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Arthur H. Goodman

OBSERVATIONS ON THE REVENUE ACT OF 1951

ARTHUR H. GOODMAN†

A new revenue act is always an easy target and, not entirely by coincidence, the critical faculty becomes particularly active when the legislation under analysis strikes one where he can least afford it. Perhaps the only perfect revenue act would be one in which Congress, through some now unforeseeable panacea, found it possible to abolish taxes altogether. Until that happy day, however, the interplay of forces—legal, fiscal, economic and political—attending the adoption of each revenue act, will be watched with the deepest public concern, and the finished product pounced upon as unfair, unintelligible, socialistic, discriminatory, or otherwise contrary to the national interest.

The Revenue Act of 1951 is pointed in the right direction; that is to say, it increases the tax collector's participation in the national income. But to the harried taxpayer or, even more so, to his lawyer or accountant who is only now beginning to comprehend the workings of the newly adopted excess profits tax, the 1951 Act means far more than a mere increase in the amount of the tax itself. The method of taxing capital gains has been changed in certain basic respects;[1] a "head of a household" has been introduced and placed approximately midway between the unmarried taxpayer and the married couple filing a joint return;[2] an attempt has been made to set at rest the bothersome family partnership problem;[3] and, among other significant innovations, capital gain treatment of sales of depreciable property between spouses or between an individual and a controlled corporation is no longer to be allowed.[4]

The wisdom of the newly enacted provisions would seem, in many areas, to be not entirely free from doubt; and in certain of the instances where this is true, a possible flaw may be disclosed by recourse to the experience of the country recorded in antecedent case law or legislative history. With this end in view and, secondarily, for the purpose of offering such suggestions as may be warranted, the following observations are presented.

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† Member of the New York Bar.

1. This was done by amendments to Sections 117, 22(n), 23, and related sections of the Internal Revenue Code. All further references herein by section numbers are to sections of the Internal Revenue Code as amended by H.R. 4473, 82d Cong., 1st Sess. (1951).
2. INT. REV. CODE §§ 12(c) and 400.
3. INT. REV. CODE §§ 3797(a)(2) and 191.
4. INT. REV. CODE § 117(O).

Heads of Households

Section 12(c) has been amended to provide a new table for computing the surtax of one who is a "head of a household" as that status is defined in the section. The effect of the amendment is to extend to single persons, who come within the terms of the statute, approximately fifty percent of the benefit of the income-splitting device available to married couples filing joint returns. To qualify as a head of a household the taxpayer must be unmarried at the close of his taxable year and must maintain "as his home," by furnishing over half of the cost of upkeep thereof, a home "which constitutes for such taxable year the principal place of abode" of a person who is a dependent, except that such person need not be a dependent if he is a child, stepchild, or descendant of a child of the taxpayer and is unmarried.

This innovation may, on its face, seem unobjectionable or even desirable. A bit of history will serve to establish, however, that congressional policy on the subject is more than slightly confused and is leading to results less sensible than ever. The Senate Finance Committee Report, in discussing the position of unmarried taxpayers who maintain households for others, states that they "are in a somewhat similar position to married couples who, *because they may share their income,* are treated under present law substantially as if they were two single individuals each with half of the total income of the couple."[5] It is, however, a matter of recorded fact that Congress, in the Revenue Act of 1948, introduced the present income-splitting procedure only in order that community property residents would enjoy no advantage over other taxpayers, and not for any such reason as the one now given.[6]

Initially, the difficulty was that a married resident of the State of Washington, for example, incurred substantially less federal income tax than he would if he lived in New York. *Poe v. Seaborn,*[7] the leading case on the point, was principally responsible for that result, holding

5. Section III—B(2), *Report of the Senate Finance Committee on H.R.* 4473, SEN. REP. No. 781, 82d Cong., 1st Sess. (1951) (italics supplied). To the same effect see Section III —B(3), *Report of the Committee on Ways and Means of the House of Representatives on H.R.* 4473, H.R. REP. No. 568, 82d Cong., 1st Sess. (1951).

6. *The Report of the Committee on Ways and Means of the House of Representatives on H.R.* 6712, H.R. REP. No. 2087, 80th Cong., 2d Sess. (1948) states: "Equalization is provided for the tax burdens of married couples in common-law and community-property States. The bill, with committee amendments to be offered on the floor, corrects existing inequalities under the estate, and gift taxes, as well as the individual income tax." 1948-1 CUM. BULL. 241. The same report states that a "major portion of this bill is devoted to the geographic equalization of income, estate and gift taxes." 1948-1 CUM. BULL. 241 at 301.

