the maximum amount of allowable credit for taxes paid. The first rule deals with taxpayers who receive an income from only one foreign country or United States possession. Both rules are rather complicated and only a summary of them will be given. The general effect of the first rule is that the total tax paid on the foreign income will be the higher of the foreign or the United States tax. An individual is never allowed a credit for foreign income taxes (when receiving but one foreign income) in excess of the amount that the United States tax would be on such income . The second rule concerns a taxpayer who receives foreign income from more than one country. In this case, the credit for all the foreign taxes cannot exceed the United States tax attributable to the net foreign income. Net foreign income means that if an individual makes $10,000.00 in Britain and losses $5000.00 in Germany his net foreign income is $5000.00. In such a case, the maximum credit allowable under the second rule is equivalent to the United States tax on an income of $5000.00. In closing it should be noted that Section 131 deals only with foreign income taxes.

Section 186 provides in effect, that each partner is allowed in his individual income tax return, as a credit against his tax, his proportionate share of any foreign income taxes of the partnership. One must, of course, first turn to Section 131 to determine how much of a credit is allowed to the partnership. The credit allowable is to be taken as a credit against the tax, rather than a deduction. A greater tax benefit will result when you credit an amount against an individual's tax liability than when you take the same amount as a deduction. R 906

Section 187 is concerned with Partnership Returns. It states:

> Every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this Chapter and such other information for the purpose of carrying out the provisions of this Chapter as the Commissioner with the approval of the

> Secretary may by regulations prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

Section 187, in effect, states that a partnership must file a return of income regardless of whether it makes a profit or a loss. As was mentioned previously, the return must be filed on Form 1065. This is merely an information return. All the members of the partnership must be listed by name in Schedule I on page 4 of the return. Each partner's distributive share of partnership gains and losses must be shown in this section. The return must be made for the taxable year of the partnership, that is, its annual accounting period whether it be a fiscal year or a calendar year. The fact that a partner has a different taxable year than the partnership of which he is a member has no significance as far as Section 187 is concerned. The return must be signed by any member of the partnership. If a partnership desires to change its taxable year then it must do so in accordance with Section 47, which deals with changing a taxpayer's taxable year.

Section 188 governs situations in which the taxable years of the partner and the partnership are different. It provides:

> If the taxable year of a partner is different from that of the partnership, the inclusion with respect to the net income of the partnership, in computing the net income of the partner for his taxable year, shall be based upon the net income of the partnership for any taxable year of the partnership (whether beginning on, before, or after January 1, 1939) ending within or with the taxable year of the partner.

The meaning of Section 188 can be best explained by an illustration. Assume that X is a member of a partnership which uses the fiscal year ending June 30th as its taxable year. X on the other hand reports his income on a calendar year basis. When X files his income tax return for his taxable year ending December 31st, he must include therein his distributive share of the partnership income for the partnership's taxable year which ended the previous June 30th. If the partnership's taxable year and the partner's taxable year are the same there is of course no difficulty. The partner merely includes in his return his distributive share of the partnership income for the taxable year of the partnership which in this case would be the same as the partner's.

Section 189 does not allow partnerships the advantages of a net operating loss deduction. It states:

> The benefit of the deduction for net operating losses allowed by Section 23 (s) shall not be allowed to a partnership but shall be allowed to the members of the partnership under regulations prescribed by the Commissioner with the approval of the Secretary.

Section 23 (s) merely provides the authority for using the net operating loss deduction. Section 122 prescribes the rules to follow in using the deduction. This section, in brief, allows the business net operating losses of one year to be taken as deductions against the net income of other years. The allowance of the deduction is an attempt to minimize the inequity which results when a taxpayer is taxed on all his income in the good years while he receives no tax benefit for losses sustained in bad years. Very generally, Section 122 provides that a net operating loss of the current year can be applied against the taxable income of the two preceding taxable years and if that is not sufficient for the taxpayer to get a full tax benefit, then the net operating loss may be carried forward to the two subsequent taxable years.

Section 189 has the effect of not allowing the partnership itself the benefit of a net operating loss deduction. However, the individual partners in computing their own net operating losses or net incomes are permitted to take into account the net operating loss of the partnership. This is but another example of the non-recognition of a partnership as a basic accounting entity. The only taxable entities involved are the members of the partnership.

