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*Part Six*

# THE DISTINCTION BETWEEN 'NET' AND 'GROSS' IN INCOME TAXATION

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*Discussion*

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# THE DISTINCTION BETWEEN 'NET' AND 'GROSS' IN INCOME TAXATION[1]

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## *I Topic Selected for Discussion*

THE DEFINITION of income for purposes of taxation is of concern to students of national income for several reasons. One of the most important is that in the measurement of national income dependence must be placed upon statements of income that have been drawn up in conformity with the requirements of the tax law. Ordinarily these statements are used in the aggregate form in which they appear in the Federal government's *Statistics of Income* and in similar publications by some states.

From the many topics that might be chosen for a discussion of the relation of taxable income to national income, this paper selects the distinction between gross and net income. The Federal income tax law and all the state comprehensive income tax laws require certain inflows to be taken into account; the aggre-

[1] This paper as printed here differs from that read at the American Economic Association meetings, in December 1936, and which formed the basis for the comments by Professors Blough and Hewett, in the following respects: the material now in Appendix A was in footnote 11; the material now in Appendix B was in the text, following the paragraph numbered (f) in Sec. II, 3; and the last two paragraphs in Sec. II, 3 are new; two sentences dealing with a lower court decision have been deleted as inadequate for a subject that would require more extended treatment than can be given here; the exception to the rule of deductibility of interest payments has been added; footnote 2, except for the first sentence, is new; a sentence has been added to footnote 50; a few minor corrections in style have been made.

gate is here called gross income. From this, they allow certain outflows to be deducted; the result is net taxable income.[2] Taking the inflows more or less as given, the observer may inquire into the principles that guide the allowance of deductions for outflows, and thus work towards a concept of 'net' as opposed to 'gross' income.

So far as gross taxable income arises from a transfer of money or money's worth—and this covers practically all instances—the existence of net taxable income for taxpayers in the aggregate depends upon the relation between the tax status of each payor and the tax status of each payee as affected by each transfer. The possible relations are, of course, four; the amount involved may be: [3]

(1) not deductible by the payor, and not taxable to the payee (e.g., a gift);

(2) not deductible by the payor, but taxable to the payee (e.g., wages of a housemaid);

(3) deductible by the payor, and taxable to the payee (e.g., wages of a factory employee);

(4) deductible by the payor, but not taxable to the payee (no example important enough to cite here).

If only items (1) and (3) were found in the law, no aggregate net taxable income would result, since every receipt either would not be included in gross income (case 1) or would be offset by an equivalent deduction from someone else's gross income (case 3). It is the existence of item (2) that results in an aggregate net taxable income. Item (4), which produces a negative net taxable

[2] The matter of outflows is not so simple, technically, as may appear from this statement; sometimes the allowance is made in the form of a 'credit' against the technical 'net income', and sometimes as a credit against the tax otherwise due. Moreover, in defining gross income, the tax law in some cases requires that against a certain inflow there be offset a certain outflow in order to arrive at the technical 'gross income'; (further offsets for certain other outflows are allowed in arriving at 'net income'). In this paper, however, taxable gross income refers to any inflow, such as proceeds from the sale of a stock of goods, that must be taken into account for tax purposes—any inflow, that is, part of which may prove to be included in net income, depending on the size of the offsets made. On the other hand, gross income will not here include inflows, such as completely exempt bond interest, that can give rise to no tax liability, regardless of what the same taxpayer's outflows may be in nature or amount.

[3] The illustrations in parentheses are drawn from the existing Federal law.

income in the aggregate, is of course rare. Item (1) is important because it includes gifts and inheritances.

Payments falling under item (2) are commonly described as 'personal expenses', while payments falling under item (3) are usually, but not always, 'business expenses'. These terms suggest in a general way why the distinction is drawn—why some receipts that are taxable to the payee are deductible by the payor and why some are not. The implication is that deduction should be allowed if the payment is in some way connected with an attempt by the payor to obtain for himself some taxable receipt. If, on the contrary, the payor's outflow has no connection with an actual or potential taxable inflow to him, the expense is personal and is not deductible (as with the other grouping, exceptions can be found). The existence of taxable net income for any individual depends of course upon the taxable inflow's being greater than the deductible outflow.

The connection between the actual outflow and the actual or potential inflow thus determines whether a given outflow falls under item (2) and is not deductible, or falls under item (3) and is deductible. About the only kind of outflow that raises no questions is an extreme case of item (3), such as an outlay for a stock of goods that can be of absolutely no use to the buyer except as he can make a trading profit by it. Practically all instances of personal expense have, from certain points of view, at least a tenuous connection with an actual or potential taxable receipt.

In the paragraphs immediately following, the discussion is concerned with cases falling under item (3)—the business expense. Subsequently, the problems raised by item (2)—the personal expense—will be considered.

## *II Business Expenses*

The 'actual or potential' nature of the taxable receipt has been emphasized to avoid any misunderstanding. The business expense may in fact result in no gross income at all, yet it remains a deductible item, at least under the Federal law. Conversely, an expense may result in taxable income, yet not be deductible, as when a gentleman farmer, in the business purely for the pleasure of it, spends $100 to receive $50. In other words, the tax law pays little or no attention to cause and effect, or association. The guiding factor seems to be intent. The question is: was the outlay made entirely in the hope that it would result in a (taxable) receipt?

These general statements may be given point by specific reference to the Revenue Act of 1936, containing the Federal income tax law, and to the Treasury Department's *Regulations 86*, interpreting the income tax under the Revenue Act of 1934.[4] The law states that deductions shall be allowed for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . .",[5] and adds that deduction shall also be allowed, in the case of an individual, for "losses sustained during the taxable year and not compensated for by insurance or otherwise—(1) if incurred in trade or business; or (2) if incurred in any transaction entered into for profit, though not connected with the trade or business. . . ." [6] A sweeping provision allows deduction "in the case of a corporation, [for] losses sustained during the taxable year and not compensated for by insurance or otherwise." [7]

The only place in these phrases where the law specifically uses the test of intent is for "any transaction entered into for profit", but the words "ordinary and necessary" in the first quotation and the implicit reliance on the scope of corporate activities in the third quotation also serve to indicate that the legislator is much more concerned with intent than with the actual outcome. A business man may spend $100,000 and fail so badly that in retrospect the expenditure seems difficult to understand, but the legislator, if he thinks about it at all, probably contemplates letting the $100,000 stand as a deduction against such income as there may be from other sources. Perhaps a limiting case may be conceived where an individual's expense, though it is sincerely made for profit alone, is so utterly mad as to be excluded from the category of "incurred in trade or business" or "incurred in any transac-

[4] As this is written, the regulations covering the 1936 Act have not been issued.

[5] Sec. 23 (a).

[6] Sec. 23 (e).

[7] Sec. 23 (f).

tion entered into for profit". The exclusion is easier, of course, if the item has to pass the test of "ordinary and necessary".[8]

Whatever the interpretation may be on some of the finer points, it seems evident that the legislator does not wish to insist on a causal connection between a given expense and a given receipt before allowing the expense as a deductible item. In other words, he does not insist that a given expense be proved to have produced a taxable income at least as large if it is to be allowed as a deduction. Capital loss deductions are limited to capital gains of the same year, plus $2,000, but it appears unlikely that the legislators enacted this provision with an idea that a capital loss is an expense that has a causal connection with capital gains.[9] Perhaps a stronger case for the existence of some such idea can be made for the provision that limits deductions for gambling losses to gains from gambling.[10]

The net income that results from this doctrine represents ability to pay as it in fact exists rather than as it might have existed if the mistaken expenditure had not been made. So far as the resulting figure of net income enters into national income estimates, the national income figure tends to become net-after-mistakes. This may be the most desirable, and indeed the only practicable, concept, but it may be slightly misleading, since it contributes to the deduction of certain business expenses that carry a large element of personal satisfaction. Persons with sufficient wealth to indulge their business fancies may make expenditures that indubitably carry an intent to obtain profit, but that are nevertheless peculiarly apt to result in a business mistake because they are made with the same lightheartedness and the same joy in spending for spending's sake that characterizes the gentleman farmer who counts on a net loss, or the estate owner who builds a private golf course. If the purpose of the national income estimate is to indicate the size of the income available to supply the personal wants of the ultimate consumer, there are

8 It is to be noted that the discussion in the text above does not turn on whether the item is so 'extraordinary' that it must be charged as a capital item and then amortized.

9 Sec. 117 (d).

10 Sec. 23 (g).

some disadvantages to a concept that, relying on intent instead of on a strict construction of 'necessary', tends to include in deductions some expenses that carry a strong personal satisfaction element.[11]

Some of the subdivisions of business expense will now be considered. The treatment will not be exhaustive, but will concentrate on the items that raise controversial questions of principle, either in statute or in administration.

### 1 CAPITAL LOSSES

Capital gains and losses are far too complex to be adequately dealt with at this point; detailed consideration would be beyond the scope of this paper.[12] However, it must at least be noted that the present Federal statistics reflect neither a deduction of all capital losses nor a refusal to allow deduction of any. A compromise course is followed that will undoubtedly prove troublesome to students of national income, whatever their views may be on the place of capital losses. For individuals the percentage of the loss taken into account varies with the length of time the asset has been held,[13] and losses on sales between members of a family are not deductible at all; [14] for almost all taxpayers, losses are not deductible in excess of the amount of capital gains plus $2,000; [15] and still other provisions add to the difficulty of deciphering the significance of the capital loss data in the statistics.

### 2 DEPRECIATION

The student of national income will obtain almost no useful de-

[11] See Appendix A.

[12] Capital gains or losses arise from the sale of a capital asset, and a capital asset is property held by the taxpayer, whether or not it is connected with his trade or business, excluding stock in trade or other property that would be included in inventory, or property held primarily for sale to customers in the ordinary course of trade or business (Sec. 117 (b)).

For discussions of the general problem of the treatment of capital gains or losses in estimates of national income by other contributors to this volume, see M. A. Copeland, Part One, Sec. IV and V, 8, discussion by Simon Kuznets, and Dr. Copeland's reply; Clark Warburton, Part Two, Sec. VI; Simon Kuznets, Part Four, discussion by A. W. Marget, Milton Friedman and M. A. Copeland, and Dr. Kuznets' reply.

[13] Sec. 117 (d).

[14] Sec. 24 (a) (6) (A).