7. 282 U.S. 101 (1930).

that the federal income tax levied "upon the net income of every individual" is a tax, not upon the earner of the income, but upon the owner of it, and that the ownership is determinable by application of state law.

The result of the *Seaborn* case had been anticipated even before the question reached the Supreme Court. Two attempts were made to correct the statute so as to avoid the consequences of the *Seaborn* rule, but each effort failed.[8] The simple and popular thing to do, apparently, was not to create uniformity by denying community property treatment to anybody, but by giving it to everybody. And so, income splitting was born. This, it has since appeared, accomplished nothing, for, in place of a disparity in incidence of tax liability depending on residence, there came an equally unwarranted difference between the cases of a married taxpayer, supporting a wife and one child on an adjusted gross income of $50,000 and a bachelor supporting, let us say, five dependents on the same income. As the law stood prior to the enactment of the 1951 Act, the unmarried taxpayer, though he supported three more people than did the married one, would incur well over $4,000 more tax liability.[9]

This result was so clearly wrong that the head of household provision has been adopted to cure the defect. The new rules bring with them their own artificial tests and arbitrary criteria. It now makes an important difference whether a dependent brother lives in the taxpayer's home or across the street in a residence maintained for him, at perhaps even greater cost, by the taxpayer. In the first case a dependency deduction and one-half of the income-splitting benefits may be taken; in the second case the taxpayer is entitled only to the six hundred dollar deduction. Thus, a serious difference is made to flow from a trivial and, actually, an irrelevant distinction, and all for little reason or none. The cause of the trouble is not hard to find. It is, in a word, that piecemeal, year by year thinking produces only patchwork in the way of legislation. The need is for a broader perspective, an approach which deals with the problem at its roots.

The first step is to achieve uniformity of operation of the income tax among the several states. It is respectfully submitted that the adoption of the following proposed statute would have that effect:

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8. The proposed statute, recommended by the Treasury Department, was as follows: "Income received by any community shall be included in the gross income of the spouse having management and control of the community property." This provision was passed by the House in 1921 but was stricken out by the Senate. In 1924 the same provision was eliminated from the Act by the House and never reinserted. See Poe v. Seaborn, 282 U.S. 101, 114 n.6 (1930).

9. It is assumed, of course, that the married taxpayer files a joint return with his spouse; it is assumed, also, that the taxable period is the calendar year 1950 and that the standard deduction is taken on both returns.

The gross income of an individual shall be determined without regard to whether he was at any time during the taxable year a member of a marital community.

This would furnish the "standard or definition of what constitutes an individual's income," which the Supreme Court, in the *Seaborn* case, said that it needed in order to avoid the conclusion there reached.[10]

Geographic uniformity having been achieved, there would no longer be any need for the income-splitting rules adopted in 1948; and, as a second step, those rules should be repealed. With the end of income splitting, the inequity, already illustrated, between the operation of the law on married couples as against single taxpayers, would disappear. The "head of a household" provisions, designed to correct that situation, would have become unnecessary and, as a third step, those provisions could also be discarded. The basic structure would be, then, a body of tax law operating without respect for state lines, as we always should have had, and with no regard for marital status, as until 1948 we did have.

With the law thus stripped of its unnecessary and cumbersome trappings, the remaining problem, not a difficult one, would be that of making suitable allowances by way of deductions or exemptions for a taxpayer who supports a spouse or a dependent. The precise amounts to be allowed by reason of that support need not long delay us here. These would vary with the times, the basic considerations being, of course, the need of the national treasury for revenue and the ability of taxpayers to provide it. Certainly, as Congress now recognizes, it is in the usual case more expensive to support a wife than a brother-in-law. No fault could be found, therefore, if the allowances were drawn so as to reflect that fact.

The essential principle, given due respect under the recommendations here advanced, is that deductions or exemptions, which rest on the social fact that under certain circumstances one income provides sustenance for more than one person, are appropriate only where there is an actual sharing of income. For the recognition of this principle, nothing as broad and sweeping as the income-splitting device is necessary or fair. Nor is that to be wondered at, in view of the fact that a presumed sharing of income had nothing to do with the adoption of income splitting in the first place.