Section 190 is concerned with the allowance to partnerships of an amortization deduction. It provides:

> In the case of emergency facilities of a partnership, the benefit of the deduction for amortization allowed by section 23 (t) shall not be allowed to the members of a partnership but shall be allowed to the partnership in the same manner and to the same extent as in the case of an individual.

Section 23 (t) provides the authority for taking a deduction for amortization of an emergency facility. Section 124 (e) (1) gives the definition of an emergency facility. It states that the term "emergency facility means "any facility, land, building, machinery, or equipment, or any part thereof that was acquired after December 31, 1939, and any part of the construction, reconstruction, erection installation, or acquisition of which has been certified by the certifying officer as necessary in the interest of national defense during the emergency period." Once a facility has been certified as an emergency facility the owner can then amortize it over a shorter period of time, generally over 60 months. The special rules governing the amortization of an emergency facility, represent attempts to give the taxpayer, who has constructed large defense projects for the manufacture of war and related materials, a chance to recover his cost basis over the expected useful life of the facilities. The man who thinks he might have to deal with Section 190 should study Section 124 very carefully as there are a lot of conditions which must be met before a facility can be definitely classified as an "emergency facility".

After having made a cursory examination of Section 190, one can conclude that its effect is to take the benefits of Section 124 and leave them with the partnership. One might wonder why it is necessary to have Section 190 in the Code, in view of the fact that a partnership can always take depreciation on its own assets before computing its ordinary net income or loss. The reason appears to border on the fact that the amortization of emergency facilities is a special benefit conferred on the taxpayer by the Congress. Since it has already been decided that the partnership is not a basic taxable entity, one might logically assume that this extra benefit might be allowed directly to the members of the partnership in proportion to holdings. Hence, in an attempt to clear up this divergence from logic, the Congress has deemed it advicable to enact Section 190.

CHAPTER IV

TAX LAW NOT CONTAINED IN THE CODE

The preceding paragraph concluded the discussion of Supplement F of the Internal Revenue Code. However, there are some important tax laws governing a partnership's transactions which are not found in Supplement F. These laws govern the following situations: the basis of property in the hands of the partnership which has been contributed by the partners; the tax consequences of a distribution by a partnership to its partners of property; the tax consequences of liquidating distributions by a partnership to one or all of its members. An examination will be made at this point, of these types of transactions.

Section 113 (a) (13) provides with respect to the basis of property contributed by a partner to a partnership:

> If the property was acquired, after February 28, 1913, by a partnership and the basis is not otherwise determined under any other paragraph of this subsection, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made...

Although the statute indicates the possibility of gain or loss being recognized on a transfer of assets to a partnership by a partner, when it states that the basis shall be "increased in the amount of loss recognized to the transferor upon such transfer," gain or loss is not recognized. Regulation 29. 113 (a) (13)-1 states:

> The basis of property contributed in kind by a partner to partnership capital after February 28, 1913, is the cost or other basis thereof to the contributing partner.

One tax case held that the partnership should be allowed a stepped-up basis for property contributed by the partners which had appreciated in value prior to the contribution.[39] The Supreme Court denied certiorari on the case. However, the rule in this case has for all practical purposes been overruled and it can be disregarded today. The weight of authority today agrees that the basis of assets contributed to a partnership by a partner remains the same as it was in the hands of the contributing partner.[40] When the partnership takes depreciation or depletion on assets contributed by its partners the basis for such depreciation or depletion is the same as the basis in the hands of the partners.[41]

The Regulations are vague on the question of how to treat any gain or loss realized on the subsequent sale of contributed property by the partnership. Regulation 29. 113 (a) (13)-1 provides:

> On the sale or other disposition of such contributed property by the partnership the gain or loss, determined on such transferred basis, adjusted as required by Section 113 (b), shall be prorated in determining the distributive shares of the partners according to their gain or loss ratios on the disposition of a partnership asset under the partnership agreement.

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39 Commissioner v. Walbridge, 70 Federal Second 683 (1934).

