

Text of President Roosevelt's Income Tax Message

WASHINGTON, June 1.—Following is the text of President Roosevelt's message to Congress asking that income tax loopholes be plugged:

To the Congress of the United States:

A condition has been developing during the past few months so serious to the nation that the Congress and the people are entitled to information about it.

The Secretary of the Treasury has given me a report of a preliminary study of income tax returns for the calendar year 1936. This report reveals efforts at avoiding and evasion of tax liability, so widespread and so amazing both in their boldness and their ingenuity, that further action without delay seems imperative.

We face a challenge to the power of the Government to collect, uniformly, fairly and without discrimination, taxes based on statutes adopted by the Congress.

CITES TAX AVOIDANCE

Mr. Justice Holmes said "taxes are what we pay for civilized society." Too many individuals, however, want the civilization at a discount.

Methods of escape or intended escape from tax liability are many. Some are instances of avoidance which appear to have the color of legality; others are on the borderline of legality; others are plainly contrary even to the letter of the law.

All are alike in that they are definitely contrary to the spirit of the law. All are alike in that they represent a determined effort on the part of those who use them to dodge the payment of taxes which Congress based on ability to pay. All are alike in that failure to pay results in shifting the tax load to the shoulders of others less able to pay, and in mulcting the Treasury of the Government's just due.

LETTER FROM TREASURY

I commend to your attention the following letter from the Secretary of the Treasury.

"The Secretary of the Treasury, Washington, May 29, 1937.

"My Dear Mr. President:

"As you know, the Treasury was surprised and disturbed by the failure of the receipts from the income tax on March 15 to measure up to the budget estimates. Therefore, we undertook an immediate investigation. Only a preliminary report can be made at this time because the complete investigation covering all the income tax returns filed will require the balance of this year. Furthermore, since many of the returns of large manufacturing corporations have not yet been filed, the present report is confined almost wholly to data disclosed by the individual tax returns.

"But even this preliminary report discloses conditions so serious that immediate action is called for. More than the usual examination and audit by the Treasury is needed. It seems clear that if tax evasion and tax avoidance can be promptly stopped through legislation and regulations resulting from a special investigation a very large portion of the deficiency in revenues will be restored to the Treasury.

MEANS OF EVASION

"I herewith enumerate some of the principal devices now being employed by taxpayers with large incomes for the purpose of defeating the income taxes which would normally be payable by them. As we continue our preliminary examination, other devices are being disclosed.

"1. The device of evading taxes by setting up foreign personal holding corporations in the Bahamas, Panama, Newfoundland and other places where taxes are low and corporation law lax.

"Americans have formed 64 such companies in the Bahamas alone in 1935 and 1936, and 22 more were organized by Americans in the Bahamas during the past two months. Panama and Newfoundland seem to be even more fertile territory since their corporation laws make it more difficult to ascertain who the actual stockholders are. Moreover, the stockholders have resorted to all manner of devices to prevent the acquisition of information regarding their companies. The companies are frequently organized through foreign lawyers and dummy directors, so that the names of the real parties in interest do not appear.

"One American citizen with a \$3,000,000 Bahamas corporation has apparently attempted to prevent the Bureau of Internal Revenue from catching up with him by filing his individual tax returns in successive years from towns in New Brunswick, British Columbia and Jamaica.

DEFIES TREASURY

"Another individual believes that he has been so successful in removing his assets from the United States to the Bahamas that he is defying the Treasury to collect a tax upon a \$250,000 fee he has received; and by way of insult, he has offered to compromise his admitted tax liability of \$33,000 for past years by a payment of \$1700.

"Still another individual showed a large net loss on his personal return for 1936. In a considerable part, the loss was due to the large deduction he claims for interest on a loan made to him by his personal holding company. But the man in question is no object of charity, for his personal holding company, organized in Canada, had an income of over \$1,500,000 from American dividends in 1936, though it has not yet filed a return.