In view of the extent of the changes here advocated, it is perhaps fitting to set forth the advantages that would result from their adoption:

First: The law would be considerably simplified. The sections of

10. Poe v. Seaborn, 282 U.S. 101, 109 (1930). The important point, for our purpose, is that the *Seaborn* case can be done away with by legislation, no constitutional issue having been raised or commented upon.

the code on income splitting would be dropped and the tax return itself would involve less arithmetic. Also, the new surtax table for heads of households, as well as the other sections of the code concerning such taxpayers would no longer be present to add their bit to the general confusion.

Second: The national treasury could realize as much revenue as it now does, even if the present surtax rates were lowered; and, if more revenue were needed in future years, Congress could again raise the rates to their present levels or even beyond, the advantage being that Congress would be less concerned, in future revenue acts, with the basic structure of the law and could, to a large extent, effect its purposes simply by making changes in the rates.

Third: With reasonable allowances for taxpayers who support others, the whole structure would be far more fair than it now is or has been ever since the rather ridiculous community property situation developed.

Fourth: It is not in keeping with candor or clarity that Congress, in order to explain the adjustment for heads of households, finds it necessary in 1951 to discover new reasons for what it did in 1948. That situation, by no means isolated or accidental, is less likely to recur if the problem is dealt with in the direct fashion here recommended, rather than in the awkward manner of the committee reports.

Family Partnerships

The problem of recognition of family partnerships is sought to be solved, at least to a degree, by amending the definition of the term "partner" in Section 3797(a)(2) to provide that the ownership of a capital interest in a firm "in which capital is an income-producing factor" constitutes one a partner "whether or not such interest was derived by purchase or gift" and by prescribing, in Section 191, statutory rules governing the allocation of income among the members of a family partnership. It is the apparent purpose of Congress to reduce the flow of cases, many of them now in litigation or in various stages of processing or administrative levels, which present, in one factual setting or another, the question of what to do about the prime breadwinner of the family who has divided his business among "his sisters and his cousins whom he reckons by the dozens" to the satisfaction of everybody and with substantial reduction of his own taxes.

Section 191 is, by its terms, confined to "the case of any partnership interest created by gift." In order, apparently, to give broader application to the new rules, it is further provided that even where an interest is purchased by one member of a family from another it "shall be considered to be created by gift from the seller" and in such case "the fair market value of the purchased interest shall be considered to be donated capital." The key provision of the statute is its first sentence, which reads as follows:

"In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital."[11]

It thus appears that the distributive share of a family partner whose interest in the firm is attributable to donated capital is subject to two limitations which are: first, that income distributable to donee partners is to represent only their share of what remains after the donor has been fairly compensated for his services; and, second, that the participation of donated capital in the income of the business may not be proportionately greater than the participation of the donor's capital. Thus, in the typical case of a father who converts his sole proprietorship into a partnership, giving each of his two sons a one-fourth capital interest in the firm and retaining a half interest for himself, the amounts taxable to each son could not exceed one-fourth of the distributable total remaining after an allowance of reasonable compensation to the father for his services.

The new statutes may perhaps be best understood by first stating the theme of Supreme Court thinking on the subject before Congress went to work. The initial expression of Supreme Court opinion was in *Commissioner v. Tower*,[12] where the following approach was prescribed:

"There can be no question that a wife and husband may, under certain circumstances, become partners for tax, as for other, purposes. If she either invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things she may be a partner. . . . But when she does not share in the management and control of the business, contributes no vital additional service, and where the husband purports in some way to have given her a partnership interest, the Tax Court may properly take these circumstances into consideration in determining whether the partnership is real within the meaning of the federal revenue laws."[13]

This language led to difficulty. It was not sufficiently clear whether a putative partner might never be recognized for tax purposes unless "she invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs

11. INT. REV. CODE § 191.
12. 327 U.S. 280 (1946).
13. *Id.* at 290.

vital additional services," or whether the Supreme Court, in expressing itself as it did, was writing *inter alia.*

In the more recent case of *Commissioner v. Culbertson* et ux.,[14] however, that ambiguity was clarified. There the Court, clearly holding that a donee may be recognized as a partner, expounded the following thesis:

"The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent —the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[15]

The problem to which these opinions are addressed is that of formulating an approach upon which to distinguish the real from the sham. It is that difficulty, and only that, which is responsible for the confusion found by Congress to exist in this area of the law. By far the greater portion of family partnership cases involves the sole issue as to whether the transaction on which the taxpayer's case rests ever took place.