40 Rabkin and Johnson, _op. cit._, p. 1008b; Prentice-Hall, _op. cit._, p. 2909.

41 Regulation 29.113 (a) (13)-1.

One authority in determing what this Regulation means concluded:

> If the formulas mean anything, they probably require that the income or deduction attributable to the discrepancy in basis is to be allocated to the distributive income or loss of the partner who contributed the property in question.[42]

The theory on which the interpretations of Regulation 29.113 (a) (13)-1 appear to be based is simply this: When a partner contributes property to a partnership the only thing he contributes is the tangible property itself. The monetary value of the property in excess of its transferred basis remains in the hands of the contributing partner. Should the partnership subsequently sell a contributed asset, any money it receives in excess of the transferred basis is credited directly to the contributing partner's capital account. In this manner, the basis of the contributing partner's equity in the partnership has been increased by the amount of gain on the sale of the contributed asset. This is a tax benefit. Hence, the contributing partner must report the gain on the sale of the contributed asset in his individual tax return. The above interpretation of the Regulation has been made slightly uncertain by a very questionable decision. of the Board of Tax Appeals.[43] In this case it was held that the aggregate gain on the sale of stock contributed by several partners must be allocated among the partners in the ratio in which they share income, even though all of the gain is attributable to the stock

42 Rabkin and Johnson, op. cit., p. 1009.

43 Isaac W. Frank Trust, 44 B. T. A. 934.

contributed by one partner. As has been pointed out, the decision is very questionable and should be disregarded in deciding the tax consequences of a sale of contributed property by a partnership.

One point remains to be investigated in a situation where a partnership sells property which has been contributed by one of its partners. When a partnership sells contributed property and realizes a gain or loss on such sale, what is the holding period of the property by the partnership, for the purpose of determining whether such gain or loss is a long or a short-term capital gain or loss? In answer to this question Section 117 (h) (2) provides:

> In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under the provisions of section 113, such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

Section 117 (h) (2) in effect says that if a partner contributes property to the partnership, of which he is a member, and he had acquired such property three months prior to the date of the contribution, then, if the partnership sells this property four months later, any gain or loss on the sale would be a long-term capital gain or loss. In other words the three months during which the partner held the property is added to the four months the partnership held the property. Hence the partnership is deemed to have held the property for seven months. Since the property was held over six months it is a long-term capital transaction.

Another important set of rules which is not included in Supplement F concerns the distribution of property by a partnership to its partners. The term "property" as used in the preceding sentence includes both money and tangible assets. A distribution of cash to a partner whether from income or capital is not a taxable transactions. However, if a taxpayer receives cash in excess of the basis of his partnership interest then this "overdrawal" will be taxed if there is no liability existing for the partner to repay such excess to the partnership. Frequently a partner will receive a salary in addition to his share of partnership income. Such payments are disregarded in computing the partnership's net income. They are considered to be a readjustment of the distributive incomes of the partners. In reality the partner should not care what this is considered to be from a tax standpoint. The partner is going to be taxed on it whether it is considered a salary or a distribution of partnership income. In fact, to recognize such distribution as a deductible salary payment by the partnership could work to the disadvantage of the recipient. If the partnership had a loss for the current year the partner would pay tax on his salary while the other partners who may possibly receive no salary would be allowed a deduction for the partnership loss. It has been held[44] that where one partner contributed cash to a partnership so the other partners could draw an agreed minimum amount from the partnership, the

44 Carroad v. Commissioner, 172 Federal (2nd) 381.

contributing partner would be allowed a deductible loss for such contribution. It would be of no significance that the contributing partner was entitled to receive the contributed amount back, since if he did, it would be taxed to him as his distributive share of partnership income. Any interest paid to a partner on his capital account is not taxable to the partner when he receives it. As was pointed out earlier in this report, such interest payments are not deductible by the partnership in computing its net income. These amounts are treated merely as a readjustment of the distributive shares of the partners.