"Perhaps the most flagrant case of this character is that of

a retired American Army officer with a large income from valuable American securities which he desires to sell at a very large profit. To escape income and inheritance tax laws, he used the device of becoming a naturalized Canadian citizen, and six days later organized four Bahamas corporations to hold his securities. He and his lawyers apparently think that he can now sell his securities free from any taxes on his profits, since there are no income taxes in the Bahamas, and that he has adroitly escaped American taxes.

FOREIGN INSURANCE

"2. The device of foreign insurance companies.

"Two New York insurance agents have caused the organization of insurance companies in the Bahamas with a view to enabling taxpayers to secure spurious deductions for interest through an ingenious scheme for the issuance of life insurance policies. Americans who went into the scheme purported to pay a large single premium for their policies, but immediately borrowed back practically the entire sum. Under the plan the so-called policyholders sought to obtain a large deduction for interest on this loan, although the fact was that no interest was really paid. By this means five prominent Americans sought to evade nearly \$550,000 in income taxes in the years 1932 to 1936. This fraud was discovered by the Treasury's investigators and all of the taxpayers have now submitted offers to pay the full amount of taxes evaded, plus interest. Until our investigation is completed we do not know how many similar companies may have been organized in other countries, and utilized by our citizens; nor do we yet know whether this newly invented type of fraud has other ramifications.

HOLDING COMPANIES

"3. The device of domestic personal holding companies:

"The rates of tax applicable to personal holding companies were reduced in 1936 at the time of the enactment of the undistributed profits tax. It was believed at that time that the combined rates of taxes would be sufficient to insure the distribution of the entire incomes of these companies, and the consequent imposition of surtaxes upon their owners. This expectation has not been realized.

"Thus, the stockholder of one large personal holding company saved himself \$322,000 by causing his company to distribute none of its income to him.

"In another case, a man and his wife saved \$791,000 through the use of personal holding companies in 1936.

"In a third case, the personal holding company reported over \$500,000 of net income, but the total taxes paid by the two stockholders, husband and wife, were less than \$6000, due principally to credits for payments on indebtedness the holding company prudently incurred in accumulating properties for its owners. If the personal holding company had not been in existence, the stockholders would have paid over \$200,000 additional income taxes.

AUDITING DIFFICULTY

"Another favorite device is to organize a considerable number of personal holding companies, not only for the sake of reducing the tax, but of increasing the Treasury's difficulties in auditing transactions between companies. At last accounts one man had caused to be set up some 96 companies scattered all over the country. Two other individuals were utilizing 23 personal holding companies.

"4. The device of incorporating yachts and country estates.

"Many wealthy taxpayers today are dodging the express provisions of the law denying deductions for personal expenses by incorporating their yachts or their country estates, turning over to the yacht or to the estate securities yielding an income just sufficient to pay the entire expenses of operation. Hundreds of thousands of dollars in income taxes are annually avoided in this way.

"Thus, one man's yacht is owned by his personal holding company, along with three million dollars in securities. He rents the yacht from his company for a sum far less than the cost of upkeep, and the company uses its income from the securities to pay the wages of the captain and crew, the expenses of operating

the yacht, and an annual depreciation allowance. None of these items would be deductible if this individual owned the yacht personally.

HOME CORPORATIONS

"A great many wealthy taxpayers are utilizing a similar arrangement for the operation of their country places and town houses.

"One man has placed his five-million-dollar city residence in such a corporation; another his racing stable whose losses last year were nearly \$200,000. The tax savings he thus sought to obtain through the use of the holding company were \$140,000.

"One wealthy woman has improved on the general plan of evasion by causing her personal holding company, which owns her country place, to employ her husband at a salary to manage it. She can thereby supply him with pocket money, and in effect claims a tax deduction for the expense of maintaining him.

"3. The device of artificial deductions for interest, losses, etc.

"Taxpayers are seeking greatly to reduce their personal income taxes by claiming deductions for interest on loans to them by their personal holding companies, or on loans to them by their family trusts. These transactions normally have no business purpose, but are merely an artificial means of shifting income from one member of the family subject to the tax rates to another member of the family subject to lower rates.