[15] Sec. 117 (a).

tails on depreciation from the Federal income tax law. The statute is exceedingly vague, and in effect leaves the matter up to the accountants, in the first instance, and, finally, to the Treasury and the courts. The wording of the basic provision for depreciation has remained unchanged from the Revenue Act of 1918 through the Revenue Act of 1936: "A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." [16]

On the other hand, administrative practice regarding depreciation allowances has been of considerable significance in its effect on the net income figure in returns where depreciation is an important item. Recent history is instructive on this point. In 1933 a subcommittee of the Committee on Ways and Means reported its concern over the amount of depreciation that was being taken as a deduction, and, while "recognizing the soundness from an accounting standpoint of these deductions", recommended that "for the years 1934, 1935 and 1936 these allowances be reduced by 25 per cent. . . ." The subcommittee added that "no permanent injustice will be done individuals or corporations, as the basis [for determining gain or loss on the sale of the asset] of the

[16] See secs. 214 (a) (8) and 234 (a) (7) in the Revenue Acts of 1918, 1921, 1924 and 1926; sec. 23 (k) in the Revenue Acts of 1928 and 1932; and sec. 23 (l) in the Revenue Acts of 1934 and 1936. The special provision for "mines, oil and gas wells, other natural deposits, and timber" similarly remained unchanged at "a reasonable allowance for . . . depreciation of improvements, according to the peculiar conditions in each case", in secs. 214 (a) (10) and 234 (a) (9) of the Revenue Acts of 1918 and 1921; secs. 214 (a) (9) and 234 (a) (8) of the Revenue Acts of 1924 and 1926; sec. 23 (l) of the Revenue Acts of 1928 and 1932; and sec. 23 (m) of the Revenue Acts of 1934 and 1936; except that the Revenue Acts of 1918 and 1921 added a phrase, "based upon cost including cost of development not otherwise deducted", that was dropped in the subsequent Acts. Some changes were made, not important for purposes of the present discussion, in the wording of the provisions stating how the allowance should be divided between persons having different interests in the property.

The Revenue Act of 1913, sec. II, phrased the basic provision "a reasonable allowance for depreciation by use, wear and tear of property, if any", for corporations [G (b)]. For individuals it was: "A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business. . ." (B), with a proviso limiting the allowance for mines to 5 per cent of the gross value of the year's output. The Revenue Act of 1916, secs. 5 (a) and 12 (a), dropped the mine provision (concerning depreciation) and rephrased the allowance: "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade. . ." The Revenue Act of 1918, as shown above, expanded the allowance to include obsolescence.

depreciable . . . property will only be reduced by the amount of these items allowable after the 25 per cent reduction." [17]

The Treasury objected, noting that, even if the reduction were made good in a later year, the distribution of the income among the years would be distorted.[18] Shortly thereafter, the Secretary of the Treasury informed the Committee on Ways and Means that the Bureau of Internal Revenue had found that "through past depreciation deductions many taxpayers have . . . built up reserves for depreciation which are out of proportion to the prior exhaustion, wear, and tear of the depreciable assets". The Bureau proposed, therefore, "to reduce substantially the deductions for depreciation with respect to many taxpayers in various industries", by "requiring taxpayers to furnish the detailed schedules of depreciation (heretofore prepared by the Bureau)", and by "amending the Treasury regulations to place the burden of sustaining the deductions squarely upon the taxpayers so that it will no longer be necessary for the Bureau to show by clear and convincing evidence that the taxpayers' deductions are unreasonable".[19]

The Committee gave up the 25 per cent reduction plan in the belief that the Bureau's administrative change would "give greater equity and increase the revenue by as great an amount as

[17] *Prevention of Tax Avoidance:* Preliminary Report of a Subcommittee of the Committee on Ways and Means, 1933, pp. 4–5. Certain qualifications, not important for purposes of the present discussion, would have to be made to the subcommittee's 'basis' argument.

[18] *Statement of the Acting Secretary of the Treasury Regarding the Preliminary Report of a Subcommittee of the Committee on Ways and Means,* 1933, p. 31.

[19] *Report . . . from the Committee on Ways and Means . . .* (on) *the Revenue Bill of 1934,* pp. 8–9. The Bureau also proposed to make specific a limitation of subsequent aggregate depreciation to the unrecovered basis of the asset, but this appears to have been considered already in a fairly specific manner in *Regulations 77,* art. 205, last sentence.

So far as the taxpayer's own practices were not altered by the new attitude of the Bureau, the published figures on income might remain unchanged, since the published statistics are based on "the taxpayers' returns as filed, unaudited except for a preliminary examination to insure proper execution of the returns, and include amended returns showing net income of $100,000 and over, but do not include amended returns with net income under $100,000" (*Statistics of Income, 1933,* p. 2). It seems reasonable to suppose, however, that many taxpayers would actually show in their returns, as initially filed, less depreciation than they would have shown in the absence of the new regulations on burden and manner of proof.

the subcommittee plan".[20] In its next published Regulations, the Treasury fulfilled its promise.[21]

## 3 DEPLETION

In contrast to its treatment of depreciation, the Federal income tax statute has for many years specified in some detail the manner in which depletion shall be taken. Likewise, the regulations concerning depletion have been much more detailed than those on depreciation. [22] The total amount of money involved, either as income base or income tax, is small compared with depreciation, but the points involved are instructive in showing how the income tax statute may on occasion prescribe a highly artificial 'net' income through the artificiality of its provisions concerning deductions from gross income. The subject is discussed at some length in Appendix B.

The artificiality of the deductions allowed for depletion reflects a combination of diverse desires: to subsidize some of the extractive industries; to achieve simplicity in administration; and to consider an industry as an industry rather than as a collection of discrete entrepreneurs.

The Federal income tax law allows depletion on several bases, as follows: [23]

a) For oil and gas wells, 27½ per cent of the gross income from the property, with certain limitations.

b) For coal mines, 5 per cent of the gross income from the property, with certain limitations.

c) For metal mines, 15 per cent of the gross income from the property, with certain limitations.

d) For sulphur mines or deposits, 23 per cent of the gross income from the property, with certain limitations.

[20] *Ibid.*, p. 9.

[21] Cf. Treasury Department, Bureau of Internal Revenue, *Regulations* 77, art. 205, last four sentences, and *Regulations 86*, art. 23 (1)–5, all after the second sentence.

[22] Cf., e.g., pp. 55–60 (depreciation) and 61–88 (depletion) in *Regulations 86*.

[23] Revenue Act of 1936, sec. 114 (b) (3), (4). For a precise statement, useful to the taxpayer or to the statistician who wishes to know exactly what elements may be reflected in *Statistics of Income* for each of the past years, the brief statement of the six methods listed here would have to be appreciably expanded to note certain qualifications and changes from year to year. The purpose here is to give a general idea of the extent and nature of the artificiality of the net income figure in so far as it results from deductions for depletion.

e) For new deposits of minerals (deposits discovered by the taxpayer after February 28, 1913), not included in (a) to (d) above, the value—not the cost—of the discovery, prorated over the estimated future units of output, with certain limitations.

f) For old deposits of minerals ('old' in relation to (e) above), the cost, or the value at the time of the latest transfer where gain or loss was recognized for purposes of the tax on capital gains, or the value as of March 1, 1913.

The development of the percentage-of-gross methods [(a) to (d) above] and the discovery-value method (e) is a result of certain pressures briefly described at the opening of this Section. They may be conveniently discussed as they affect: [i] properties that do not represent discoveries made since the income tax law took effect; [ii] properties that do represent such discoveries.

Properties in the former group do not raise the question of discovery value, but they do create pressure for the use of some method of computing depletion that will not involve estimating their value. Unless such a method—for example, the percentage-of-gross method—is devised,[24] an estimate of value to serve as a base for depletion must be made as of the date when the income tax law took effect and, more important for the present point at issue, when the property changes hands in a transfer where a taxable capital gain or a deductible capital loss is realized.

Properties in the latter group raise the question whether it is not fairer to the discoverer of the property to allow him depletion on a discovery rather than a cost basis. But since a discovery basis necessitates valuation, pressure develops to put even new properties on a percentage basis or something analogous to it. If it is difficult to find a percentage formula that will perform the same functions as a cost basis or a basic-date valuation basis, it is also difficult to find such a formula as a substitute for a discovery value basis. In practice the result is likely to be an artificial method of determining the deductible amount, far removed from what most students of national income would probably wish for their purposes.

[24] Unless capital gains and losses are ignored, however, the necessity for estimating values is not escaped even by this method; see Appendix B.

### *III Personal Expenses*

Section II, 'Business Expenses', has considered the kind of outlay that is made with practically the sole intent of getting some sort of taxable receipt. Other categories of outlay (e.g., food, clothing, shelter) may be grouped under the heading 'Personal Expenses', if that term is given a somewhat broader meaning than usual so that it includes, for example, gifts.

A general characteristic of these personal expense outlays is that, under existing income tax laws in the United States, they are not deductible from gross income in arriving at net income. Some personal expense outlays—for example, gifts—are not taxable to the recipient and therefore do not contribute towards the aggregate net income of society as shown by *Statistics of Income*. These will not be considered in the following discussion.

Each broad category of personal expense can be divided into two groups: (a) personal expenses that are made with an intent to contribute towards the acquisition of taxable gross income; (b) personal expenses that contain none—or practically none—of this intent. Group (a), it will be recalled, may be distinguished from business expenses by the fact that in the latter the intent to acquire gross receipts is the sole intent. The chief point at issue under the income tax law is the extent to which allowance might be made for the expenses in group (a). For example, a taxpayer must eat a certain minimum amount if he is to be able to operate his business and get taxable profits from it. To this extent there is a connection between outgo and income that might justify allowance of the outgo as a deduction. However, the taxpayer does not eat even this minimum amount solely in order to operate his business and make a profit in the sense that he buys goods solely in order to sell them and make a profit. As to expenses in group (b), probably no one would urge that they should be deductible, for, if they were, all items in group (a) would logically be deductible, and the community in the aggregate would show no net income at all.

1 FOOD

In most cases, taxpayers must eat if the gross income that is entered on their tax returns is to be maintained. A few, living exclusively on investment income, can fast without destroying the tax base: the gross income lives on without them.

The primary difficulty in allowing any deduction at all for food is the intimate way in which the business of living and the business of earning a living are intermixed in food consumption. A start might be made by disallowing any deduction for food that is almost certainly not necessary to the acquisition of a taxable gross income. Those who receive no income from current earnings of their own, but live on investment income and gifts, might be granted no deduction at all.[25] Those who clearly eat more than they need to keep themselves fit for work might be disallowed a part of the food expenses. With adequate technical assistance from dietitians and others, a roughly satisfactory scale of absolute allowances in money terms might be made. In fixing these allowances, recognition might be taken of differences in occupation (e.g., a ditch-digger vs. a bookkeeper) and location (e.g., cold vs. warm climates), but refinement could scarcely ever be pushed to the point of recognizing individual differences in physical constitution.

The next step, and much the more difficult and dubious, might be to attempt some division of the remainder of the food expense into deductible and non-deductible on the grounds that, while all was essential to the production of the income, much of it, if not all, also contributed to the taxpayer's enjoyment.

In any case, it would probably be impracticable to base a deduction on amounts actually spent. The bother of keeping records and the difficulties of allocating certain expenses (e.g., depreciation on the kitchen in the home) would be forceful reasons for using a scale of flat allowances. As has been suggested, various

[25] However, some difficulty arises with investment incomes if a long period, instead of one year, is considered. It might be argued that the investment income is a result of savings that the taxpayer has made on the assumption that a certain amount of expense would have to be incurred later in keeping him or someone else alive so that the investment income could be enjoyed. In other words, the prospect of sufficient food would be a necessary part of the complex of factors that induced him to save and thus made possible the investment income.

degrees of refinement could be given to the allowances, and they would of course have to be reexamined every so often in the light of changing price levels.