Section 113 (a) (13) provides:

> ... If the property was distributed in kind by a partnership to any partner, the basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property. A partner's 'partnership interest' is, in effect, the sum of his capital account and his share of any undistributed income on which a tax has been paid. The 'properly allocable basis' to a partner receiving distributed partnership assets in kind is determined by the following formula:

$$\text{Partner's Basis for Property Distributed} = \text{Basis of distributees partnership interest} \times \frac{\text{Fair Market Value of Assets Received}}{\text{Fair Market Value of all Partnership Assets}}$$

The above formula will assign a basis to the property received. Thus, even though the property has appreciated or depreciated in value, this change is not taxable to, nor deductible by, the partner. It should be noted that the formula used might possibly assign a different basis to the distributed assets in the hands of the partner, than they had in the hands of the partnership. In other words, the individual's gain or loss on the sale or exchange of such property might be more or less than the resulting gain or loss from a sale of the same property by the partnership. Whenever this type of transaction is contemplated an investigation should be made to determine which method will result in the smallest tax liability. For the purpose of determining the "holding period" of property distributed in kind to a partner, the partner is deemed to have held the property from the date the partnership acquired it. The partner, in effect, is deemed to be a co-owner of the property held by the partnership. An additional holding period may be added when the property distributed in kind by a partnership was originally contributed to the partnership by a partner. Then the period the original contributing partner held the property may also be added to the holding period of the distributee partner. In conclusion it may be said, that although there is no specific statutory provision eliminating the recognition of gain or loss on the distribution of property in kind to a partner, Section 113 (a) (13) has this effect.[45]

The third and final set of rules which this report will examine, and which is not covered in Supplement F, is concerned with liquidating distributions by a partnership to its partners. Regulation 29.113 (a) (13)-2 provides:

> When a partner retires from a partnership, or the partnership is dissolved, the partner realizes a gain or

[45] For an excellent discussion of this problem see Rabkin and Johnson, _op. cit._, pp. 1010-13.

> loss measured by the difference between the price received for his interest and the sum of the adjusted cost or other basis to him of his interest in the partnership plus the amount of his share in any undistributed partnership net income earned since he became a partner on which the income tax has been paid.... If the partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property received in liquidation.

A literal interpretation of the preceding clumsy regulation would give results that are wholly inconsistent with the concept of partnership taxation. The term "adjusted cost" as used in the Regulation is interpreted to mean the original cash contribution of the partner plus all gain taxed to the partnership which has not been distributed to the partners and minus the reductions of the partners capital account due to partnership losses available to the partners throughout their period of membership. When the regulations limit the increase in basis of a partner's partnership interest to income "on which the income tax has been paid" they are very misleading. A literal interpretation of this phrase would exclude tax-exempt income such as government bonds, life insurance policies, etc. By not allowing the partners to increase their basis for the proceeds this regulation would be indirectly circumventing the statutes which exempt such income. This regulation would also exclude from a partner's basis of his partnership interest income which was reportable by the partnership (let us assume) five years previously. Assuming all the conditions have been met which are required to start the Statute of Limitations running, theoretically the government could not tax this income which was reportable five years previous.

But if the partner is not allowed to increase his basis by the amount of such income, the Statute of Limitations would be indirectly circumvented. This regulation would also exclude from a partner's basis, partnership income which has been earned during the year of liquidation since this could hardly be income on which the tax has been paid as of the time the basis is determined. Fortunately for the taxpayer, Regulation 29.113 (a) (13)-2 has never been literally applied.

The regulation under discussion is misleading in another sense. A careful study of its content will leave the reader with idea that the liquidation of a partnership will normally produce gain or loss to the partners. This is far from the truth. One the contrary, most partnership liquidations, when there is a proportionate distribution of cash and property, result in no tax liabilities to the partners. The cash that is received reduces the basis of each partner's partnership interest. It is very common that any business has a very small amount of cash in relation to its tangible assets. Assuming this to be true, the reduction of basis caused by the cash received will leave the partner with some basis for the assets. When the partner sells these assets he realizes a gain, to the extent, that the proceeds exceed his remaining basis for the assets. However, the gain is not realized at the time of the partnership liquidation, as the regulation implies. If a partner receives in liquidation an asset that has appreciated tremendously in value and is greatly in excess of his partnership basis, no gain is recognized even then. The gain will not be recognized until the partner sells the asset in excess of his adjusted basis for his partnership interest.

