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CARL STANLEY KARLSSON

On February 8, 1945, First Lieutenant Carl Stanley Karlsson died of wounds received the preceding day in an engagement on Luzon, Philippine Islands. Lieutenant Karlsson entered the service immediately subsequent to the declaration of war by the United States and since April 7, 1942, had been in the Pacific theater where he took part in numerous campaigns. At the time of his death he was serving with the 108th Infantry of the 40th Division.

Karlsson was awarded the Bachelor of Arts degree (Magna Cum Laude) by the University of Washington in 1940 and was a member of Phi Beta Kappa. He commenced his law study at the University of Washington Law School in 1939 and when called into the service had completed over two years of the law course with an almost perfect scholastic record. In 1940 he was elected to membership on the Student Editorial Board of the Law Review, serving as Note Editor in 1941, the same year in which he was awarded first prize in the Frank W. Baker Constitutional Law Contest.

By his death the profession has lost a young man of exceptional ability, who was held in affectionate esteem by all who knew him.

COMMENTS

AVERAGING FLUCTUATING INCOME OF THE INDIVIDUAL FOR INCOME TAX PURPOSES

It is a familiar feature of our system of taxation that tax rates be graduated in proportion with the ability of the taxpayer to pay. As income rises, the percentage of tax is increased by the so-called surtax. For the taxpayer with approximately the same income, year after year, an annual imposition of tax according to these rates is equable; but unlucky is the individual who has high income one year and low income the next, for he must pay a substantial amount of tax over and above that which he would have had to pay had his income been level throughout the years, due to the surtaxes in the years of high income.

The present Internal Revenue Code contains several provisions which in some measure alleviate this heavier burden on the individual with the fluctuating income. Substantially, however, the present law has been wrought upon the theory that it "is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals."[1] Thus, at the end of each calendar[2] or fiscal[3] year, the taxpayer must pay a tax based on only the profits and losses of that year, necessitating the use of the yearly accounting system,[4] unless he comes within one of the special provisions. The "back-pay" section,[5] the provisions allowing a "carry-back" and "carry-over" of losses incurred in a trade or business,[6] and the "installment sales" provisions[7] may be cited as examples of the present day allowance of proration of income over several years' time; but these apply only in specific situations and are hedged around with so many conditions that few can take advantage of them.[8] These scattered provisions have apparently been the result of a rather obviously unequal tax burden in certain situtions, and consequently have been limited in scope; and they have also been the subject, in most cases, of a narrow construction by the courts and by the commissioner.[9] It is proposed herein to examine what can and, if possible, what should be done to ease the burden still applicable to the greater number of taxpayers with fluctuating incomes.

[1] Security Flour Mills Co. v. Commissioner, 321 U. S. 281, 88 L. ed. adv. ops. 471, 64 Sup. Ct. 596 (1944).

[2] I. R. C., § 41.

[3] *Idem;* and *see* Reg. 111, § 29.41-3.

[4] I. R. C., § 41; Reg. 111, § 29.41-1 *et seq.* "Income is taxable on the basis of fixed annual accounting periods; and anything that is income within a given period is taxable in that year and no other." Brown v. Helvering, 291 U. S. 193, 78 L. ed. 725, 54 Sup. Ct. 356 (1934); Reg. 111, § 29.22(a)-1.

[5] I. R. C., § 107(d).

[6] I. R. C., § 122.

[7] I. R. C., § 44.

[8] *See, e.g.,* Gallagher Realty Co., 4 B. T. A. 219; Reg. 111, § 29.44-1 *et seq.*

[9] *See, e.g.,* Dixie Pine Products Co. v. Commissioner, 320 U. S. 516, 88 L. ed. adv. ops. 209, 64 Sup. Ct. 364 (1944); and Security Flour Mills Co. v. Commissioner, 321 U. S. 281, 88 L. ed. adv. ops. 471, 64 Sup. Ct. 596 (1944).