The committee reports[16] deplore the confused state of affairs. But the amendments to the law would seem to suggest that Congress has failed to understand that the only real problem lies in deciding whether there is a partnership; and that Congress, not mindful of that fact, has not come to grips with the basic problem at all. Section 191 relates only to the attribution of the income of a partnership already found to exist. Section 3797(a)(2) is of equally little help, providing only, as the *Culbertson* case had already held, that if the transfer of an interest is real, it is not to make any difference that there was no consideration for it.

Apart, for the moment, from the question of whether the new legislation will do any harm, it is important to consider how it has happened that Congress, though cognizant of a bothersome situation and intending to address itself to the real cause of the trouble, has failed to do so. One need not look beyond the committee reports to see what is wrong. The reports state that even since the *Culbertson* decision, donee partners

14. 337 U.S. 733 (1949).

15. *Id.* at 742.

16. The quotations from the committee reports on the family partnership problem appear at Section V-M, *Report of the Committee on Ways and Means of the House of Representatives on H.R.* 4473, H.R. REP. No. 568, 82d Cong., 1st Sess. (1951), and Section VI-A (7), *Report of the Senate Finance Committee on H.R.* 4473, SEN. REP. No. 781, 82d Cong., 1st Sess. (1951).

have been denied recognition for any one of the several reasons—that they "performed no vital services"; that the intrafamily gift was made without "a desire to benefit the business"; or that the gift was "not complete because the donor contemplates the continued participation in the business of the donated capital." The reasoning of the congressional committees is that donee partners, even in cases where the transfers are proved to be real and not sham, have been denied recognition for any one or more of the reasons given.

This reasoning is wrong and the fallacy in it explains why the statutes miss the mark. Performance of services, for example, is not a legal requirement which must be met in order that the donee of a bona fide transfer be recognized as a partner. On the contrary, non-performance of services is one factor, to be considered along with all the other circumstances of a case, in resolving the basic issue of whether any gift of a partnership interest was really made. Similarly, neither the donor's desire "to benefit the business" by making the transfer nor his contemplation, when he makes the transfer, that the donated capital will remain in the business, is a legal requirement, as the committees imply, but both are useful guides in deciding whether a transaction is a reality or a pretense.

It is stated at one point in the committee reports that the bona fides of the parties in forming a partnership is to be passed upon by considering "all the facts and circumstances" involved in the transaction. But, we are told at another point, "where there is a real transfer of ownership," the gift is to be respected for tax purposes "without regard to the motives which actuated the transfer." The committees, obviously, are under the impression that the matter of motive has been considered, under the case law, separately and apart from the question of good faith. The fact is, however, that motive has never been more than one possible test of good faith, to be weighed with the other proof in a particular case.

The committees take issue with the decisions from which, they say, it appears "that an intrafamily gift of a partnership interest, where the donee performs no substantial services, will not usually be the basis of a valid partnership for tax purposes." They observe that "the settlement of many cases in the field is being held up by the reliance of the field offices of the Bureau of Internal Revenue upon some such theory." The truth of the matter is that the bureau is not actually relying upon any "such theory." It is simply unable to satisfy itself, in many cases, that the gifts were more than paper transactions.

The whole tenor of the committee reports is that the statutes are expected to expedite the disposition of family partnership cases; this is to be accomplished, we are left to infer, by the adoption of statutes which free the law of erroneous theories and wrong rules. The cure adopted by Congress, it is here predicted, will not work. The reason is that the theories and rules were not in the law in the first place. They were criteria by which the courts and the bureau arrived at answers to a question of fact. And as long as the question of fact remains, the criteria must still be applied.

The new enactments, besides leaving the essential problem unsolved, have actually done affirmative harm. Unless Section 3797(a)(2) is utterly devoid of meaning, its effect on the situation must be that the gratuitous character of a transfer can no longer be considered as a point against the taxpayer. Such a rule is not good law because it is not good sense. The courts and the Treasury Department have heretofore recognized a difference between a sale of a partnership interest to an adult relative and a gift of such an interest to a trust for a child of three years. The law should recognize a distinction between these transactions for the reason that they are widely different in family and in business life. Forcing the two situations into one mold, as Section 3797(a)(2) appears to do, increases the difficulty of telling the real from the sham.

