STATE TAXATION OF PERSONAL INCOMES

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PREFACE

BELIEVING that the fiscal aspects of state income taxes were in danger of being overlooked in the enthusiasm for progressive income taxation, the writer made a brief study of the yield and cost of these taxes early in 1920. The paper appeared as "Fiscal Aspects of State Income Taxes" in the *American Economic Review* for June, 1920. In the present study an attempt has been made to present more fully the facts which represent the financial standing of these taxes, together with a description of their background and of the manner in which they operate.

The writer wishes to acknowledge indebtedness to Mr. A. E. Holcomb of the National Tax Association for helpful suggestions and for permission to reprint the material in the appendices, to Mr. Nils P. Haugen, formerly chairman of the Wisconsin Tax Commission and to other state officials who have generously supplied information which was not available in published reports, and especially to Professor Edwin R. A. Seligman of Columbia University, under whose direction the study was carried on and whose constructive criticism made its accomplishment possible.

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TABLE OF CONTENTS

PAGE

CHAPTER VI

Income Taxes in Virginia, South Carolina, and North Carolina

CHAPTER VII

The New York Income Tax

CHAPTER VIII

The North Dakota Income Tax

CHAPTER IX

The Income Tax Movement in New Mexico and Alabama

CHAPTER X

The Income Tax Movement in Other States

CHAPTER XI

Modern Income Tax Methods and Results

APPENDIX I

EXTRACT FROM THE "PRELIMINARY REPORT OF THE COMMITTEE APPOINTED BY THE NATIONAL TAX ASSOCIATION TO PREPARE A PLAN OF A MODEL SYSTEM OF STATE AND LOCAL TAXATION," SEPTEMBER, 1918

III. THE PROPOSED PERSONAL INCOME TAX

Section 11. The first decision reached by the committee was that in the proposed model system of state and local taxation there should be a personal tax levied with the exclusive view of carrying out the principle that every person having taxable ability should pay a direct tax to the government under which he is domiciled. There appeared to be four forms of personal taxation which have been employed for this purpose.

The first of these is the poll tax. It is evident, however, from the nature of the case that this tax would be utterly inadequate to accomplish the object in view, even if levied at graduated rates, as has sometimes been done in other countries. It would be so unequal and so far inferior to the other forms of personal taxation that it cannot be deemed worthy of serious consideration. Whether, as a supplement to an adequate system of personal taxation, it might be desirable to retain the poll tax as a means of insuring some contribution from people owning no property and having small incomes, the committee preferred not to consider in this report. It has been our desire to confine ourselves to main issues, and not to undertake to solve every minor problem of taxation. We, therefore, say nothing about the poll tax, except that it is inadequate for the purpose that we have in view, and cannot be recommended as an important element in any system of state and local taxation.

The second method of imposing the personal tax would be to levy a tax upon every man's net fortune, that is, upon the total of his assets in excess of his liabilities, without exemption of any kind of asset or exclusion of any liability. This would not mean a general property tax, but a net property tax such as is found in some countries in Europe. It would be a tax levied not upon property as such, but upon net fortune as a measure of the citizen's personal liability to contribute to the government under which he is domiciled. It would be entirely distinct from any tax that might be levied objectively upon property, as property, at the place of its situs, and would have to be levied exclusively upon the property owner at his place of domicile. It would necessarily be levied at a moderate rate, perhaps $3 per $1000, which would correspond approximately to a six per cent income tax upon investments yielding five per cent. Although precedents may be found in other countries for such a personal tax levied upon net fortunes, the committee has concluded that it is not to be recommended for adoption in the United States. Such a tax would raise the difficult constitutional question of the right of a state to levy a tax even upon the *net* fortune of a citizen if that fortune included tangible property located in another commonwealth. It is, furthermore, foreign to American experience, and would certainly not lead us along the line of least resistance. Since the coming of the federal income tax, it is obvious that it is easier for the states, and more convenient for the taxpayers, to adopt income rather than net fortune as the measure of the obligation of the citizen to contribute to the government under which he lives.