From time to time there have appeared various proposals and suggestions that the individual and other taxpayers should be allowed to average his income over the space of some years, thus eliminating some of the inequities above mentioned. Nor is such a general averaging provision a new concept in the field of the law itself. It has been tested in Australia[10] and Wisconsin,[11] and England has made limited attempts along these lines.[12] Of these it may be said generally that they failed primarily because they were detrimental to state interests. In a word, they went too far and reversed the equities. It should be clear that any effective averaging system will lower government income in some measure. Consequently, tax rates must be raised somewhat to compensate. While it is a prime objective to tax all individuals alike, according to their means, it should not be overlooked that the first purpose of any tax is to raise revenue. And so opportunities for tax evasion should be limited as much as possible, even at the expense of some slight equity in favor of a few individuals.

While the main advantage of an averaging system in income tax law would be to relieve the unequal burden on the taxpayer with the fluctuating income, it would have other results equally as desirable. The complicated problems relating to shifting of income from one year to another would disappear in large measure, if not entirely, because under an averaging system there would be little incentive. Since a great many of the differences arising between the taxpayer and the government are based on the question of correct allocation of income to a particular year, there would be a great saving in time, money and worry to both parties. Likewise, the special provisions as to certain classes of taxpayers already discussed would be entirely superseded as to individuals, so that it would not be necessary for the taxpayer to walk a worried legal tight-rope in order to bring himself within the special class for whose benefit the provision was enacted. Further, such a provision would eliminate the necessity of the special treatment of capital gains and losses, since the purpose behind these concessions was to be rid of the inequity of a tax based on highly irregular income.[13] It would no longer be necessary to reason that the income derived from a "capital gain" had been accumulating over the years and therefore a certain percentage of the tax should be forgiven due to the pyramiding of surtax rates. In this respect, it also should be noted that some simplification of the individual income tax laws would result, which would be in accord with the present popular movement.

However, inherent disadvantages may be found in every averaging system, both as to the government and the taxpayer. While the law would be simplified in some respects, there is no doubt that further computation would be required from the taxpayer. In addition, his records must be complete for the entire period in order to make such computations, and he would be forced to file a return every year even though no tax is due for that year, in order to have a basis for averaging future gains. This in turn enlarges administrative work; records

[10] Income Tax Assessment Act (1922-28), § 13.

[11] Wisconsin Laws of Regular Session, c. 539; Wis. Rev. Stat. § 71.10; *and see* Note 6, WISC. L. REV. 49.

[12] Schedule D, Income Tax Statutes; *and see* 39 Geo. III, 3.13 § 79 (1799).

[13] *See* SIMONS, PERSONAL INCOME TAXATION (1938), pp. 148-169 (Ch. VII); 1939 COM. BULL. (Part II).

must be kept, and any controversy would require the checking of all computations for the period; if an error be found in, say, the first year of the period, subsequent returns would have to be amended since the basis for them would have changed to some extent. Any refund due the taxpayer at the end of the period would be delayed for approximately two years (this being the delay today in "auditing" the returns) even though overpayment was made the first year of the period. Perhaps more important, revenue receipts would be delayed considerably at the end of a depression, due to the accumulation of losses. This would probably have serious economic effect, a discussion of which is not relevant here. Further problems would be found in the taxpayer's change of status during the period, a difficult question under the short annual system today; and also in the removal of the taxpayer from one reporting district to another, with its attendant transfer of records.