"Thus, one woman claims a large annual deduction for interest on a loan made to her by her husband as trustee of a trust which she created for their children. The mother thereby seeks to secure a deduction for her contribution to the children's support, and since the trust is revocable by her husband, the parents still have the desired control over the property and its income.

HOBBY LOSSES

"In the same category are losses deducted by taxpayers who claim that their racing stable or hobby farms were operated for profit, even though, a profit is never realized. Thus, a prominent manufacturer seeks a deduction of over \$125,000 against his income from his business, on account of his losses in operating a chicken farm.

"6. The device of the creation of multiple trusts for relatives and dependents.

"Splitting income two ways, between husband and wife, reduces income taxes and leaves the family income intact. Splitting the family income many ways by means of many trusts, all for the same beneficiaries, may effect a much greater saving, while leaving the money actually in the same hands, for the creator of the trust often constitutes himself or his wife as trustee, and thus retains full control over the investment and disposition of the fund itself and of its income.

"One thrifty taxpayer has formed 64 trusts for the benefit of four members of his immediate family, and thereby claims to have saved them over \$485,000 in one year in taxes.

"Another thrifty pair have constituted 40 trusts for their relatives, and a prominent lawyer and his wife utilize 18 trusts for the same purpose. The first pair maintains numbered brokerage accounts, and only at the end of the year are the beneficial owners identified. In this way innumerable transactions are carried on, often between accounts, which do not actually affect the beneficial interests of their owners, but which are designed solely to reduce tax liability.

FAMILY PARTNERSHIPS

"7. The device of husband and wife or father and children partnerships.

"The purpose of these partnerships, like the multiple trusts, is to split the family income artificially into two parts; or, if the children are taken in, into still smaller fractions.

"There are many instances of this kind; but to illustrate the point, it is sufficient to cite the case of a New York brokerage firm which late in 1935 admitted into partnership the four minor children, two boys and two girls, of one of the partners. The tax saving he sought thereby in 1936 amounted to over \$50,000.

"8. The device of pension trusts.

"For 10 years the revenue acts have sought to encourage pension trusts for aged employees by providing corporations with a special deduction on account of contributions thereto, and exempting the trust itself from tax. Recently this exemption has been twisted into a means of tax avoidance by the creation of pension trusts which include as beneficiaries only small groups of officers and directors who are in the high income brackets. In this fashion high salaried officers seek to provide themselves with generous allowances, while at the same time the corporation claims a deduction therefore, in the hope that the fund may accumulate income free from tax.

PENSION TRUSTS

"Thus, in one case \$43,000 is annually appropriated by the corporation to a pension trust for the benefit of its two chief officers. One of the co-owners will retire at the age of 65 with a monthly pension of \$1725, and the other will retire at 60 with a monthly pension of \$1425.

"These eight types of tax avoidance are sufficient to show that there is a well-defined purpose and practice on the part of some taxpayers to defeat the intent of Congress to tax incomes in accordance with ability to pay. In some cases, the bureau of internal revenue under existing law can establish a liability or indeed proceed on the ground of fraud; but many of these cases fall in the category of a legal though highly immoral avoidance of the intent of the law. It seems, therefore, that legislation should be passed at this session of the Congress in order to eliminate these loopholes which our preliminary investigation has proved; and that as a result of the further investigation this summer and autumn the next session of the Congress should finally close any further loopholes which may be discovered.

LEGAL EVASIONS

"In addition to these cases of moral fraud, there are three other major instances in which the law itself permits individuals and corporations to evade their equitable share of the tax burden.

"1. Percentage depletion: "This is perhaps the most glaring loophole in our present revenue law. Since 1928, large oil and mining corporations have been entitled to deduct from 5 to 27 1/2 per cent of their gross income as an allowance for the depletion of their mines or wells, and the deduction may be taken even though the cost of the property has been completely recovered.