The present Federal law gives no help in suggesting ways of constructing a deduction for food. As interpreted by the Treasury, the law disallows as deductions all expenditures for food, except meals purchased on a purely business trip.[26] This deduction is specifically permitted by the law: "traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business." [27] This departure from the general principle probably represents nothing more than a concession to administrative difficulties.

2 CLOTHING

The remarks made about food may be applied to clothing, with this difference, however: the possibility of using actual expenditures rather than a flat allowance is not so slight. In certain cases it might appear reasonable to deduct the entire cost of clothes purchased especially for work. This possibility is illustrated by a Treasury ruling of a narrow scope: "The cost of equipment of an Army officer to the extent only that it is especially required by his profession and does not merely take the place of articles required in civilian life is deductible. Accordingly, the cost of a sword is an allowable deduction, but the cost of a uniform is not." [28]

3 SHELTER

For shelter a still better case exists for trying to use actual expenditures instead of a flat allowance if any deduction at all is to be allowed. The annual amounts involved are fairly large but, unlike those for food, they are not composed of several small items that make record-keeping so tedious. There is probably much more variation among taxpayers in the expense traceable to the business element than in the expense for either food or clothing. This makes the matter more important from the point of view of equity.

The problem is not, as in food or clothing, one that is conceiv-

[26] Art. 23 (a)–2.
[27] Sec. 23 (a).
[28] *Regulations 86*, Art. 24–1.

able largely in terms of so many units at certain prices. Rather, it is one of a gross differential—chiefly a differential based on location. The problem is not so much 'How many rooms (or cubic feet) represent shelter necessitated by the business?' as it is 'To what extent does the cost of living here, rather than elsewhere, represent a cost of business?' If a man's job requires that he be within, say, an hour's time of an office in the heart of a crowded city, he must undergo the expense of high rental (or high land prices, if he buys a house) or of transportation. Compared with a man in a small town who walks to work from a house located on land that has slight value, the worker in the large city definitely incurs a certain part of his dwelling expense as a means of obtaining income. If he can command a larger income only because of this, a refusal to allow deduction of any part of the dwelling or commutation expense places him at a disadvantage.[29]

Sometimes business considerations determine the size and appearance of the dwelling. The doctor who has his office in his home is an illustration of the former—and the doctor with a lucrative practice in the upper social strata may claim, with reason, that the appearance of his dwelling is a vital factor in his success.

Ascertainment of the deduction by a method that will not appear irrational at one time or another is, however, extremely difficult. If location is the factor in question, what other location is to be used as the standard? A city worker who lives in an apartment costing $120 a month might conceivably live in innumerable places at less cost. In some he would be so located that he could get a job that would keep him alive, and in others he would be unable to get any job. Where the size of the house is the point at issue, the solution seems easier.

The distinction between location and size is carried out in the Treasury's interpretation of the Federal income tax law. Except for lodging expenses incurred while away from home on a business trip, which it explicitly allows as a deduction, the law is silent on the question of shelter as a personal expense versus a business expense. However, the Treasury has allowed a deduc-

29 The expense not only of shelter, but also of clothing, food, etc., may be markedly higher in some places (e.g., a remote mining camp) than in others, thus raising the kind of question discussed above.

tion for depreciation on that part of a dwelling used as an office.[30] On the other hand, it makes no allowance for expenses incurred on account of location, and it expressly denies the right to deduct commuting fares as a business expense.[31]

## 4 MEDICAL EXPENSES

The treatment of medical expenses under the income tax is in some respects more important than the treatment of expenditures for food, clothing and shelter. The incidence of medical expense is more uneven. Failure to treat the item properly is therefore likely to cause more instances of severe injustice. For national income estimates the unevenness is not so important.

Sometimes a medical expense is obviously connected with a person's occupation. It may take the form of payments on a health or accident insurance policy, or of bills for medicine and travel and for the services of doctors, nurses and hospitals. Of course the sick or injured person spends money to get well, not merely in order to work but also to enjoy life generally. The expense might therefore be considered similar to the expense for a minimum of food, from the point of view of intent. In a broad sense, however, the medical expense is incurred solely with an intent to obtain taxable gross receipts, and therefore falls entirely outside the category 'personal expense' and becomes in principle fully deductible as a business expense. That is, the taxpayer enters the occupation realizing the special risks of accident or illness. Standing at the point of time before the disaster occurs, the prospective, or possible, medical cost is seen to be purely a business cost.

Whether deduction should be allowed for medical expenses arising out of a clearly non-occupational situation—for example, an accident occurring on a week-end pleasure trip—depends on the general attitude taken towards expenses of mixed intent. If deduction were allowed for the minimum of food necessary for work, a deduction presumably would also be allowed for an operation for acute appendicitis.

It is often difficult, if not impossible, to ascertain whether

30 Robert H. Montgomery, *Federal Tax Handbook, 1934–35* (Ronald, 1934), p. 513.

31 *Regulations 86,* Art. 23 (a)–3.

medical expenses are really expenses to maintain health and ability to work or luxuries with an opposite effect. Of course the same type of difficulty is found with all other kinds of expense, but it seems to be especially acute with medical expenses. For example, the determination of a reasonable deductible expense would be difficult for a wealthy patient who enjoyed the luxury of obviating a future crisis by having his appendix extracted before it had given him any trouble, or for a patent medicine hypochondriac. Probably many medical expenses are clearly deductible, if any deduction at all is to be granted; the practical difficulty would lie in singling out the non-deductible instances.

The amount of medical expense would not be difficult for most taxpayers to record if an estimate were permitted for minor medicines purchased more or less regularly. Considerable importance would attach to a fairly precise record because of the wide variation in expense from one taxpayer to another and from one year to another for a given taxpayer. For the same reasons a flat deduction applicable to all taxpayers alike would not be much improvement over the present situation.

Extremely heavy medical expenses, if deductible at all, might properly be capitalized and spread over several years. A provision for carrying over to succeeding years any negative net income would in most instances serve the purpose of allowing the entire expenditure to be utilized effectively as a deduction, but it would not necessarily be an adequate solution. It might result in too great a fluctuation in net income, compared with what would result if the expense were amortized over several years. With shelter, for example, few persons would advocate charging off the entire cost of a house (if a deduction were allowed at all) in one year and then relying simply on a carry-over provision to get the total amount effectively deducted. Some medical expenses—for a major operation, for example—might be considered as suited to amortization as expense for shelter.

If the expense could be regarded as affecting the income of all the remaining years of the taxpayer's life, it might simply be depreciated, by any one of several systems, on the basis of the probable remaining life span of the individual. The treatment of the undepreciated balance upon the individual's death would present a difficulty, however. Unless some arrangement could be worked out for allowing it as a deduction from the income of the estate or from the tax base of the death duties, the life-span method might better be abandoned in favor of some fairly arbitrary means of wiping the amount off the tax books within a few years. For example, for purposes of deduction, the capitalized expense might be divided equally over the first three or four years after the expense had been incurred, with allowance for unequal division of a further carry-over if such an allowance were needed in order to absorb the entire amount.

The present United States Federal law does not mention medical expenses specifically. The state income tax laws, with the sole exception of the Minnesota law, also do not mention medical expenses, and they presumably consider them personal expenses and non-deductible. Minnesota's provision is: "Payments of the necessary expenses of sickness and accidents to the taxpayer or his dependents during the taxable year shall be allowed as deductions".[32] A state official informs the writer that this provision has been abused and should be repealed.

### 5 EXPENSES OF TRAINING FOR A PROFESSION

Certain occupations, particularly those known as 'professions', require training that often costs an appreciable sum. The expenses ordinarily take the form of tuition fees and outlays for books and equipment. They seldom cause difficulties of allocation or record-keeping. Perhaps the only reason that they are not now deducted from gross professional income is that usually they are not incurred in the same year in which the income is earned; moreover, little consideration has been given to capitalizing them.

If personal exemptions are high and rates in the lower brackets are not very substantial, the possible deduction of training expenses will concern chiefly lawyers, doctors, architects, engineers and teachers. Otherwise, it will also be important for bookkeepers, cashiers, designers, draftsmen and stenographers.

A technical question that assumes more importance here than in the consideration of food, clothing, shelter and medical expense arises when the taxpayer does not, after all, utilize the expense to obtain income. A training expense is highly specific,

[32] Income Tax Law of 1933, Sec. 13 (K).

and frequently no connection is evident between the expense and the income of later years. Probably the intent is obvious enough in most instances to justify deduction, if intent is to be the test, but the occasional dilettante presents a problem analogous to that of the gentlemen farmer.

### 6 INTEREST

Oddly enough, the Federal tax law, while refusing deduction in many cases of mixed intent (e.g., a minimum of food), and even in cases that are probably to be classed as business expenses (e.g., certain medical expenses), grants deductions to certain kinds of outflow even though they are purely personal—that is, made without any intent whatsoever of getting taxable gross receipts. Interest paid by the taxpayer is an example. Under the present provisions of the Federal law, the net income figure is after deduction of all interest payments, no matter for what purpose, except interest on loans contracted to finance the purchase of tax-free bonds.[33] Instalment buying of consumption goods must account for an appreciable interest charge of a kind that logically has no place as a deduction in arriving at either individual or national net income so long as expenses for food, clothing, shelter and medical care are not deductible.

### 7 TAXES

Outflows in the form of taxes present somewhat the same situation as interest payments. Not all tax payments are deductible; but the dividing line between deductible and non-deductible tax payments, whatever it may be, has nothing to do with intent or lack of intent to acquire a taxable gross receipt. The Federal income tax allows deduction of all tax payments except: (a) Federal income taxes; (b) Federal, state or local death taxes or gift taxes; (c) local special assessments.[34]

### 8 BAD DEBTS

Like interest and tax payments, outflows in the shape of bad debts do not, under the existing Federal law, depend for their deductibility upon any business or profit-seeking connection.

[33] Sec. 23 (b).

[34] For minor qualifications to this list, see sec. 23 (c).

Moreover, the net income statistics are likely to be distorted, particularly when a supposedly bad debt turns out not to be bad after all and the amount recovered is entered as an item of gross income in the year of recovery instead of as a rectification of the deduction item of the earlier year.[35]

### 9 CASUALTY AND THEFT LOSSES

Even if the property in question is not connected with a trade or business, the Federal law allows a deduction for a loss arising from fire, storm, shipwreck or other casualty, or from theft, if the loss has not been compensated for by insurance or otherwise. If the national net income figure is to represent a sort of disposable income, it may be a close question whether the national gross income should or should not be diminished by the amount of such losses,[36] but the lack of any intent to incur the risk or repair the loss in order to acquire taxable gross receipts is evident.

### 10 CHARITABLE CONTRIBUTIONS

Contributions to non-profit organizations of various types and, in the case of individuals, to governments are deductible under the Federal law up to a certain percentage of the net income as computed without the benefit of the deduction. This percentage is 15 for individuals and 5 for corporations. The nature of the intent of the average taxpayer in making such gifts is not entirely clear. Possibly some of these contributions have a strong business expense element, so that if no deduction were allowed the statistics would show a net income figure too large, as they may now show one too small.

## *IV Summary*

In the use of statistics compiled from income tax returns, students of national income must, among other things, take account

[35] A change to a policy of reopening the return would usually make no difference in the statistics for the year of reopening (see note 19), but would make a difference for the year of recovery.