Far from simplifying or localizing the issues in family partnership cases, the statutes now enacted will actually broaden and complicate them. The matter of fixing reasonable compensation for the donor's services must arise wherever Section 191 is involved. And we know from experience in cognate types of cases that the task of evaluating personal services is, all by itself, at least as great a problem as that of attribution of family partnership income. We may find, therefore, that section 191 actually raises more disputes than it settles or avoids.

Section 191 may also, very possibly, add a new kind of device to the arsenal of evasive mechanisms heretofore used by taxpayers to deflect income. A father who divides his business among his sons, retaining no capital interest in it, may assure himself of a satisfactory income by making a long term employment agreement with the partnership. If the conveyance is bona fide, the limitations set forth in Section 191 do not apply, since that statute relates only to cases where donor's capital and donated capital are both present. The new rules as to attribution of income being inapplicable, the parties are free to let the income fall where the family, as a unit, enjoys the greatest tax saving. To upset such an arrangement the government must invoke the reasoning and the authorities governing conveyances to living trusts within families, no simple matter at best.

In a word, the whole problem is in a worse state than ever before and all only because Congress, seeking a ready solution to questions of fact, thought it could use statutes as substitutes for testimony and exhibits.

The Supreme Court was doing as good a job as could be asked and Congress might better have let matters rest as they were.

Percentage Depletion

Section 319 of the new act amends Section 114 of the code to effect increases in the rates of percentage depletion on several minerals. The most important of the increases is the one on coal, where the rate was raised from five percent to ten percent. Ordinarily such a step would appear to present nothing of absorbing interest to a legal writer. When read alongside the committee reports, however, it appears that this change in the revenue law involves more than revenue itself. A rather important point of principle is at hand.

The theory of percentage depletion is, to state it briefly, that the owner of a depletable interest in property is entitled to a deduction whereby he may recover, tax free, the value of a wasting asset during the years when it produces taxable income. Because the deductions are in percentages of gross income derived from the property, irrespective of basis, it is quite possible that the total of the deductions taken before the asset is fully depleted may exceed the basis.

The Supreme Court, in the case of *Anderson v. Helvering*,[17] stated the theory as follows:

"Oil and gas reserves, like oher minerals in place, are recognized as wasting assets. The production of oil and gas, like the mining of ore, is treated as an income-producing operation, not as a conversion of a capital investment as upon a sale, and is said to resemble a manufacturing business carried on by the use of the soil. . . .The depletion effected by production is likened to the depreciation of machinery or the using up of raw materials in manufacturing. . . . The deduction is therefore permitted as an act of grace and is intended as compensation for the capital assets consumed in the production of income through the severance of the minerals."[18]

The Senate Finance Committee Report gives quite a different reason for increasing the percentage depletion deduction:

"The testimony received by this committee both in connection with this bill and the bill which became the Revenue Act of 1950 revealed that in a number of cases nonmetallic minerals which are not in the enumerated group under existing law are competitive with those receiving percentage depletion, or have just as good a claim for such treatment as the enumerated minerals. The testimony also indicated that the 5-percent rate allowed coal is of little practical value and that the coal mining industry is peculiarly in need of more favorable tax treatment because of the inroads which alternative sources of energy, particularly oil and gas, have made on the potential markets of coal."[19]

17. 310 U.S. 404 (1940).

18. *Id.* at 407.

19. Section VI-A (6), *Report of the Senate Finance Committee on H.R.* 4473, SEN. REP. No. 781, 82d Cong., 1st Sess. (1951).

The same statement appears in the Report of the Committee on Ways and Means of the House of Representatives.[20]

There may have been a time, though perhaps most of us would now doubt it, when revenue laws were confined to the vexing problem of raising funds to pay for the operation of government. During the last war, however, our citizenry became educated to the idea that the revenue raising power might be exercised to prevent inflation, which is to say that income might be taxed in order, as the press then put it, "to syphon off" excess spending money lest the national currency suffer complete deterioration. Bearing, as it did, some semblance of good sense, this new reason for using the Sixteenth Amendment could be countenanced. An increase in taxes accomplished whatever the revenue system had to do in order to preserve the value of the dollar during a period when dollars were too plentiful in relation to the available volume of consumer's goods.