There are several instances in which gain will be recognized by a partner on liquidation of the partnership. One instance is where a man buys a partnership interest for more or less than his proportionate share of the basis of the partnership assets. Even in this case gain will only be recognized if such partner on liquidation receives cash in excess of his basis for his partnership interest. The most frequent case of gain being realized to a partner on liquidation is where the partner is paid in cash on account of greatly appreciated property being distributed to another partner. The problem is similar to the situation in which a retiring partner is paid in cash for his share of the partnership assets, and the assets are retained by the continuing business. In these cases the transaction is in effect a sale by the partner who receives cash in lieu of his partnership interest. Conversely, if the cash received is less than the partner's basis for his partnership interest he is allowed a loss. Such a loss usually is caused by unrealized depreciation of the partnership assets. It is important to note that such a loss is not deductible if the other partners are members of the distributees family.[46]

When a partner is deemed to have sold his partnership interest and an immediate gain or loss is recognized, a very difficult problem

[46] Henry v. B. Smith, 5 T. C. 323; Nathan Blum, 5 T. C., 702.

arises. Is the sale of a partnership interest the sale of a capital or a non-capital asset? The answer to this question will decide whether the gain or loss recognized is an ordinary gain or loss or a capital gain or loss. The problem is basically whether the partnership is to be recognized as an entity, and whether a partnership interest is to be considered as a single property right. In most aspects of partnership taxation, the "entity" theory gives way to the co-ownership concept. If one is going to recognize the co-ownership concept, then in order to determine whether any gain or loss on liquidation is capital or ordinary gain or loss it would be necessary to determine just what assets were included in the partnership interest sold. Did the interest represent inventory or a building? An attempt to determine what assets were sold would obviously entail tremendous difficulties. Possibly with a view to the practical aspect of the matter, most decisions have adopted the "entity" theory in connection with this problem.[47] In effect they held that a sale of a partnership interest is a sale of a capital asset and any gain or loss resulting therefrom is a capital gain or loss. The decisions state that it is not necessary to determine whether capital or non-capital assets were represented by the partnership interest. When the "entity" theory is accepted the partner's holding period of the partnership interest, for the purpose of determining whether a short-term or a long-term gain or loss is realized, is measured from the date he

[47] Rabkin and Johnson, op. cit., p. 1018.

became a member, and not from the date the partnership acquired the assets.

Another aspect of the "sale" problem of a partnership interest is whether any loss realized may be carried forward or back under the "Net Loss Carry-Over" provisions of Section 122. Wherever the "entity" theory is adopted, the net loss carry-over is disallowed on the ground that the loss resulted from the sale of a partnership interest. Since such loss was recognized as a capital loss it follows that a net loss carry-over will not be allowed since the loss was not an ordinary business operating loss.

If a partner retires before the end of the partnership taxable year, and is paid his share of the income earned up to the date of his retirement, the amount he receives which represents such income is taxed to him as ordinary income. Even in jurisdictions that adopt the entity theory on the sale of a partnership interest, the same conclusion is reached. The fact that the transaction is termed a "sale" by the retiring partner of his partnership interest, does not convert this income into a capital gain. Assume that a partner retires on July 1st, during a partnership taxable year which ends on December 31st. As of the date of the retirement, the members get together and estimate the amount of income made up to July 1st and pay the retiring partner accordingly. It has been held that such a payment is taxed to the retiring partner as ordinary income even though it was not realized at the time of payment, and was in fact an estimate.[48]

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48 Doyle v. Commissioner, 102 Federal (2nd) 86.

As was noted earlier, no gain or loss is recognized to a retiring partner who is paid out in property. The idea is to postpone the realization of any gain or loss until such time as the taxpayer sells the property. To provide for this eventual realization Regulation 29.113 (a) (13)-2 states:

> If the property was distributed in kind by a partnership to any partner, the basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property.

Certain problems arise from this regulation. Assume a partner has received in liquidation assets worth \$100,000.00 for which he has a basis of \$50,000.00. He later sells \$50,000.00 of the assets. Has he recovered his \$50,000.00 basis or has he recovered \$25,000.00 basis and \$25,000.00 profit? The issue has not been resolved. If he must allocate his basis to the property he would, of course, use the following formula:

$$\text{Basis of Asset Sold} = \text{Basis of all Assets} \times \frac{\text{Fair Market Value of Assets Sold}}{\text{Fair Market Value of all Assets}}$$

The preceding discussion of partnership tax law, not contained in Supplement F, is not intended to be complete. Numerous rules of law have been omitted. The most important of which are concerned with the following situations: The payment of income to a deceased partner; The classification of payments made to a deceased partner's estate; The payments to a deceased partner's estate with the intent of purchasing the deceased partner's partnership interest.[49] The

[49] Stanley and Kilcullen, *op. cit.*, pp. 280-283.

objective of this discussion, was to illustrate the amount of tax law not contained in the Internal Revenue Code itself, and how the Regulations, in their often confusing manner, provide the key to the correct interpretation of a tax law.