[36] On this point see Solomon Fabricant, Part Three, Sec. VI.

of the deductions that the tax laws allow from gross income in arriving at net income.

The distinction usually drawn by the income tax laws between business expenses in general and personal expenses in general may not be satisfactory for the purpose of national income estimates that are designed to indicate in some way the changes in national or social welfare.

Within each of the two broad categories more specific matters may be noted. Depreciation allowances may change in amount simply by changes in administrative practice. Depletion deductions under the Federal income tax are allowed on grounds that have little in common with the concepts that guide the student of national income.

The customary refusal to allow any deduction for food, clothing, shelter and medical expenses, and the restrictions upon deductions for training expenses may give too large a figure for national income. Some parts of some of these expenses are clearly connected with certain streams of gross income. Their proper treatment depends largely, of course, upon the weight that should be given the accompanying personal element. The present treatment of interest, taxes, bad debts, casualty and theft losses, and charitable contributions, on the other hand, tends to minimize the net income total.

## *Appendix A*

### PERSONAL EXPENSE AND UNWISE BUSINESS EXPENSE: EFFECT ON THE NATIONAL INCOME TOTAL

THE EFFECT on total national income when a business expense results in a loss, compared with the effect when an equivalent amount is spent for personal enjoyment, can be illustrated by a simple hypothetical instance.

1. Assume an economy of four men—A, B, M and N, starting with zero assets

| | CATEGORY IN WHICH PAYMENT FALLS (SEE SEC. I) |
|---|---|
| 2. Suppose A, using free raw materials, pays M $100 for extractive labor | 3 |
| 3. A then sells the product to B for $110 | 3 |
| 4. B pays N $100 for manufacturing and selling labor | 3 |
| 5. B sells the product for $225 to: M (who contributes $100), N ($100), A ($10) and to himself (B) ($15) | 2 |

The situation can then be summarized as follows:

| PERSON | RECEIPTS | EXPENSES | | NET |
|---|---|---|---|---|
| | | DEDUCTIBLE | NON-DEDUCTIBLE | INCOME |
| A | $110 | $100 | $ 10 | $ 10 |
| B | 225 | 210 | 15 | 15 |
| M | 100 | | 100 | 100 |
| N | 100 | | 100 | 100 |
| National Income | | | | $225 |

| | |
|---|---|
| 6. Now assume that A, as before, pays M $100 for labor | 3 |
| 7. A, as before, sells to B for $110 | 3 |
| 8. B hires N to work on the product, but the result is so unsuitable that the article will sell for no more than if N had never worked on it. B owes N $100. | 3 (in usual method of accounting) |
| 9. B sells the product for $125 to: M ($100), A ($10), and to himself (B) ($15) | 2 |

The situation is then as follows:

| PERSON | RECEIPTS | EXPENSES | | NET |
|---|---|---|---|---|
| | | DEDUCTIBLE | NON-DEDUCTIBLE | INCOME |
| A | $110 | $100 | $ 10 | $ 10 |
| B | 125 | 210 | 15 | –85 |
| M | 100 | | 100 | 100 |
| N | 100 | | | 100 |
| National Income | | | | $125 |

10. If B had hired N not to work on the material but to do a song and dance for B's personal pleasure, national income would have been increased to $225:

| | | | | |
|---|---|---|---|---|
| A | $110 | $100 | $ 10 | $ 10 |
| B | 125 | 110 | 115 | 15 |
| M | 100 | | 100 | 100 |
| N | 100 | | | 100 |
| National Income | | | | $225 |

11. That is, the shifting of $100 of B's expenses from the deductible to the non-deductible class represents the fact that, in contrast to the former situation, he is now getting a personal satisfaction out of N's labor.
12. Another way to compute the last two examples would be to reduce B's deductible expenses in No. 9 and his non-deductible expenses in No. 10 by $100 and eliminate N's income of $100. This procedure assumes that B never pays N. The result in No. 10 is, however, a national income of only $125 unless $100 is added to B's income (but not to his taxable income, note) as a gift.

# *Appendix B*

## DEDUCTIONS FOR DEPLETION

### 1 Properties not Representing Discoveries Made since the Income Tax Law Took Effect

Unless some special provision, such as the percentage-of-gross method, is made, the generally accepted way to compute depletion is to find a capital value and then in some way prorate it over the units of output. For deposits already in existence when the income tax law takes effect, the usual practice is to use as the depletion base the value of the property at that time. No further valuation is necessary unless the property changes hands in a transfer where a taxable capital gain or a deductible capital loss is recognized.[37] When such a transfer occurs the problem of valu-

[37] Where the property passes by gift or by death, however, a valuation must be made for purposes of the gift or death tax.

ation may, however, be difficult. Properties that are subject to depletion are often bought and sold with no definite price set in monetary terms. Instead, the seller receives stock in the purchasing company or a right to a certain proportion of future profits, or in some other way avoids the troublesome task of setting a money value on the property. In these cases, a valuation of the property must be made by the tax officials (or made by the taxpayer and checked by the officials) if a certain aggregate allowable amount of depletion is to be ascertained. If the property is sold to a going concern whose stock is listed on an exchange or is otherwise readily valued, the task of setting a value on the property is relatively easy. In any other case it is difficult. It is particularly difficult for metal mines, where data on royalties from, and money sales of, similar properties are scanty or non-existent.[38] The degree of difficulty is indicated by the wide variations in valuations of the same property at the same time by experts; a variation of 400 or 500 per cent is apparently not uncommon.[39]

One of the results of this difficulty is likely to be a pressure, both by taxpayers and by tax administrators, to introduce methods for calculating depletion as a fixed percentage of gross or net income. In this way a depletion allowance can be fixed without reliance on any capital value. Unless capital gains and losses are eliminated, however, there must be a valuation at date of transfer, for tax purposes, no matter what method of depletion is used. The valuation must be made in order to ascertain both the immediate taxable gain or loss of the recent owner and the basis for the future gain or loss to be realized by the new owner.[40]

[38] For evidence on this point, see *Preliminary Report on Depletion,* Reports to the Joint Committee on Internal Revenue Taxation from Its Staff (Washington, 1929), Vol. I, Part 8, pp. 6–7.

[39] *Ibid.*, p. 7. A table of valuations of ten copper companies, including some of the smallest and some of the largest, shows one engineer reaching an aggregate valuation of 951 million dollars, and a second engineer reaching a figure of 168 million dollars. Presumably these are engineers in the Bureau of Internal Revenue. For a description of the 'analytic appraisal method', the method used by the Bureau in most cases, see *Depletion of Mines,* Hearings before the Joint Committee on Internal Revenue Taxation, 1930, pp. 32–3, 44–6, and *Preliminary Report on Depletion,* pp. 5–6.

[40] A possible method of minimizing this difficulty is to eliminate the taxation of capital gains and losses on such properties, with the provision that the original depletion base shall follow the property—that is, the buyer would have to use as

## 2 Properties Representing Discoveries Made since the Income Tax Law Took Effect

As to properties that represent discoveries made since the income tax law took effect, an important matter to settle is whether the value (not merely the cost) of the discovery should be allowed to be returned tax free through depletion. For instance, if a miner spends $50,000 developing a claim and then finds he has a mine worth not $50,000 but $1,000,000, should the total depletion allowed through the life of the mine be $50,000 or $1,000,000?

## 3 Discovery Depletion

First, the term 'discovery' must be examined. Many definitions are possible. Near one extreme, the term may be restricted to veins or deposits that are physically separate from other veins or deposits and whose existence was highly uncertain when the developing expenses were incurred.[41]

Near the other extreme, 'discovery' might mean any ore not included when the last preceding valuation was made because its presence was not then known.[42] In a still more extreme form it

his depletion base not the price he paid for the property but the basic-date depletion base that would go with the property.

A similar valuation problem arises with depreciation, since the amount to be depreciated is: (i) the cost or other basis as determined in sec. 113 (b) for ascertaining gain or loss, less (ii) the salvage value.

[41] This is approximately the meaning given the term in the present United States Federal income tax. "Discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist, and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit." Moreover, discovery depletion is granted only if "such mines were not acquired as the result of purchase of a proven tract or lease . . ." *Revenue Act of 1936,* sec. 114 (b) (2).

[42] This broad interpretation has been advanced by mining representatives. ". . . the whole of his [the miner's] possession in mineral consists of capital [that should be recoverable tax-free through depletion], and the measure or value of that capital is the value of the whole of the mineral . . . regardless of whether it be an uninterrupted part of a deposit he may be working or may otherwise know, or whether, on the contrary, it comprehends wholly independent masses and bodies of mineral; and, further, regardless of whether, at any time, he may or may not be aware of its existence" (L. C. Graton, *Depletion of Mines,* p. 5).

may mean any ore value that was not foreseen—value, for example, arising from an unexpected increase in selling price.

If the latter extreme is not adopted, some provision must be made to care for such newly discovered ore as does not come under the discovery rule. The procedure followed in the United States is to retain the old valuation in dollars, but to increase the number of physical units to which it applies, thus getting a smaller amount of dollar depletion per physical unit of subsequent output.[43]

The most obvious reason for allowing any discovery depletion at all is a desire to encourage exploration for minerals. The strength of this encouragement will of course depend upon the height of the tax rate applicable to the part of the mine's proceeds that is otherwise taxable. Contrast with a mining enterprise carried on by a corporation subject only to a moderate flat-rate tax, a mining enterprise carried on by an individual who would pay a high rate under a personal income tax progressive rate scale on that part of the mine's proceeds that would be taxable were it not for discovery depletion. In the latter enterprise the subsidy represented by the tax exemption granted under the discovery clause may be substantial enough to result in certain exploratory work and a consequent production of minerals that would not otherwise occur, at least within the same time period. In the former enterprise, the hidden bounty may be so slight in relation to the risk involved as to lead to no added production. The incentive may be made stronger for a corporation if some means is devised for passing on the exemption to its stockholders,[44] but even this device may not make the exemption seem worth much to the managers of a large, widely-owned concern.

[43] For critical observations on this process of 'dilution', see *ibid.*, pp. 8–9.

[44] This has not been done in the United States. In interpreting sec. 115 (a), *Revenue Act of 1934,* since unchanged ("The term 'dividend' . . . means any distribution made by a corporation . . . out of its earnings or profits . . . [not out of 'income' as defined by the statute]"), art. 115–6 of *Regulations 86* says: "A distribution from a depletion reserve based upon discovery value to the extent that such reserve represents the excess of the discovery value over cost or March 1, 1913, value, is, when received by the shareholders, taxable as an ordinary dividend." In Canada, however, where depletion in certain cases is at a flat rate of 33⅓ per cent on net income, the stockholders get the benefit, since the stockholder is allowed to take 33⅓ per cent of his dividends as return of capital, hence tax-free (Ramstedt, *Depletion of Mines,* p. 41).

Consequently, the effectiveness of discovery depletion in increasing output probably depends more on the character of the ownership interest than on any other factor.[45]

Allowance of at least some discovery depletion has been supported on the ground that some allowance should be made for money that has been spent by the same taxpayer in other years,[46] or by other persons in the same general line of activity.