Even then, however, percentage depletion meant, at least so far as recorded legislative history shows, what the Supreme Court held it to mean and what, in their naive bookishness, tax theoreticians and advisors believed. The classic explanation of that term is, in view of the position Congress now takes, no longer valid. Percentage depletion is, today, in addition to whatever else it may be, a tool by which a kind of competitive *status quo* among certain industries is maintained or changed as Congress deems wise. Whether the coal industry or any other industry should receive aid through legislation is a broad question involving, undoubtedly, a great many extra-legal factors; and with that question we are, therefore, not here concerned. It is clear, also, that the coal industry could have been given the same competitive benefit through decreases in the percentage depletion deductions on oil and gas, with consequent gain rather than loss to the revenue. Here, too, we can only say that this obvious alternative may have been considered and for good reasons rejected.

Whether, in the judgment of Congress, some special action was needed by way of granting a subsidy or other form of aid to the coal industry, lest the nation suffer a loss of needed coal, or whether the difficulty appeared to relate directly to taxation, requiring that Congress, in the national interest, make some extra allowance in the tax law itself, is entirely beside the point. No issue whatever is here raised as to the propriety of whatever end Congress sought to achieve by making the amendments to Section 114. The trouble is that the wrong means were used. An allowance or deduction or other congressional concession to an industry or other body of taxpayers should be called what it is.

20. See Section I, *Report of the Committee on Ways and Means of the House of Representatives on H.R.* 4473, 82d Cong., 1st Sess. (1951).

It should not be called percentage depletion if, in fact, it is granted "because of the inroads which alternative sources of energy, particularly oil and gas, have made on the potential markets of coal."[21]

A serious point of principle becomes involved when, by legislative action, a legal concept retains its technical name, while it undergoes a real change in content that is discernible only from committee reports. From this practice, especially if carried into phases of the tax law which involve more taxpayers, only widespread confusion and misunderstanding can result.

Capital Gains and Losses

It was for many years the law that, in cases of taxpayers other than corporations, a loss of one dollar on the sale or exchange or a capital asset, realized within the short-term holding period, offset a like gain of two dollars, realized during the long-term holding period. By the adoption of certain very appropriate amendments to Section 117 of the code, it has now been made impossible for an individual or other non-corporate taxpayer to pocket half of a long-term capital gain, entirely tax free, and by well synchronized short-term losses, to erase the other half of the gain. A new method of treating capital gains and losses has been devised and, in view of its widespread interest to taxpayers, it is here proposed to illustrate and explain the salient features of its operation.

To begin with, Section 117(b), which formerly provided that long-term gains and losses were taken into account at fifty percent and those of short-term transactions at one hundred percent, has been completely rewritten, so that the percentage differential is no longer in the law. In place of it, however, is a provision allowing a new deduction from gross income. The provision for the deduction is couched in these terms:

> "In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 per centum of the amount of such excess shall be a deduction from gross income."[22]

Complementing this provision are Section 23(ee), newly enacted, to allow, "in the case of a taxpayer other than a corporation, the deduction [of 50 percentum of the excess of long-term gains over short-term losses] for long term gains provided in Section 117(b)" and an amendment to Section 22(n) whereby the newly created deduction may be taken from gross income to arrive at adjusted gross income.

A simple example, somewhat more in detail than those offered in the committee reports,[23] will serve to illustrate the effect of the foregoing.

21. See note 19 *supra*.

22. INT. REV. CODE § 117 (b).

23. The reason for using our own illustration is to demonstrate the effect of section 22 (n)(7) on adjusted gross income. The committee reports fail to bring that out.

Let us assume a taxpayer who had $10,000 of ordinary income and who during the taxable year sold two capital assets, one, held for more than six months, at a gain of $5,000, and another, held for less than six months, at a loss of $3,000. The computation would be as follows:

Ordinary income		$ 10,000
Net long-term capital gain (taken into account at 100 percent per § 117(b) as amended).		5,000
Gross income		15,000
Less: Net short-term capital loss (§§ 23(g)(1) and 22(n)(6)).	$3,000	
Half of excess of net long-term capital gain over net short-term capital loss (§§ 23(ee) and 22(n)(7)).	1,000	
Total deductions		4,000[24]
Adjusted gross income		11,000

Under the law as it stood prior to the amendments the result would have been quite different, to wit:

Ordinary income	$10,000
Net long-term capital gain (taken into account at 50 percent per § 117(b) as it formerly read).	2,500
Gross income	12,500
Less: Net short-term capital loss (fully taken into account §§ 117(b), 23(g)(1) and 22(n)(6))	3,000
Adjusted gross income	$9,500[25]