In any discussion of averaging, the method to be followed in determining the average will be foremost in importance. Applicable to such a proposal are three methods: the simple average; the progressive average, and the moving average. Each of these presents its own special problems and aids in addition to the general advantages and disadvantages summarized above, and consequently must be discussed separately. In presenting these, periods of equal time duration will be used in examples wherever possible for purposes of comparison. However, it may be said generally that this period may be lengthened or shortened, within reasonable limits, to best reflect the equities and administrative exigencies. If the period is too long, any relief afforded may come too late, and if it is too short, the average will have little validity or effect, and the number of adjustments increased needlessly.[14]

THE SIMPLE AVERAGE

The simple average, for our purposes, would be an averaging at the end of every, say, four years of the income of the taxpayer within those years, a subsequent determination of the tax as it would have been had the income been steadily received, a crediting of the taxes paid during the three prior years against this, and the result will be the tax due for the taxable year.[15] A surprising resemblance between this method and the collection system lately adopted[16] can be seen, since under the latter some individuals must file quarterly declarations of estimated tax and make payments accordingly; and the total income for the four quarters determines the final amount of tax due. But as we have seen, the period here is too short. Can it be lengthened?

It has been suggested[17] that this should be done, making it optional with the taxpayer and provided that no year appears in more than one averaging computation. Claims would be limited to those over a certain percentage of tax payments, or over a certain amount; income before filing or after death would be ignored; and the burden would be on the taxpayer to establish his right to a refund. It is said that the loss of revenue to the government in bad years is offset by the readjustment in equity and the added incentives toward risky enterprises.

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[14] Simons, *op. cit. supra* note 56 at 154.

[15] *See* Atlas, *Average Income and Its Use in Taxation*, 13 ACCOUNTING REVIEW 124.

[16] Current Tax Payment Act of 1944; I. R. C., § 58 *et seq.*

[17] GROVES, PRODUCTION, JOBS AND TAXES (1943), pp. 84-86 (Ch. II); *cf.* Atlas, cited *supra* note 15 at 124 *et seq.*

In one great essential, this method is excellent. The tax is paid annually as heretofore and at annual rates. This enables the taxpayer to pay his taxes when he is able to do so, and apply for a refund (or credit) at a time when his income is low, if the year of averaging were at his election.[18] But an optional method would result in variance of period lengths for each taxpayer: *i.e.*, *A* might wish to average his tax for the last three years only, while *B* might choose to average the last eight years. The result would be a confused administrative staff, a mass of records and extensive bookkeeping. It would therefore be necessary to limit the averaging to a definite period of, for example, the taxable year and the three years preceding, leaving it optional with the taxpayer to average four consecutive years at the close of any year, so long as no year was averaged twice.

Such a provision would go far toward elimination of some of the usual objections to the simple average method. The arbitrary choosing of the first year to which the average would apply would result in cries of "discrimination" by those disliking the choice made. More important, such an option would result in staggering the credits over the years, whereas the allowance of such averaging only at the end of every fourth year would result in a great mass of administrative work together with a great loss of revenue due to refunding and crediting in the fourth year. The proposal that such refunds or credits be limited to those over a certain percentage of the tax paid[19] would further eliminate administrative work and loss of revenue, since many of the refunds or credits would be small in amount; but *quaere* as to the policy of this limitation since it would tend to discriminate in favor of a certain group. In any event, crediting such refunds on the returns for the taxable year would eliminate much administrative work.

Under this system, the present problems presented by attempts to shift income would probably not be intensified, but rather subdued, inasmuch as the taxpayer would have no idea what his average income would be in the next period. Of course, he gets the benefit of the credit only once in every four years, being deprived of the use of the amount of overpayment made in the first year; perhaps interest should be added to this refund or credit to compensate, if it would not result in great complication.

Where there is a change of status of the taxpayer, an added difficulty arises. At the present time it is provided that his status shall be determined as of the last day of the taxable year,[20] but this should surely not be extended to four years. Hence, averaging should be confined to net income less all deductions and exemptions, or such deductions and exemptions could be prorated throughout the period. Added difficulties may be found in the community property states, but this system of property ownership should not be allowed to interfere with government revenue to any great extent. A requirement of joint returns from all families should solve this problem.

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[18] *See* Tibbetts, *The Accounting Period in Federal Income Taxation*, 7 SOUTHERN ECONOMIC JOURNAL 362.