Additional grounds are advanced to support allowance of discovery depletion on a broad basis so that practically all units not previously taken into account in setting a value may, as soon as they are discovered, add their value to the existing depletion base. One of the arguments of special interest from the point of view of national income estimates is that put forward by certain mining representatives who emphasize that, whether or not the owner of a mining property is aware of the actual extent of the mineral in his property, all is his property or 'capital', as is shown in cases involving theft.[47] "To deny an owner's property right in this extra [i.e., lately discovered] mineral by denying his right to compensation or depletion for its removal would be to deny him what, as a legitimate mine operator, would be granted to him as the victim of theft from his property by another." [48] Another phase of the same argument contends that, even though the physical content is found to be the same as estimated, additional depletion is justified if the mineral is in fact sold for more than was anticipated.[49] In essence, then, this argument would set, as

45 "In enacting the discovery clause in the Revenue Act of 1918, Congress doubtless intended to grant relief chiefly to the individual prospector. This has not turned out to be the case. The greater part of the benefit from discovery depletion has gone to corporations having full opportunity to charge exploration expenses of years prior to discovery against their income" (*Preliminary Report on Depletion*, p. 12).

46 This was one of the reasons for the enactment of the discovery clause in the United States Revenue Act of 1918 (*Preliminary Report on Depletion*, p. 11).

47 Ramstedt, *Depletion of Mines*, pp. 14 ff.

48 *Ibid.*, pp. 18–19. "The [mine] value exists by gift of nature, and its value is not diminished by the fact that full count of it cannot be made at any given and arbitrary time, but only as the inherent conditions of mineral occurrence allow the value to be disclosed" (*ibid.*, p. 17).

49 Cf. a criticism advanced against the (narrow-concept) discovery depletion allowed under the United States Federal income tax act: "For example, taxpayers who make discoveries in periods of prosperity are allowed large deductions for depletion, whereas those who are so unfortunate as to make discoveries in years of

the capital value that might be depleted, the value that an observer would set on the property at the beginning were he able to foresee perfectly all the relevant events that do in fact occur throughout the life of the property. The income tax statistics would then never reflect, as net income, the value of discoveries.

If the income tax law is one that taxes capital gains, care must be taken to make some provision for special treatment of the sale of natural deposits if the purpose of discovery depletion provisions is not to be partly negated. If a prospector discovers, at a cost of $100,000, a deposit worth $1,000,000, the $900,000 profit can be returned to him tax free under a discovery depletion provision if he retains the deposit and works it himself. If he sells it for $1,000,000 instead of operating it, however, he has a profit of $900,000, which will be subject to tax unless some special provision is made. To be completely uniform with the discovery depletion provision, the capital gains provision should entirely exempt this profit by using the $1,000,000 instead of the $100,000 as the basis. However, various reasons of policy such as a desire to aid the prospector-operator rather than the pure wildcatter, may dictate a somewhat restricted exemption.[50]

## 4 Percentage Depletion

Discovery depletion necessitates valuation, and valuation of mining properties on a large scale leads to pressure from certain mining groups to substitute some method that promises greater simplicity.[51] The most obvious suggestion seems to be a flat

depression are required throughout the life of the property to take a lower rate" (*Preliminary Report on Depletion*, p. 2).

[50] Thus the United States Revenue Act of 1918 restricted the maximum surtax rate in such cases to 20 per cent (the ordinary maximum rate was 65 per cent), and placed a similar limitation on the corporation war excess profits tax. For 1922-33 the rate limit was 16 per cent. The limit was then dropped until the 1936 Act revived it at 30 per cent for oil and gas properties. The basis in case of sales is cost, not discovery value; and in recent years this basis is adjusted by the actual depletion allowed (the same provisions apply with respect to percentage depletion); see Revenue Act of 1936, Sec. 113 (b) (1) (B).

[51] It is significant that the first industry in the United States to be brought under a percentage depletion plan was an industry (oil and gas) that at the time of the change was apparently about 90 per cent under discovery depletion, in contrast with basic-date depletion or cost depletion (*Depletion of Mines*, p. 110).

percentage applied to gross income or to net income,[52] or a specific amount in cents per pound or ton.[53]

Under neither the gross method nor the net method is any limit set to the aggregate amount of depletion that may be claimed through a period of years by a given concern.

The advantage of the percentage-of-net method, from the taxpayer's viewpoint, is that it allows him to take the depletion when it counts, and (assuming the rate has been judiciously set in the manner explained below) does not force him to take it when it does not count. That is, if he has a bad year and has no tax to pay even without the depletion allowance, he is better off if he can save up the allowance for that year and apply it to a subsequent, profitable year. This argument applies only if the law does not allow an indefinite carrying forward or carrying back of losses from one year to another. In no year is the income entirely wiped out by depletion, and therefore the great fluctuations in taxable income from year to year that are sometimes found when depletion is based on cost, or basic-date value, or discovery value (or on gross receipts) cannot obtain under the percentage-of-net method.

Of the two, the percentage-of-net method has certain modest logical advantages over the percentage-of-gross method, under particular restricted conditions. Let it be assumed that the owner of a newly discovered mine has practically no means of knowing even roughly how much profit he will get from it. If he assumes, however, that in any case it will be spread more or less evenly over a more or less certain time-span (say, twenty years), it becomes possible to express the capital value [54] (whatever it may be

[52] Canada has adopted the percentage-of-net method for gold and silver mines (50 per cent), copper, lead and zinc mines (25 per cent), and oil and gas wells (25 per cent) (*Preliminary Report on Depletion*, p. 22). Note, however, that Canada does not tax capital gains to the same extent as the United States (*Depletion of Mines*, p. 112). The United States, as already indicated, uses the percentage-of-gross method for certain kinds of deposits.

[53] This method is used in Canada for coal mines. At a uniform rate it is obviously inapplicable to a wide range of different kinds of mine (e.g., the various metal mines); see *Preliminary Report on Depletion*, p. 13.

[54] There are of course some difficult problems involved in distinguishing between the capital value of the ore, subject to depletion, and the capital value of the plant, subject to depreciation. The existence of these problems, however, does not invalidate the general thesis set forth above. The staff of the joint committee,

in dollars) as a percentage of total income (whatever it may be in dollars)—assuming too, of course, a certain rate of interest.[55] Whether these assumptions can be reasonably made without a considerable amount of information on the dollar amount of capital value may be questioned. However, if the percentage rate so derived is applied to the annual income, it will have yielded by the end of the period an aggregate amount equal to the capital value that would have been estimated at the beginning of operations if the estimator had been able to foresee the exact absolute amount involved. A different percentage would be required, however, for every mine differing in expected life.

If an unsuspected extension of a deposit or vein is found in the mine some years after operation has started, the percentage-of-net method has a tendency to bring the value of this extension into the capital value aggregate that is to be recovered tax-free through depletion. The action may not be precisely the same as if the extension were valued without error, since the life of the extension may not, and probably will not, be the same as the life of the main body of the mine. Therefore, it actually requires a different percentage from that applied to the net income from the main body. Evidently, however, the percentage-of-net method tends to accomplish the same result that is sought under the broadest use of the discovery-depletion method.

The percentage-of-gross method, the method used in the United States Federal law, is still further removed from capital value, that is, from the only concept that gives depletion meaning. Such validity as this method may have must depend upon some

in recommending use of a percentage-of-net method, specifies a particular variant of this method that allocates a reasonable amount of the net income to plant investment (*Preliminary Report on Depletion*, p. 3).

[55] For example, L. C. Graton has testified with reference to the Hoskold formula, which has been used in the Internal Revenue Bureau of the Treasury in valuing mines: "For instance, on a mine with an estimated life of 20 years, and for which it is deemed that an 8 per cent (in all these cases the 'security' rate on sinking fund is taken at the usual 4 per cent) true profit on the value of the mine is appropriate, the Hoskold reciprocal is 44 per cent. This means that the total operating profits expected from that mine during its 20 years of estimated operation, when multiplied by 44 per cent, gives the value of the mine according to the estimates assumed. Similarly, for a mine of estimated life of 35 years with a 7 per cent return of true profit on mine value, the Hoskold reciprocal is about 34 per cent. For a mine of, say, 8 years of life valued so as to yield a true profit of 10 per cent, the Hoskold reciprocal is about 60 per cent" (*Depletion of Mines*, p. 67).

ascertained or assumed relation between gross and net income. In this way a tenuous connection with capital value may be established. Otherwise, there is no basis whatsoever upon which to fix the percentage rate. Of course it is possible to examine records of depletion allowances that have been granted on the basis of genuine attempts to estimate capital values in dollars, and then ascertain the ratio that, when applied to gross income, would have given the same results. Obviously, however, the ratio will be different for practically every company for practically every year. Averaging the results to obtain a representative percentage is a procedure that has no logic to support it.[56] The process of averaging and, in general, the desire to obtain uniformity of percentage (whether of gross or of net) among all units in an industry and among industries [57] negate the philosophy according to which the depletion should vary with the capital value. If firm X has been receiving depletion that, translated to a percentage of net income, equals 40 per cent, while for firm Y the corresponding percentage is 60 per cent, an average of 50 per cent written into the law and thenceforth applied to both X and Y accomplishes nothing that can be logically linked to the prior situation.

If percentage depletion is allowed as a substitute for discovery depletion, the problems of capital gains and corporate shareholders are still relevant. If the desire is to benefit prospectors who sell before developing as well as those who discover and develop, the percentage provisions must be supplemented by suitable exemption of part of or all the profit gained by sale of the property. Likewise, if the desire is to benefit corporate investors as well as individual investors, provision must be made for exempting a suitable amount of the dividends received by the shareholders.[58]

[56] This procedure has been followed, however, in arriving at the percentages now in use in the United States Federal income tax law. The logical confusion is particularly marked when depletion values representing various kinds of method are lumped together for the averaging—when, for example, cost-depletion allowances, basic-date depletion allowances, and discovery-depletion allowances are included in the total that is divided by the aggregate gross income to get a percentage to put in the law; cf. *Preliminary Report on Depletion,* pp. 61–67.

[57] See, e.g., the disapproval of non-uniformity of percentages expressed in *Preliminary Report on Depletion,* pp. 7–11.

[58] A provision of the former type (see note 50 above) but not of the latter, exists in the present United States Federal income tax law. As to corporate dividends, sec. 115 as interpreted by *Regulations 86,* art. 115–6, is as follows: "The amount

Indeed, if this provision is not made, the simplicity claimed for the percentage method will be lost when it is necessary to discover the excess of percentage depletion over ordinary depletion in order to ascertain how much of a given dividend is taxable. Instead of avoiding capital valuation, the law will then require both it and the percentage calculation.

by which a corporation's percentage depletion allowance for any year exceeds depletion sustained on the basis of cost or March 1, 1913, value, computed without regard to discovery or percentage depletion allowances for the year of distribution or prior years, constitutes a part of the corporation's earnings or profits accumulated after February 28, 1913, within the meaning of section 115, and, upon distribution to shareholders, is taxable to them as a dividend."

## *Discussion*

### I ROY BLOUGH

THE purpose of this note is to compare the deductions of taxes from gross income allowed in the Federal income tax law and reflected in Federal income tax statistics with the deductions of taxes from gross income appropriate in the estimation of national income. The note thus endeavors to link the results of the papers of Professors Shoup and Colm.