The mechanics for computing the alternative tax under the new law are so devised as to effect the purpose of Congress that, as in the illustration given, the taxpayer's right to exclude from income half of the long-term gains is superseded by a deduction in the amount of half of the excess of net long-term gain over net short-term loss. The first step, provided for in the amended Section 117(c)(2)(A) is to compute a

24. Net income is arrived at by taking the other deductions allowed by law.

25. See note 24 *supra.*

"partial tax," at ordinary rates, "upon the net income reduced by an amount equal to 50 per centum" of the excess of net long-term capital gains over net short-term capital losses. The result of this part of the computation will be the tax, at ordinary rates, on all of the income other than the excess of net long-term gain over net short-term loss. This is so because one-half of that excess will have been eliminated from net income by the new deduction granted in Section 23(ee), and the remaining half of the excess, while still part of net income, is, under the aforequoted language of Section 117(c)(2)(A), eliminated from the base of the partial tax.

The second part of the computation, based on the amended Section 117(c)(2)(B), is to calculate a tax, at twenty-five percent, on the full amount of the excess of long-term gain over short-term loss. The maximum effective rate of tax on capital gains remains unchanged, for, having taken the gains and losses into account in full amount, we have proceeded to tax the excess at twenty-five percent with the same result as though half the excess were taxed at fifty percent.[26] The difference, of course, is that the profit realized by the taxpayer, and eventually taxed, is now offset by the deduction under Section 23(ee) and not, as heretofore, by the non-recognition of half of every long-term gain. In this manner the tax on the capital gains becomes different than under former law, not by any change in rates, but by a change in the amount of the excess of long-term gains over short-term losses.

Finally, of course, the partial tax and the tax on the excess are totalled to reach the alternative tax, which, if it is less than the tax arrived at by taxing all the income at ordinary rates, is the total tax payable.

In a case where there is no net short-term capital loss, either because the taxpayer had no short-term transactions or because they resulted in a net gain, the tax is the same as under prior law. This is illustrated in the case of a taxpayer who realizes $15,000 of gain in long-term transactions and $5,000 of gain in short-term transactions. Under the law as it previously stood, the long-term gain would have been taken into account at $7,500 and the total of $12,500 then taxed either at ordinary rates or under the alternative method.

Under the new law the gains are added together for a total of $20,000 and then, under Section 23(ee), there is a deduction in the sum of $7,500, leaving, again, a taxable balance of $12,500. The deduction is arrived at by taking one-half of the excess of net long-term gain ($15,000) over the net short-term loss, which is zero.

In a case where there is a net long-term loss exceeding a net short-term

26. The increase in rate of tax on capital gains is ignored for the purpose of this discussion.

gain, the taxpayer fares better than he did before the amendments. Let us assume a net long-term loss of $5,000 and a net short-term gain of $1,000. The gain, under the new rules, offsets the loss dollar for dollar, and the taxpayer has a capital loss carry-over of $4,000. Under prior law the loss would have been taken into account at $2,500 and the carry-over would be only $1,500, Section 23(ee) not entering the picture at all.

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CONTRIBUTORS TO THIS ISSUE

CHARLES S. DESMOND, A.B., 1917, Canisius College; LL.B., 1920, University of Buffalo School of Law; LL.D., 1933, Canisius College. Justice of the Supreme Court of New York, 1940; Associate Judge of the Court of Appeals of New York, 1941 to date. Author of SHARP QUILLETS OF THE LAW (1949). Contributor to numerous legal periodicals.

ARTHUR H. GOODMAN, LL.B., 1938, Fordham University School of Law. Member of the New York Bar. Comments Editor, FORDHAM LAW REVIEW, 1937-8. Author of *The "From, Through or Under" Rule as to Competence of Witnesses,* 9 FORD. L. REV. 65 (1940).

JOHN G. JACKSON, B.A., 1901, Columbia College; LL.B., 1903, Columbia University School of Law. Member of the New York Bar. Contributor to various legal periodicals.

DWIGHT ROGERS, Classes of 1918 and 1921, Ohio State University; LL.B., 1948, Fordham University School of Law. Member of the New York Bar. Author of *Capital Gain Dividends,—A Suggestion for Draftsmen,* 20 FORD. L. REV. 79 (1951), reprinted, 90 TRUSTS AND ESTATES 300 (1951).

FLORENCE W. SIEGEL, A. B., 1944, PH.D., 1949, New York University.