[19] Groves, cited *supra* note 17 at 85; *and see* Vickrey, *Averaging of Income for Income Tax Purposes*, 47 JOURNAL OF POLITICAL ECONOMY 379.

[20] I. R. C., § 25(b)2.

[21] *See, e.g.*, Atlas, cited *supra* note 15; Groves, cited *supra* note 17; and Simons, cited *supra* note 14.

The simple average, in one form or another, is the one most frequently offered as the simplest method of accomplishing this result,[21] because no revolutionary changes in tax law as it presently exists are necessary and the equities are roughly provided for, even though the average may, and probably will, fluctuate somewhat from period to period. No great conflicts are presented, and "simplification" is even aided somewhat by elimination of various problems occasioned by the annual period.

THE PROGRESSIVE AVERAGE

In taking a progressive average, a certain period is adopted and then each year within the period the income for that year and the prior years, if any, within the same period is averaged. The tax is then computed as if the average income had been received each year, and the previous overpayment, if any, is credited to the tax due for the taxable year.

William Vickrey, in a well-considered article,[22] advocates the use of this system, and in conjunction therewith develops the concept of "adjusted total income" in order to put all taxpayers on the same tenable footing. In essence this is the total income received during the period plus compound interest on tax payments previously made. Under his proposal, this amount would be computed; the average income within the period which would give this result is determined; the present value of the taxes that would have been payable on such a constant income according to the present methods of assessment and the rates of the various years within the period is then computed; the present accumulated value of the taxes paid during the period is deducted, and the remainder is the tax due.[23]

While more than somewhat complicated, this method of computation does enable the taxpayer with a given total income to stand on exactly the same footing with all other taxpayers having the same total income, regardless of where, during the period, such income was realized. His suggestion is that the duration of the period should be the lifetime of the individual, or at least from majority to death.[24] At the end of the period then, each taxpayer will have paid the same amount that every individual having the same total income and the same life or earning duration will have paid. Thus, the equities would be exactly adjusted, and the government would be in receipt of revenue at the time the income is earned, except in one situation—where tax rates are raised and individual income declines sharply.[25] This would be the occasion for a government "relief" provision, authorizing the use of a supplementary schedule of rates.

It is further proposed that the "complications" be ameliorated somewhat by governmental schedules, similar to those now provided,[26] for each number of years the taxpayer would have been subject to this method. *Quaere* if such a proposal would meet the approval of "simplificationists" today, however.

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[22] *Averaging of Income for Income Tax Purposes*, cited *supra* note 19.

[23] *Id.* at 383-385.

[24] *Id.* at 390.

[25] *Id.* at 386-389.

[26] *See* form 1040A, B.G.R. (1944); Schedule "T," Individual Income Tax Act of 1944.

Hereunder there would be little or no shifting of income problem,[27] and the end and beginning of the periods would be staggered over the years.[28] But in the latter respect, it must be remembered that averaging computations are made every year. In addition, voluminous records must be kept by the government, although perhaps this would not be required of the taxpayer, who could carry the figures over from his last return. The problem of change of status of the taxpayer is not adequately met; suggestions are made that the period be cut on marriage, divorce or death; or separate returns of each member of the family be required; or there be consolidation of family income in one return, and apportionment among the family.[29]

It can readily be seen that such a proposal, while adjusting the present burden on fluctuating incomes with exactitude, would involve wholesale changes in existing tax law concepts and, in addition, would put an impossible burden on administrative agencies.