It should be reiterated that the somewhat lengthy discussion dealing with Income Tax Law applicable to the partnership, was not given for the purpose of leaving the reader with a knowledge of income taxation as related to partnerships. If this knowledge was gained, then a secondary objective has been accomplished. The primary purpose of this report was more fundamental in nature. If the reader of this report finds himself with a clearer idea of how to go about interpreting a section of the Interal Revenue Code relating to the Federal Income Tax Laws then the main objective of this report has been accomplished.

CHAPTER V

SUMMARY AND CONCLUSIONS

It should be remembered that there are certain definite steps to be taken when a question of how a matter should be handled for income tax purposes arises. The natural assumption is that any man charged with giving the answers to questions involving tax matters possesses a better than average knowledge of the Internal Revenue Code. This being the case, a person confronted with such a question, should first definitely determine the precise subject matter of the question. It does not require a very high degree to tax knowledge to determine whether you are confronted with something that might be a capital gain or loss under Section 117, or a determination of basis under Section 113. Having thus definitely determined that the matter falls squarely into the purview of a certain section of the Code, this section should be carefully read in an attempt to ascertain its exact meaning. However, there remains a very grave danger. Oftentimes a transaction will fall squarely into one section of the Code but because of another section, which is not referred to in the section under investigation, this seemingly applicable section will be rendered inoperative by such other section. How is a tax advisor going to guard against these dangers? The best answer to this question is to make a very comprehensive study of the issue. In these circumstances it is often necessary to refer to the standard authorities on tax matters. Some very good books dealing with tax matters are: Commerce Clearing House, Prentice-Hall, and Rabkin and Johnson. The tax practitioner should read these books to see how similar situations are treated by these authorities. Cases will often be cited to show exactly how the matter was handled in litigation. These cases which seem to border on the problem should be read with great care. By this process authorities may be found who will help support your contention if the matter ever reaches the courts. The authorities will also refer to sections of the Internal Revenue Code applicable to the problem under discussion. In this way it is possible for a tax practitioner to guard against unheard of sections of the Code which change the answer to a tax question. There is no simple way to obtain all the correct answers to a tax question. Thoroughness and perseverance appear to provide the most accurate answers.

The Income tax Regulations, which are cross-referenced to the Code, also provide many valuable interpretations of the Code. For this reason it is mandatory that a tax practitioner have a thorough understanding of the one or more Regulations applicable to a tax issue. While it is true that the Regulations do not have the weight of a court decision, they are a good ally to have on your side if the matter is ever litigated. Many times the Regulations will provide the practitioner with a speedy direct answer to a tax question. In this manner they help save many hours of tedious investigation.

In conclusion it may be stated that the true meanings of the

Internal Revenue Code are hidden behind a terrifying mask of technically accurate statements. It should be remembered that the Internal Revenue Laws are based on the necessity of obtaining revenue for the Federal Government in the most equitable manner possible. Wherever there is equity there must be logic. If one grants that the basic foundations of our Income Tax Laws rest on logic the task of their interpretation becomes easier. However, with each passing year this logic is more completely hidden by attempts of the Congress to make it harder for the tax evader to accomplish his objectives. Logic must also give way to the necessity of obtaining revenue. When logic fails to produce needed revenue then it must be discarded. Fortunately this abandonment of logic is only found in the details of our over-all tax policy. The fundamental logic still remains. It is unfortunate indeed that it is becoming harder each year for the tax practitioner to ferret out this hidden logic and arrive at the true meanings of the Internal Revenue Code. However, the fact remains that the Internal Revenue Code is not as impossible of interpretation as a first glance will lead one to believe. The true meanings of the Code, which are usually what one should believe them to be, are present. The only difficult aspect of its interpretation is the long and careful examinations which are required before a person can be reasonably assured that he has found the true meaning. Once having arrived at the true meaning of a section of the Code, the tax practitioner will become aware of the vitality and interest embodied in it.

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