

"A SYSTEM GROWS"

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It's that time of the year!!! My "red and blue package" has arrived. It was only a couple of years ago when one could not have revealed the "colors" of his package, as it would have exposed his relationship to his favorite Uncle Sam. Things have changed, and our Uncle Sam has become discreet, but it is still the same message, always entitled, "A Special Message from the Commissioner". This message has been issued every year since 1913. It has been called "a masterpiece of informative written matter, and I am inclined to agree. It explains all that is needed for the U .S. Taxpayer to compute his personal income tax liability. A few hours of study and the average taxpayer should have little trouble in pulling together his #1040, and supporting it with Schedules A, B, C, D, E and R, F, and S E, Forms #4136 and #4875. Do the homework in early January and your refund should be in your mail box in time for the KEA break and it should go a long way toward financing your trip to Florida.

Bismarck once remarked that one should not look at what goes into the law or sausages. With this statement in mind, it will be my purpose to take a look at how our income tax system has grown, and not to ease our problems in meeting the system's requirements.

In an earlier attempt your writer gave you the bone-dry facts in a paper entitled, "The Birth of the Blues". In this effort to-night, I would like to point out a human side of our income tax system, and to explore some of the principles which have emerged.

The first income tax laws passed in the U.S. were during the Civil War. A source of federal revenue has long been needed that did not have to be apportioned among the states upon the basis of population. This early attempt was followed by a number of others, all to meet defeat when found unconstitutional. It was only after the 16th Amendment, adopted February 25, 1913, that the income

tax was removed from the requirement of apportionment among the states, that this source of revenue became legally available for the support of our U.S. government. A very simple law, taxing something common to us all, Income, for the simple purpose of raising income to support a federal government. The position of both taxpayer and government was well stated by Baron de Montesquieu's "The Spirit of the Law". I quote, "The revenues of the state are a portion that each subject gives of his property, in order to secure, or to have the agreeable enjoyment of the remainder."

"To fix these revenues in a proper manner, regard should be had both to the necessities of the state and to those of the subject. The real wants of the people ought never to give way to the imaginary wants of the state - - imaginary wants are those which flow from the passions, and from the weakness of the governors, from the charms of an extraordinary project, from the distempered desire of vain glory, and from a certain impotency of mind incapable of withstanding the attacks of fancy. Often has it happened, that ministers of a restless disposition have imagined that the wants of the state were those of their own little and ignoble souls."

This statement seems to fit even today! Our questions are not of the fact that we are taxed, to that fact we are reconciled, but our questions and doubts at the point of "for what purposes". Is the tax for purposes of revenue only, or is it for the purpose of redistribution of our nation's wealth? Are our incomes taxed for government purposes in line with our ideas of what is proper governmental purposes? Have our income tax laws been used to further social goals which Congress thinks are worthy, thus using their "power to tax" to promote these goals? Should the power to tax be used to further social goals that may not be in keeping with what the greater majority of our people approve. These are only a few of the questions currently raised, but let's take a look at

some of the questions raised in the early development of the law that established the "golden spikes" that have held this law, born out of the 16th Amendment of the Constitution, together.

WHAT IS INCOME? This was the first question faced, and resulted in the first important victory of the Government. The law became effective on March 1, 1913. Were dividends paid after February 28, 1913 from corporation earning prior to that date income to the stockholder? This was a real threat to millions in revenue. The Supreme Court ruled that Congress had the power to tax "everything that became income, in the ordinary sense of the word - - including dividends received in the ordinary course by a stockholder from a corporation. The dividend was the fruit of stock ownership, and became income when available to the stockholder for his use and benefit. Dividends were no different from rents or interest flowing from property or capital and was "in the ordinary sense" income. Thus the Government established a principle of taxation that has become one of the "golden spikes" that still holds the law together. The writers of the law can not cover all points, but the law must be made to work so as to carry out its purpose, to tax income, and income must have a meaning that is acceptable "in the ordinary sense".

DOES INCOME MEAN ONLY CASH? This was the next issue that raised its head. A corporation had declared a dividend, but transferred property to the stockholders in lieu of cash. The Supreme Court was clear in its answer. Income was anything of value, its fair value, when received. The principles established in these two early cases had to be fundamental if the tax law was to work.