#### 1 TAX DEDUCTIONS IN COMPUTING TAXABLE INCOME

In general, taxes paid or accrued are deductible in computing taxable income. However, the exceptions are very important. Non-deductible taxes include: Federal income taxes (together with war-profits and excess-profits taxes); estate, inheritance, legacy, succession and gift taxes; and taxes assessed against local benefits of a kind tending to increase the value of the property assessed—that is, special assessments—except those allocable to maintenance and interest charges.[1] With certain minor exceptions all other taxes are deductible.

Professor Shoup observes (Sec. III, 7) that the difference between deductible and non-deductible tax payments, whatever it may be, has nothing to do with intent or lack of intent to produce taxable gross receipts. It will be noted that if the intent to produce taxable gross receipts were the criterion of deductibility personal taxes should not be deducted while business taxes should be deducted. This, however, is not the rule. Federal income taxes, whether personal or business, are not deductible. State income taxes, whether personal or business, are deductible, as are also property taxes and other taxes generally.

[1] Revenue Act, 1936, sec. 23 (c).

The provisions for deductibility of taxes are not, however, without logical basis. The principle that seems to be followed is that of ability to pay the tax. The non-deductible special assessments finance government services that directly add to the value of the property, and are treated for taxation in the same manner as are other investments. When the benefited property is sold the special assessment is allowed as a deduction in determining capital gain [2] in the same way as other costs. Estate, inheritance, legacy, succession and gift taxes are logically not deductible since the receipts from which they are paid are not part of taxable income and thus not a measure of ability to pay. The Federal income tax is logically not deductible since the ability to pay a tax should be measured before, not after, its payment.

Making the other taxes deductible is also in line with the ability to pay principle. While, in general, taxes pay for services to persons as other expenditures do, there are important differences. Taxes are payments largely outside the control of the payor; whether or not he desires the services of government he must pay. The services that he receives do not ordinarily increase his money income, and they bear no necessary relation to the amount he pays. From the viewpoint of ability to pay, taxes should, with the exceptions mentioned, be generally deductible, otherwise an income tax may be imposed for which the individual does not have the means of payment—a paradox in a personal tax.

## 2 TAX DEDUCTIONS IN COMPUTING NATIONAL INCOME

*Income Sum Method.* In discussing the treatment of taxes for computing national income by the 'income sum' method, Professor Colm divides taxes into three classes.[3] The first class includes taxes paid directly from incomes that have been received by individuals and are already included in the income sum. In this class he places personal income taxes and poll taxes; and also taxes on those undistributed business profits that are added—presumably before tax deduction—to incomes received.[4] Other taxes imposed on individuals that he does not specifically include but that appear properly to belong in this class are inheritance,

[2] Revenue Act, 1936, sec. 113 (b) (1) (A).
[3] Part Five, Sec. II, 1 and 2.
[4] *Ibid.*, Sec. 111, 2.

estate and gift taxes; [5] motor vehicle license taxes; and taxes on intangible property. All these are paid directly from income already counted and it is believed none is shifted beyond the payor so as to enter into the value of any good or service. Whether taxes on owner-occupied land, buildings, and personal effects should be included in this class depends on whether the services of such property are added separately to the income sum. If so, they fall in the second or third class, if not, in the first class.

The second class includes taxes that are imposed on industry and that diminish the amount of income received by individuals. Examples are taxes on employers shifted to employees in lower wages, and taxes absorbed as a reduction of corporate profits. The third class includes taxes on industry that are shifted and thereby increase the value product of industry. Taxes belong in this class only when shifted to the consumer; if absorbed at some point before reaching the final consumer or if shifted backward the tax would fall in the second class. Taxes of the third class are paid by the individual out of income already recorded in the national income sum; they are paid not directly but in the form of price.

Professor Colm shows that these three classes of tax should be treated differently in computing national income. Taxes paid directly by the individual from income already recorded—the first class—need not be added to the sum of personal income since they have already been recorded. Taxes that reduce the incomes received by individuals—the second class—should be added, since they have not been recorded. Taxes that are shifted to consumers in higher prices—the third class—should be added when 'real income' is being computed but not when 'nominal income' is being computed.[6]

[5] In the case of inheritance, estate and gift taxes this statement is made on the assumption that changes in property inventory from year to year will not be used as elements of national income. Professor Colm apparently excludes inheritance and estate taxes from the class of taxes on income (see *Ibid.*, Sec. V, (1)). Contrast in connection with the inclusion of changes in property values W. I. King, *The National Income and Its Purchasing Power* (National Bureau of Economic Research, 1930), p. 38; Simon Kuznets, *National Income, 1929–1932,* 73d Cong., 2d Sess., Senate Doc. 124 (Washington, 1934), p. 5; and Maurice Leven, *Income in the Various States, Its Sources and Distribution, 1919, 1920, 1921* (National Bureau of Economic Research, 1925), pp. 19–38.

[6] Part Five, Sec. II. Professor Colm adds all government revenues to the income

Nominal national income, as he uses the term, is the actual sum of dollars of income received.[7] When computing nominal income, changes in the forms of taxes not accompanied by changes in the 'social heap' should not have any effect on the number of dollars of income received. For this reason taxes that are shifted to consumers should not be added to the sum of personal incomes since they are paid indirectly by the individual out of income already received by him. If they are added, the number of dollars of income is increased whenever taxes that are shifted to consumers are substituted for taxes that are not shifted.

Real national income is income corrected for differences in the purchasing power of the dollar from time to time and from place to place.[8] When computing real income, changes in the forms of taxes should not have any effect on the amount of income after deflation by an appropriate price index. When taxes are shifted to consumers in higher prices the price index rises. When this higher price index is applied, the resulting income figure is reduced although no real reduction has occurred. To avoid this, in computing real income the amount of the taxes that are shifted to the consumer should be added to the income sum.

The real income figure thus computed is, Professor Colm points out, not very satisfactory. When shifted taxes replace personal taxes they must be added to the income sum. However, if the higher price index resulting from their use is applied to the amount of taxes to be added the result is a diminution of the figure of real income where no diminution has occurred. Accordingly, the amount of such taxes must be added to the income sum without being deflated by a price index. This presents a serious practical problem because, as Professor Colm points out, it is difficult, perhaps impossible, to compute changes in the amounts of such shifted taxes for different periods of time. Furthermore, adding the undeflated taxes to a deflated income sum results in part of the income being included at one price level and part at another and possibly much different price level, which might cause substantial error.

sum and then deducts certain taxes. For the present purpose the direct addition of taxes seems to be a clearer approach.

7 *Ibid.*, Sec. II, 2.

8 *Ibid.*, Sec. II, 3.

In computing real income, Professor Colm deducts from the income sum those government expenditures that represent 'cost services' to industry.[9] He does not suggest a proper treatment in computing nominal income. It would appear, however, that in computing nominal income they should not be deducted as they do not ordinarily increase the value product of industry and thus are not counted twice. In computing real income they should be deducted since they are used up in producing other income. When the price index is applied there is double counting unless they have been deducted.[10]

*Value Added Method.* The treatment of taxes in computing nominal and real income may be analyzed further by passing from the 'income sum' method to the 'value added' method of computing national income. In this method the expenditures of government have been combined with the value added by different industries. Accordingly, all income has been included at least once. The question here is not what taxes should be added but what taxes should be deducted to avoid double counting.[11] Personal taxes paid out of income and taxes on businesses that are absorbed by reducing personal incomes do not cause duplication and should not be deducted. Taxes imposed on industry and shifted to consumers are treated differently in computing nominal and real income.

In computing a nominal income figure consistent with nominal income derived by the income sum method, taxes imposed on industry and shifted to consumers should be deducted. These taxes appear in income twice, once in income produced by government and a second time in the higher prices of goods sold by industry.

9 *Ibid.*, Sec. III, 1.

10 See Example 2 below.

11 The proper treatment of taxes in estimating national income by the value added method (estimate of income produced) was discussed in Volumes I and II of *Income in the United States* (National Bureau of Economic Research, 1921, 1922). In Volume I the treatment proposed was to deduct taxes imposed on business that are shifted and not to deduct taxes on business that are not shifted (pp. 51–55). In Volume II the proposed treatment of taxes is that taxes paying for services to industry should be deducted while taxes paying for services direct to persons should not (p. 5). While no distinction was made between nominal and real income it appears that the treatment proposed in Volume I is correct for computing nominal income while that proposed in Volume II is correct for computing real income.

Government cost services to industry should not be deducted in computing nominal income for they do not increase the number of dollars of value product of industry and thus do not duplicate any value product.

In computing real income, however, a different procedure is consistent with Professor Colm's income sum method. If the nominal income is divided by the price level the result will not be a real income figure that can be compared with that for countries or periods in which other price levels prevail. To produce a comparable real income figure shifted taxes should not be deducted and cost services should be. The following example—referred to below as Example 1—may help to clarify the point. Suppose that government services of a purely personal and non-business character are being financed by personal taxes, no tax being imposed on industry. Obviously there should be no deduction of taxes in arriving at either nominal or real national income any more than if the services were being performed by private industry and sold at a price. Suppose, now, that the financing of this service is transferred from the personal tax to an excise tax imposed on the manufacturers of a specific commodity. The tax would probably be shifted in whole or in part to consumers, thus enlarging the value product of the industry. The national income, however, has not been increased. To fail to deduct the taxes would record an increase in nominal national income where none has occurred. However, if the price index number is computed it will be found to be higher because of the shifted taxes. Applying this increased price index number to the nominal income, the taxes not having been deducted, will reduce the real income to the same figure as before. If the taxes are deducted the real income will be less than before. Accordingly, when computing real income by the value added method to reach a figure consistent with that computed by the income sum method, taxes, whether shifted or not, should not be deducted from the combined value product of industry and government.

A second example—referred to below as Example 2—may clarify another aspect of the problem. Assume a situation where all concerns of an industry have been obliged to pay the cost of private policing and fire control services. These costs, being borne by all concerns in the industry, enter into price and enlarge the value product of the industry. Now suppose that the government starts to supply these services free, financing them by a general net income tax on individuals. In the case of a competitive industry the removal of these costs will result in a decrease in price and a decline in the value product of the industry.[12] Yet there has been no real decrease in national income, only a change in its distribution and price labeling. If the cost of the government services received by the industry is deducted from the value product of the industry a non-existent decrease in the dollars of national income will be recorded. Accordingly, to compute nominal income government services to industry should not be deducted. However, the price level will have fallen and when nominal income is deflated a non-existent increase in income is shown. To arrive at real income government cost services to industry must be deducted.

Some may suggest that since the comparison of national income in different times and places requires a real income figure, nominal income may be omitted from consideration. However, one defect of real income as computed by the methods described above is that parts of the national income cannot be compared accurately to the whole.[13] Changes in taxing methods or methods of rendering services may result in recording important internal changes in the makeup of income. An example is seen in the computation of ratios of taxes to net income. In Example 1, the effect of substituting shifted for non-shifted taxes was to increase the number of dollars of nominal national income before deflation without changing the dollars of total taxes. The computed ratio of taxes to national income is decreased although no change has taken place in the true ratio.