The Moving Average

A moving or running average is found by taking, each year, the average of the taxable year's income and the income of a certain number of preceding years, the number of years averaged always being the same. Such a system was utilized in Australia,[30] Wisconsin[31] and, to some extent, in England.[32]

The Australian provision provided for the use of a moving average extending over a period of five years, including the taxable year. The Wisconsin provisions were essentially the same, but for a three-year period, as were the restricted English provisions. No attempt will be made herein to discuss the advantages or disadvantages of these laws,[33] but in general it is agreed that the failure of each of these was due in large respect to the fact that the tax was not collected when the taxpayer was able to pay it; *i.e.*, in the year the income was received.[34] It can easily be seen that, under this method, should a single year of high income be received, with low years stretching on either side, the taxpayer will have but a relatively small amount to pay in the year of high income; but three years thereafter he would have a fairly high tax to pay without benefit of a large income or a large credit from past tax payments. Such a situation is very likely to develop in depression years.[35] However, it might be possible to overcome this difficulty by providing that in cases where the income of the present taxable year exceeds the average income for the averaging period by a certain percentage or amount, a special surtax shall be added to the tax due for that year, subject to refund or credit at the time when such high income year shall be the first year in the period (since, in the subsequent years,

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[27] Vickrey, *op. cit. supra* note 19 at 390.

[28] *Id.* at 391.

[29] *Id.* at 392.

[30] *See* note 10 *supra.*

[31] *See* note 11 *supra.*

[32] *See* note 12 *supra.*

[33] For a full discussion of the history and defects of the Wisconsin and English Acts, *see* Atlas, cited *supra* note 15; *and see* also Vickrey, cited *supra* note 19; Tibbetts, cited *supra* note 18; Groves, cited *supra* note 17; H. B. Spaulding, Income Taxation in Great Britain and the United States, pp. 211-28.

[34] *See* note 33 *supra.*

[35] *See* Report of Wisc. Tax Com., 1934.

the high income year will no longer be averaged), unless the income of any year succeeding such high income year within the period shall be still higher, when such overpayment for the first high year shall be credited to the surtax due for the second high year.

The provision outlined above for use with the moving average would thus remove the major difficulty with the use of this averaging method. However, it is possible that the shifting problem, not ordinarily presented by the use of the moving average, would thereby be revived somewhat. Change of status during the period is not a greater problem than it would be if the simple average were used, and the same solutions, as hereinbefore discussed,[36] should be adequate. But there is a large burden put upon the administrative agencies, since there is an averaging computation each year, although not a complicated one. Records must be kept, but only for the preceding three years (if the total average period is four years); and under various provisions and regulations today[37] old returns may be re-opened and amended for the preceding three years. There will be, of course, the inevitable lag in "audit" by the government, but any averaging system entails this as a necessary evil.[38]

Problems such as corporate dissolution and reorganization have been omitted throughout as this paper has been confined to considerations of individual taxpayers alone, but it might be well to note their existence especially under the moving average, due to their contribution to the downfall of the Wisconsin provisions;[39] however, this is the change of status problem as applied to others than individuals, and therefore should not be insuperable. Taken as a whole, the moving average, while presenting some difficulties, does not deserve the reputation it has received because of its previous failures.

CONCLUSIONS

It is impossible to say that one of the above averaging methods will work out in practice. While the inequity of the annual method of assessment is recognized, and special provisions have been enacted in some cases for a class especially bearing this cross, there is a tendency to stay clear of any general averaging provision due to the Wisconsin precedent. Then again, reluctance to radically change existing laws is clearly manifest everywhere, and from this standpoint, of the three methods, the simple average would perhaps be the least objectionable. The progressive method involves both too great a change in existing law and too many complicated mathematical revolutions on the part of the taxpayer, but does provide for absolute equality. As between the simple method and the moving method, the latter probably will provide a more equitable average, fluctuating but slightly and tending to follow income, but the simple average has fewer complications and at the same time provides for a reasonable adjustment of the equities. It is suggested that this method be adopted for an experimental period of two years, suspending all present averaging devices, in order to determine its practical application.

CLYDE R. MAXWELL, JR.

[36] *Infra* p. 108.
[37] *See*, for example, I.R.C., §§ 311, 272.
[38] *Infra* pp. 106, 107.
[39] *See* Atlas, cited *supra* note 15, for an excellent summary of these problems.