If income was to be a basis for taxing there had to be a period within which to measure the flow of income. One man's income, or the income of a business can not be determined until that man ceases to earn an income, or that business has wound up its affairs. This approach to taxing income would not do

the job. It is the essence of any system of taxation that there be a determination of the tax at regular intervals.

WHEN IS INCOME INCOME? This is still a problem that faces us after 60 years. The cash basis or accrual basis for reporting income does not fully answer our question. Eg., can a taxpayer escape paying his tax on income by refraining from accepting it, or by letting someone else accept it? The answers to these questions came loud and clear from the courts. A very interesting theory developed around this problem often referred to as "the tree and its fruit" theory. The tree takes the place of capital and its fruit becomes income. The owner of the tree owns the fruit and whether he chooses to pick the fruit himself or let his neighbor do it for him, it remains his fruit. Taxpayers have tried in many ways to evade this principle only to lose their cases. The father owns the bonds, the interest coupons he gives to his son, and it follows that the son should pay the tax. NOT SO! Give the bonds to the son and those coupons matured at the date of the gift will still be income to the father. The fruit belongs to the owner of the tree.

We can see that a system for taxing income did not happen on March 1, 1913, but has been hewn out, and it is still being patterned from the constant battles between the taxpayer and his government, and from almost the first preferences were demanded and many won by the taxpayers.

Capital is necessary if our economy is to grow and capital must be able to move to where it is most needed. This in many cases means selling the tree.

It has been determined that the original investment could be recovered without income, but that any excess received was income. Was this income to be just like the income earned at the job, or the same as the fruit from the tree that was being sold? It was in 1921 that this problem was faced and the result gave us "Capital Gains" still with us today. A sound principle of taxation, and the

section of the law under which all want to find a resting place.

It seems that there are always those people that ask to be exempt, and there was no exception in the field of income taxes. The most interesting group that claimed exemptions from the income tax laws were the Federal Judges (and it might be added, the President and Vice-president). It was all quite legal. The Constitution had always provided that the salary of a Federal Judge could not be changed while in office. This was reason enough for them to claim exemption from the new income tax law. The Revenue Act of 1918, however, reached out and included Federal Judges' income as gross income to be fully taxable. It is of local interest that the U .S. Judge for the Western District of Kentucky who took office prior to the enactment of the 1918 Act took his case to court. The District Judge for the Southern District of Ohio, a Mr. Justice Peck, heard the case. It is to the credit of Justice Peck that he wanted to be a tax paying citizen as well as a Judge. (Evans vs. Gore, 262 Fed. 555 (1919)). However, the Supreme Court reversed the decision and Federal Judges remained non-tax paying citizens until 1932 when a new and successful attempt was made to tax their salaries.

"What is income?" becomes even more complex when we consider it to be what is left after "allowable" deductions. The business deduction would appear to be an easy one, but it, too, had to be won. The statements, "entered into for profit" and "can reasonably expect a profit" as a basis for a deduction has raised some real problems. Consider the high income professional person or executive that develops a real interest in horses, buys a farm and starts losing money. Can he expect the Government to subsidize his love for horses by allowing him to deduct his losses? The questions arise - - has he "entered for profit" and can he "reasonably expect a profit"? The rule has evolved that if he can show a profit in two of five consecutive years he's in business, unless the Commission can prove

otherwise. His problem comes down to planning his flow in income and expenses; but, he must produce an income.

There is another principle for deductions that has preserved our revenues but still isn't understood by most taxpayers. It holds that before something can become a deduction or a loss, for tax purposes, it must have been included as income. A most amusing example of this principle may be found in the following case. A person raised a litter of registered pups. They were worth \$100.00 each, the wife of the taxpayer has anticipated this income since their birth, but something happens and they all die. A loss has been sustained, of this there is no doubt, but try to explain that there is not a deduction!! It never ceases to be an almost impossible task. Even the farmer that raises cattle, expenses all the feed and other costs, can't quite accept the fact that when one of his prize cows falls into the limestone sink hole he has no deduction. So, even business losses can not be deducted under this principle.