"Thus, in 1936, one mining company deducted nearly three million dollars under this provision, although it had already completely recovered the cost of its property. The amount of the deduction was a sheer gift from the United States to this taxpayer and its stockholders, and the revenue that we lost thereby was \$181,000. Similar annual losses of revenue in the cases of a few other typical companies are: \$584,000; \$557,000; \$512,000; \$272,000; \$267,000; \$202,000, and \$152,000. The estimated annual loss of revenue to this source alone is about \$75,000,000. I recommended in 1933 that this provision be eliminated but nothing was done at that time; and it has since remained unchanged.

INCOME DIVISION

"2. Tax division of income between husband and wife in the eight community property states.

"This is another major cause of revenue loss, which is unjustifiable because obtained at the expense of taxpayers in the 40 states which do not have community property laws. A New York resident with a salary of \$100,000 pays about \$32,535 Federal income tax; a Californian with the same salary may cause one-half to be reported by his wife and the Federal income taxes payable by the two will be only \$18,626. The total loss of revenue due to this unjustifiable discrimination against the residents of 40 states runs into the millions.

"3. Taxation of nonresident aliens. "The 1936 act eliminated the requirement that a nonresident alien (without United States office or business), should file a return;

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fixed the withholding rate for individuals at 10 per cent; and freed the nonresident alien from taxation on American capital gains. Since the total Federal tax upon a citizen or resident amounts to 10 per cent of his total net income at about \$25,000 (in the case of a married individual with no dependents), the withholding rate has proved in practice to be too low as applied to wealthy nonresident alien individuals. There are a number of cases of nonresident aliens with large incomes from American trusts or with large American investments whose taxes have been cut to one-third or one-fifth of what they paid under the prior act.

WOMEN EVADERS

"Thus, one American woman who married an Englishman had an income from this country in 1935 of nearly \$300,000. Her tax for 1936 will, therefore, be approximately \$30,000 as against over \$160,000 under the prior law.

"Another American woman who married a Frenchman has an income of over \$150,000 from American trusts, on which she paid a tax of about \$55,000 in 1935. Her tax is reduced to about \$15,000 by the 1936 law. Although the tightening of the withholding provisions in 1936 will tend to insure more revenue from nonresident aliens in the lower income brackets, the present taxing provisions are not satisfactory as applied to nonresident aliens with incomes in the higher brackets.

"The problem of tax avoidance is not new. The Congress devoted particular attention to it in 1933 and 1934, and by legislation effectively put a stop to many evasive devices discovered then as having been in use. The practices outlined above can and should be stopped in the same way.

"In conclusion, I have two observations to make from the evidence before me. In the first place, the instances I have given above are disclosed by a quick check of comparatively few individual returns. As I have said before, most of the large corporation returns have not yet been filed. The general audit of 1936 returns is just beginning. Nevertheless, it is likely that the cases I have digested above are symptomatic of a large number of others, which will be disclosed by the usual careful audit.

BURDEN ON CITIZENS

"In the second place, the ordinary salaried man and the small merchant does not resort to these or similar devices. The great bulk of our 5,500,000 returns are honestly made. Legalized avoidance or evasion by the so-called leaders of the business community is not only demoralizing to those who practice it as well. It throws an additional burden of taxation upon the other members of the community who are less able to bear it, and who are already cheerfully bearing their fair share. The success of our revenue system depends equally upon fair administration by the Treasury, and upon completely honest returns by the taxpayer.

"The disclosures are so serious that I recommend that authority be given the Treasury Department with an adequate appropriation in order

FEELS INDIGNANT

A feeling of indignation on reading this letter will, I am confident, be yours, as it was mine. What the facts set forth mean to me is that we have reached another major difficulty in the maintenance

of the normal processes of our Government. We are trying harder than ever before to relieve suffering and want, to protect the weak, to curb avarice, to prevent booms and depressions—and to balance the budget. Taxation necessary to these ends is the foundation of sound governmental finance. When our legitimate

(Turn to Page Eight)

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