Another reason for not abandoning nominal income is that there are possibilities of using it in arriving at a real income figure. The reason nominal income fails to measure relative real income when divided by the price index is due to difficulties with the price index used rather than with any fundamental inaccuracy in the nominal income figure. The indexes used for elimi-

[12] In case of cost services to only a few concerns or to a monopoly the savings might not be passed on to consumers. In such cases the expenditure should be deducted even in the computation of nominal income.

[13] See Colm, Part Five, Sec. II, 3.

nating differences in dollar purchasing power have included only privately produced goods and services. They do not take into account that part of such goods may be paid for partly through taxation or that their prices may contain taxes going to finance government services to persons. It is seen that in Example 1 the taxes imposed directly on individuals were reduced by the change in taxing methods, but this reduction did not affect the deflating index. Likewise, in Example 2 taxes to individuals were increased but this increase did not in itself affect the deflating price index. If the deflating index took into account the change in the tax burden on individuals the nominal income figures when deflated would become comparable real income figures. The price index needs to be adjusted by adding in some way the 'cost services' of government to industry that are financed by non-shifted taxes and by deducting in some way the government services to persons financed by shifted taxes.

This adjustment of the deflating price index cannot be made for individual prices. It can apparently be done for the price index as a whole in the following manner for income computed by the 'value added' method. (a) Determine the total amount of the taxes that are shifted. (b) Determine the total amount of government cost services to industry. (c) Subtract the total of shifted taxes from the total of cost services, retaining the algebraic sign of the result. (d) Find the ratio of this result to total nominal income excluding the value of all government services. (e) Multiply the usual deflating price index by this ratio. (f) Add (signs considered) the resulting percentage adjustment to the price index. (g) Deflate the total 'nominal income' with the adjusted price index. The result is a national income figure, which, while not the same in amount as the 'real income' described above, appears to be consistent with changes in price levels due to changes in taxation or government services. A basic assumption of the procedure is that changes in the 'price level' of government services are proportional to the changes in the price level of other goods and services, which, while probably not correct, is perhaps the most reasonable assumption that can be made.

The real income computed in this way appears to avoid the difficulties mentioned above for real income figures. However, the method is perhaps of only theoretical significance since no adequate measurement of tax incidence or of government services to industy has been made.

## 3 TAXABLE INCOME AND NATIONAL INCOME

A remaining task is to compare the treatment of taxes in computing taxable income with the treatment in computing national income. Since statistics from income tax returns are chiefly of value in the 'income sum' method and are not widely useful in the 'value added' method, the comparison will be made only for the former.[14] The treatment of taxes for national income will be that presented by Professor Colm with the revisions suggested above in the case of personal taxes other than income taxes.

It is apparent that the treatments for national income and for taxable income are not the same. National income theory requires that personal taxes should not be deducted. Income tax treatment does not allow deduction of Federal income taxes but allows deduction of state income taxes, motor vehicle license taxes, poll taxes, intangible property taxes, and so forth. National income theory requires that non-shifted business taxes be added to the sum of personal incomes. Income tax treatment allows, for example, the deduction of land taxes on business property in arriving at an individual's income. National income theory requires that shifted business taxes be added to the sum of personal incomes in computing real income. Such taxes are deducted under the income tax and should be added back to correct the

[14] A survey of the actual use that has been made of statistics from income tax returns in computation of national income may be helpful. W. I. King's *Wealth and Income of the People of the United States* (Macmillan, 1915) was published before statistics from Federal income tax returns were available. In the National Bureau's *Income in the United States* statistics from income tax returns were used little if any in the estimates of income by source. In the estimates of income received they were used for incomes of over $2,000 per year and for corporate surplus. They were relied on very heavily for determining the distribution of incomes. The Federal Trade Commission report of 1926 also relied on income tax statistics for distribution of incomes. They do not appear to have been used largely in computing the amounts of income. In Dr. King's *National Income and Its Purchasing Power* statistics from income tax returns are not used for wages and salaries but are used for dividends in the case of a very few industries. They are also used in figures of income distribution and to determine the part played by corporations in collecting and disbursing national income. In *National Income, 1929–1932*, by Simon Kuznets, statistics of income were used largely for interest, dividends, corporate savings and at times for interpolating figures for which oth. data were not available in all years.

figures. In computing nominal income, however, the income tax deductions of this class of taxes are proper.

In some respects income tax deductions correspond to national income theory. Special assessments for capital improvements do not increase the value product in the year in which paid, if at all, and are properly not deductible. Likewise, estate, inheritance and gift taxes are not deductible either for taxable income or national income.

It thus appears that the effect of income tax deductions is to reduce national income below its true level. To correct this, taxes deducted in computing individual taxable income should in general be added to the reported income, although shifted taxes should not be added in the computation of nominal income. Adding back the individual taxes will not complete the correction since certain corporation taxes must also be added to the income sum.

If only those taxes that were imposed on property owned or transactions carried on with the intention of producing taxable income were deductible for income taxation the national income figure would likewise be reduced below its correct level if the income sum were based on income tax returns, since no business taxes should be deducted in computing real income and only part of the business taxes should be deducted in computing nominal income.

## II WILLIAM W. HEWETT

The definition of income and its application to specific problems has for many years given rise to vigorous controversy. There are very few corners in the entire field of economics so infested with tricky, intricate problems whose solutions seem to appear just ahead of the student, but have the unhappy faculty of disappearing into thin air, after the manner of a mirage. Professor Shoup has probed deeply into one small section of this broad subject and I shall await with great interest the final product of the larger study, of which I understand this paper to be a small fragment. I confess some misgivings in discussing Professor Shoup's paper for I am not at all sure as to the exact question, or questions, to which he has directed his attention. He appears to have in mind, at least in some measure, three distinct questions: (a) To what extent does the Federal income tax law, in distinguishing between gross and net income, involve theoretical inconsistencies that should be eliminated? The analysis of depletion, for example, considers various alternatives for the solution of this problem (discovery value, discovery cost, percentage-of-gross) and goes so far as to make such definite suggestions as, "to be completely uniform with the discovery depletion provision, the capital gains provision should entirely exempt this profit".[1] (b) To what extent does the distinction between gross and net income encourage production, stimulate efficiency, and achieve a rough approximation to social justice? Numerous interesting and pointed comments are made with this question in mind. In the depletion analysis Professor Shoup informs us that, "the most obvious reason for allowing any discovery depletion at all is a desire to encourage exploration for minerals". In discussing the incidence of medical expenses he asserts that, "failure to treat the item properly is therefore likely to cause more instances of severe injustice". This discussion of problems of justice, equity and social policy opens the door wide for a broad analysis of the whole problem of income taxation. (c) To what extent does the distinction between gross and net income lead to reported taxable incomes that are unreliable as data for estimating the size of the national income? If I understand Professor Shoup correctly, it is this question he had primarily in mind and the material dealing with my first two questions should be considered interesting digressions. Unfortunately, a statement is rarely made as to the plus or minus effect upon the size of national income of the deductions considered, and certainly the conclusions of the paper do not grow out of the material presented without considerable interpolation by a reader.

I shall confine my remarks to the problem of utilizing income tax returns as data for the measurement of national income. At the start a serious difficulty arises from the fact that Professor Shoup does not state the definition of income within which he is working when he argues the case for or against each deduction

[1] See Appendix B. The profit is that secured by selling a mine for more than discovery and exploration costs.

allowable under the Federal law. This procedure makes it impossible to trace the overstatement or understatement of national income as evidenced by taxable income returns. Obviously, a student who held the position of Irving Fisher, that income is a flow of services, would arrive at very different conclusions as to the merits of a given deduction, than those which would be reached by a student who accepted a standard commodity and service definition of income of the type adopted by the National Bureau of Economic Research. The treatment of depreciation, for example, is quite different in the two definitions. Professor Fisher's definition does not allow a deduction for depreciation, while the National Bureau definition insists most emphatically upon such a deduction to arrive at net income. What Professor Fisher applauds, the National Bureau severely condemns. If Professor Shoup means to accomplish something more than a demonstration of the dangers of inconsistencies in the construction of the law (a demonstration unnecessary to anyone at all conversant with the Federal income tax law), then some standard, or norm, must be adopted that will enable one to say 'this provision overstates, while that provision understates, the correct size of national income'.

### 1 THE DISTINCTION BETWEEN THEORETICAL, LEGAL AND TAXABLE INCOME

Considerable confusion can be avoided in studies that must utilize the concept of income, if a sharp distinction is made between 'taxable income' and what I have called elsewhere the 'legal definition of income'.[2] An income tax law is not designed to supply economists with data; the only reason for its enactment is the necessity of obtaining government revenue. A tax law must therefore carry water on two shoulders—it must satisfy in a reasonable manner the demands of sound income theory and at the same time adjust the tax burden with efficiency and equity. It is this dual requirement that leads Professor Shoup from equity to measurement and back again in such a confusing manner. Now the men who are charged with the formulation of an income tax law must begin with some preconceived theoretical concept of

[2] W. W. Hewett, *The Definition of Income and Its Application in Federal Taxation* (Philadelphia: Westbrook Publishing Co., 1925), pp. 78–88.

income in mind—at least vaguely. This concept I shall call the theoretical definition of income. Faced with the problems of taxation, the theoretical definition must be modified to conform with the requirements of efficient, economical, tax administration; the law must provide certainty and convenience as to the time and manner of payment and it must be economical to collect. The experience of the legislature and the decisions of the courts have gradually evolved principles that allow a definition of income for purposes of taxation; a *legal definition* of income. These principles, in my opinion, are reasonably clear and have been followed with very commendable consistency. (a) The Federal law is concerned only with receipts of money or money's worth. Food raised by the taxpayer for his own consumption, the services of a housewife, or the rental value of a house occupied by the owner are all items that most income definitions would include, but since they do not 'come in' as receipts or payments, they are not a part of legal income. (b) The Federal law is concerned only with realized gains; realizability is not sufficient. This is the principle that gives rise to so many cases of confusion in the treatment of fluctuating property values. Suppose A, B and C each bought one hundred shares of United States Steel at $80 a share and that the market value of the stock increased over a period of years to $95 a share. A sells, realizing a gain of $1500 with which he purchases an automobile. B likewise sells, but at once purchases the equivalent in United States bonds. C, satisfied with his steel stock, does not sell, but continues to hold it. An income tax levied on a realized basis taxes both A and B on the $1500 addition to income. C, having realized no gain, would not be taxed; he would report no taxable income gain. Yet it is clear that these three individuals have an equal gain in economic strength. Realizability would appear to measure the improved position of the taxpayer much more consistently than the test of realization. The same difficulty exists for all forms of property such as real estate, stocks, bonds, and even durable household equipment. But a tax law formulated on the principle of realizability would be almost impossible to administer with the present level of control over accounting practices. Every change in the value of an item of property would have to be reported as a gain or loss during the entire period in which the property was held by the taxpayer. The inconvenience in time of tax payment would also be serious, for a taxpayer might find it necessary to sell his property in order to make tax payments on an accrued, but unrealized, gain. Therefore, with but few exceptions, the Federal income tax law restricts its definition of income to realized gains.[3] (c) The Federal law is directed towards the output of the productive process, what Sir Josiah Stamp has called the 'national heap'. Gains that are not part of the productive process, but are simply transfers of the rights to wealth or income, are excluded from the law. In a famous court case, Gould vs. Gould,[4] it was declared that alimony, or an allowance based on a separation agreement, was not to be included in gross income and was not deductible as an expense in the computation of net income. Gifts and inheritances fall within this same category; they are not additions to the national heap, but are transfers of rights to wealth or income.