It takes only a couple of examples to establish the fact that the income tax laws are used to further social and economic goals. Let's look at them.

HOME OWNERSHIP - All interest and taxes on your home are deductible. These are very personal expenses and really there is not one good reason for them being deductible except that home ownership is considered a worthy goal for all Americans. These deductions do not begin to be equitable. The person with the high income can always get the full value of these deductions, when the low income home owner may get his smaller deduction, if he can find enough non-business expense when added to his mortgage interest and taxes to effect a saving. The poor fellows who continue to pay rent have no benefit at all. It has been determined that this benefit gives an average tax saving of \$1,7000.00 for each person with an adjusted income of \$100,000.00 and over, compared to an average saving of \$.39 for the taxpayer making between \$7,000.00 and \$10,000.00.

EXPLORATION EXPENSE AND DEPLETION - are excellent examples of the economic goals promoted by the law. No one would agree that oil or coal, which took thousands of years for nature to produce, should be used for the personal benefit of anyone; however, our laws have made millionaires in both fields. When examined closely we have to agree that the law might be right. The economic goals that were the basis for the allowance for both exploration expense and depletion were to attract funds needed to find and develop our natural resources. The law has brought together the wild-catter and the man with wealth, the individual driller and the New York banker. Not always has the investor been the winner but he got his deduction for exploration and drilling cost and hopefully enjoyed his dream of becoming a millionaire from his depletion allowance. Some of you can recall the effective purposes that these deductions served in North Christian County in the not too distant past. I hope this reminder will not be too painful.

As taxpayers, we all can testify that the law has been effective in raising funds. We can all see a need for changes; we all want those changes that will favor us. Over the years the pressures for change to benefit special groups, promote social goals, encourage economic growth where needed, and to plug the loop holes created by ingenious plans to evade the law has created a monster. During the recent presidential campaign we heard much about tax reform, most of it completely irresponsible "hog-wash"; however, a major tax reform must come within the next few years.

Why tax reform? The present law has become too complex, this, in my opinion, is the major reason. Our system is a self-assessing system, and if it is to continue to work, there must be a real effort to make it understandable by the average tax-payer. The Commissioner's annual message just can't explain it, and the professional tax lawyers can't do much better. The Internal Revenue Code fills almost 2,000 pages, treasury regulations fill another 4,500

pages, and you and I are expected to assess our own taxes!

A "reform" can't come about under one administration and any attempt to do the job must be one that will over-ride the promises of any one party.

It would seem reasonable to assume that after 60 years of experience, we could develop a basic tax law that would produce the revenue needed, and keep the system simple. Maybe all tax preferences can't be eliminated, but with their elimination and a reduction in the rates we could move a long way toward the goal. It could be that the social and economic goals, now promoted by the Code, should be met by direct subsidies, in this way we could all see who is getting the benefits..

This has not been written to answer questions, but to give some overview of how we got up to our necks in taxes. There has not been one word about tax relief. There can be no actual tax relief unless there be a reduction in the expenditures by our government. Easing the task of assessing our taxes, or a shift in the burden will result from tax reform, but only by a reduction in government expending can give tax relief. Our federal, state, and local governments take approximately 33 1/3% of our nation's income. Some countries take well over 50%, so by comparison we are in good shape. The recent announcement that farm conservation expense will no longer be paid 50% by the government, is the only type of thing that will reduce taxes. This will cost Christian County farmers hundreds of thousands of dollars, and that is not good; still, it is moves like this that can bring tax relief. There was another announcement this week that will bring a loud scream. The Rural Electric Co-ops have for over thirty years borrowed money at 2% or less from the National Rural Electric Co-op Bank. This was a direct subsidy for the development of rural electricity and certainly was a worthy cause. Last week Mr. Nixon raised that interest rate to 5%. Still, you and I as tax-payers, will have to pay the difference between 5% and the actual cost of money; but, that is 3% less than before, and millions

of dollars are saved.

We might not agree with either of these, but such moves are the way toward tax relief.