Here are three definite principles implicit in the Federal income tax law that make possible a formulation of a legal definition of income. Legal income is *the receipt of money or money's worth, growing out of the productive process and actually realized.*

Taxable income is this legal income modified to secure special political or social objectives. These objectives have nothing whatever to do with the theory of income and only confusion results from any attempt to deduce such implication. A few illustrations may be helpful. Under the present law only 30 per cent of the gain in value of a capital asset is included in computing taxable income if the asset has been held by the taxpayer for ten years. This provision does not tamper with the theory that a realized gain is legal income; it has entirely different objectives and does not give aid and comfort to those who hold to the theory that capital gains are not income. The discovery value provision referred to by Professor Shoup belongs to this group of items, as do also the provisions permitting partial deductions of contributions and donations. Many of the exemptions from gross income

[3] Some income-determining factors are recognized that are on an accrual basis, as for example, inventories, accounts receivable, accounts payable and depreciation. These exceptions are made because they are necessary deductions if the *realized gross income* is to be reduced to a net figure.

[4] 245 U. S. 151.

and the credits allowed have social or political objectives. All these provisions tend to understate, in reported taxable income, the correct legal income. Taxable income is a residual sum after diverse inconsistent exceptions have been made to the general principles set up in the law in defining income.

My personal interest in the theory of income may have caused me to exaggerate the importance of the distinctions I have just drawn, but I believe they furnish a useful method of analysis, especially when some of the broader aspects of the income tax law pass under review. But the distinction can be of assistance in simplifying the problem faced by Professor Shoup, that of measuring national income. If his paper is to be interpreted as an appraisal of the effect upon the size of national income of each specific deduction he has presented, and if other provisions of the law such as those concerned with exemptions and credits are later to be brought within his purview, then it is necessary that a direct comparison of the theoretical definition of income he believes most acceptable be made with the definition that underlies the law. Once basic differences of principle are understood and appraised, the additional problem of specific inconsistencies growing out of political, social or other objectives will appear in their proper perspective. The difficulty I encountered in following Professor Shoup's thread of thought was in no small measure due to the absence of any norms that might be used as yardsticks in evaluating the effects of the various points he raised. Inconsistencies have been demonstrated, but their meaning in terms of national income has not been indicated.

## 2 BUSINESS EXPENSES AS DEDUCTIONS FROM GROSS

Turning now to a more direct discussion of the deductions from gross income, I wish to comment on business expenses, depletion, and the effects of price level changes. Business expenses are deductible items under the Federal income tax law. To draw a line between business and personal expenses, Professor Shoup believes the law applies a test of *intent*. Deduction as a business expense is allowable if the expenditure is for the purpose of obtaining additional taxable income. From this it follows that a consistent policy would require that all business expenses made for the purpose of securing direct personal satisfaction rather than additional income should be denied deductible status. A wasteful or spendthrift expenditure made for the 'joy of spending', and carrying with it a large element of personal satisfaction has been compared with the expenditure of the same sum of money for the hire of someone to do a 'song and dance' for the entertainment of the taxpayer. The intriguing theoretical issue here raised has far-reaching implications, for consistency would demand a new deduction from gross income to allow for dissatisfactions beyond the normal expectations of a given expenditure. The employer who finds it necessary to attend all the funerals of deceased employees suffers a loss in satisfaction just as real as the gain in satisfaction by spendthrift activity. That rich man who spent for the joy of spending may have a son whom he requires to work his way upward through the plant and who at the moment of the wasteful payment is suffering the agonies of the damned down in the stockroom for $12 a week! The implications are equally disconcerting when the test of intent is applied to personal expenses. The food, clothing and shelter necessary as a minimum to keep the taxpayer in sufficiently good health to carry on his employment and produce gross incomes becomes a deductible business expense. At the end of this road is a concept of income that requires a nice balancing of utility against disutility. J. A. Hobson actually attempted such an evaluation of human costs and human utilities in relation to the size of national income in his interesting book, *Work and Wealth.*[5] Irving Fisher's theory comes rather close to this concept of income, but even he draws the line between services and psychic satisfaction. A definition of income that is to be usable as a statistical tool must rigidly rule out satisfaction and dissatisfaction. We cannot trace down a measure of apples to learn the outcome in satisfaction; was a poor man saved from incipient starvation or did a small boy get an unfortunate case of indigestion? The legal definition of income I formulated above does not involve the subjective question of intent. The receipt of money or money's worth growing out of the productive process is as far as the law goes. The test is the objective act of the taxpayer, not his state of mind. Professor Shoup admits that in only one place does the law use a phraseology that might be labeled 'intent'. But the words *trade,*

[5] Macmillan, 1921. Ch. III is of special interest to the point here at issue.

*business, profession* appear throughout the law, and, I might add, the court cases dealing with the law. Where it is obvious that an item that normally is a personal expense shades into an expense in trade, business or profession, the law does permit a deduction. As I see it, this policy is in the interest of consistency; it is not an evidence of inconsistency. Misguided, wasteful business expenses must be deducted regardless of intent, or national income will be overestimated in terms of goods and services produced. The food purchased on a business trip, the sword of an army officer, and the space used as a professional office by a physician in his own home should be deducted for exactly the same reason. The degree of inconsistency involved depends upon the definition of income selected as a standard. The National Bureau of Economic Research in its publication, *Income in the United States*, Volume I, found it necessary to define income in a manner open in many ways to the same criticism Professor Shoup makes of the tax law.

### 3 DEDUCTIONS FOR DEPLETION

The analysis of the deductions for depletion I found the most interesting and useful section of Professor Shoup's paper. The British law has simply refused to grapple with this problem, and generally speaking does not permit any deduction at all for wasting assets. The entire return for annuities is taxable as income without allowance for the capital sum invested.[6] In a case dealing with timber lands it was clearly declared that, "It has long been the law of the United Kingdom that exhaustion of capital, however it might be treated in strict actuarial principles or according to certain principles of economics, may for purposes of taxation be treated as a profit." [7] The opposite extreme was presented to the United States Supreme Court in a case growing out of the Corporation Excise Tax of 1909. The plaintiff, Strattons Independence Limited, a gold mining concern, claimed it had no net income. The difference between the market value of the gold extracted and the costs of extraction was declared to be the value of the gold in place in the mine. All the apparent gain was only depletion of capital. The American income tax law position

[6] Coltness Iron Co. vs. Black, 1 Tax Cases 305.

[7] Kauri Lumber Co. Ltd. vs. Comm. of Taxes, 1913 A. C. 771.

is a very unsatisfactory compromise between these two extreme cases, in the hope that at least some approximation of equity between the government and the taxpayer may be assured.

If the definition of income is agreed to be a net flow of commodities and services, it would seem that net income in a case of wasting assets should be equal to the difference between actual costs (discovery, extraction and marketing) and gross return. In the case of assets acquired by purchase, the purchase price should be included. This procedure would credit national income with the net gain in commodities and services. The method of prorating the total cost over a period of years should be selected in the light of ease of administration. Professor Shoup's analysis of this problem is very suggestive.

### 4 SHIFTING PRICE LEVELS

As a final comment I should like to call attention to the absence of discussion of the effect of shifting price levels upon the taxable income. At no point does the law permit deductions for price level increases. Depreciation accounts are placed on a cost basis, and capital gains and losses are reportable as of the price level at the time of realization. A taxpayer who bought a machine for $1000 may find that the same machine costs $1500 when he is forced to replace it. An increase in the price level results in his replacement fund being insufficient to secure a new machine; his real net income has been overstated in his reported taxable income. The same error is involved when capital gains reflect an increase in the price level; an increase in the money value of an item of property is not an increase in real income; reported taxable income is inflated by rising prices and deflated by falling prices. This error cannot be removed by reducing money income to a base year, without including in the calculation the entire value of the capital asset on which the gain or loss was reported. If a share of stock increased in market value from $100 to $150 because of a 50 per cent increase in the level of prices, the entire $50 must be deducted; you cannot deduct 50 per cent of $50, or $25. The method of reducing capital gains to a base year will not give an accurate estimate of net real income.

In conclusion, I wish again to express great interest in the ultimate product of Professor Shoup's study. He is breaking new ground and the results should be of real value both to the theoretical economist and to the tax expert.

## III CARL SHOUP

Professor Blough agrees that the present Federal income tax provisions regarding the deductibility of taxes are not consistent with the general principle that would allow deduction of an outgo only when it was made with an intent to produce taxable gross receipts. He says, however, that these provisions follow the principle of ability to pay. This conclusion may be questioned if the significance of the 'intent' principle is that it acts as a guide to determining relative personal ability to pay. If two men, A and B, have equal incomes and equal outgoes in all respects except that A spends \$20 a year on admissions to amusements, and B saves the \$20, it is generally conceded that both should pay the same income tax (assuming that savings are not deductible in any case). If the government levies a 10 per cent tax on purchasers of tickets to amusements, and A then spends \$18.20 on admissions plus \$1.82 tax, should he now pay less income tax than B? If the following year A has to spend the \$20 buying a set of technical books that he intends to use as a means of maintaining his income—that is, he fears that without the books he will suffer a decrease in gross income—deduction of the \$20 would be generally accepted.

Deductibility of state personal income taxes raises an additional question of priority of rights of the Federal and the state governments. The present provision of the Federal law acts as a hidden form of Federal aid to states that impose income taxes rather than, for example, sales taxes. Part of the amount the taxpayer pays to the state in income tax represents money that would be available, not to the taxpayer, but to the Federal government, if the state had no income tax.

Professor Hewett expresses uncertainty over the exact question or questions to which attention is directed, but is correct in assuming that the main point was intended to be, in his words, "To what extent does the distinction between gross and net income lead to reported taxable incomes that are unreliable as data for estimating the size of the national income?" The chief purpose of the paper was to call these problems to the attention of students of national income, without offering specific advice in each case on how to adjust the final national income figures. Although a demonstration of the mere existence of the dangers may not be necessary, a listing of the dangers with some background material on their history and the arguments relevant to them (which account for the first two questions noted by Professor Hewett) may be helpful to those who must decide where and by how much to adjust their computations of national income.

The test of intent, for determining whether an item is deductible, is opposed to the test of results. Hence the test of intent rules out satisfaction and dissatisfaction, instead of depending on them. Professor Hewett's legal definition of income does not, of course, involve the subjective question of intent, since it does not deal with the question of what items can be deducted from the receipt of money or money's worth in order to arrive at a *net* income figure. The point seems to be that business itself must be defined ultimately in terms of either results or intent, and since the tax law does not use the test of results, it must be assumed to use the test of intent. Thus the objection to such a phrase as "misguided, wasteful business expenses must be deducted regardless of intent" is that, in order to determine whether they are business expenses, some assumption has to be made about the intent of the spender at the time he made the outlay.