The third method of personal taxation is what may be called a presumptive income tax, that is, a tax levied upon persons according to certain external indicia which are taken to be satisfactory measures of taxable ability. House rent is the index commonly used in such presumptive income taxes, and a tax on rentals has been proposed in times past by special commissions in Massachusetts and New York. Such a tax would be comparatively easy to administer, and would raise no difficult constitutional questions. It would undoubtedly be better than an income tax or a tax on net fortunes if those taxes were badly administered. But the amount that a citizen pays for house rent is after all such a very imperfect and inadequate indication of his income or fortune that the committee is unwilling to recommend it to any state in which there is any reasonable expectation that conditions are, or may presently become, favorable for the introduction of a better form of personal tax. It appears that in France, where the tax on rentals has been in continuous operation since the Revolution, there is so little correspondence between house rents and taxable ability that in the greater part of the communes the taxing officials disregard to a greater or less extent the letter of the law, and assess people according to what they appear able to pay. The committee finds, therefore, that the tax on rentals is not to be recommended except, perhaps, as a last resort in states where administrative and other conditions are unfavorable to the introduction of any better form of personal taxation.

There remains a fourth form of personal taxation, the personal income tax. By this is meant a tax levied upon persons with respect to their incomes which are taxed not objectively as incomes but as elements determining the taxable ability of the persons who receive them. This tax is better fitted than any other to carry out the principle that every person having taxable ability shall make a reasonable contribution to the support of the government under which he lives. It is as fair in principle as any tax can be; under proper conditions, it can be well administered by an American state, as Wisconsin and Massachusetts have proved; it is a form of taxation which meets with popular favor at the present time, and therefore seems to offer the line of least resistance. The committee, therefore, is of the opinion that a personal income tax is the best method of enforcing the personal obligation of the citizen for the support of the government under which he lives, and recommends it as a constituent part of a model system of state and local taxation.

Section 12. While it is impossible in this report to describe the proposed taxes in every detail, it is essential that the committee should explain at least in broad outlines the manner in which these taxes should be levied. In so doing it will be necessary to refer constantly to the general principles previously stated, and to adjust the details of each tax in such a manner as to enable it to carry into effect logically and consistently the principle upon which it is based.

Since the purpose of the personal income tax is to enforce the obligation of every citizen to the government under which he is domiciled, it is obvious that this tax must be levied only upon persons and in the states where they are domiciled. It is contrary to the theory of the tax that it should apply to the income from any business as such, or apply to the income of any property as such. The tax should be levied upon persons in respect of their entire net incomes, and should be collected only from persons and at places where they are domiciled. It should not be collected from business concerns, either incorporated or unincorporated, since such action would defeat the very purpose of the tax.

At first thought this proposal will doubtless seem objectionable to many, who will ask why a state should not tax all incomes derived from business or property located within its jurisdiction, irrespective of whether the recipients are residents or non-residents. And if the personal income tax were the only one proposed, the objection would be well grounded. The committee, however, is under the necessity of reconciling the conflicting claims of the states, and of doing so in a manner that will avoid unjust double and triple taxation of interstate business and investments. We, therefore, propose as the only practicable remedy a system which comprises three taxes, each of which is designed to satisfy fully and fairly the legitimate claims of our several states. We are elsewhere providing methods by which property will be taxed where located and business will be taxed where it is carried on. At this point, we are dealing exclusively with a personal tax designed to enforce the right of our states to tax all persons domiciled within their jurisdictions; and we are merely insisting that, in enforcing this claim, the states shall act consistently, and shall confine personal taxation to persons and attempt to levy it only at the place of domicile. If the personal income tax is levied in any other way, it will simply reproduce and perpetuate the old evil of unjust double taxation of interstate property and interstate business.

The second detailed recommendation we have to make is that the personal income tax shall be levied in respect of the citizen's entire net income from all sources. Under existing constitutional limitations, of course, interest upon the bonds of the United States and the salaries of federal officials cannot be taxed by the states, but we recommend that all other sources of income be subject to the income tax without exception or qualification. We are aware that, under the unreasonable and unworkable requirements of the general property tax, it has appeared desirable in times past to exempt state and local bonds from taxation, to exempt real-estate mortgages, and to grant various other exemptions. All such exemptions are inconsistent with the theory of the tax we here propose, and should be discontinued as rapidly as the circumstances of each case permit. Against the policy which led to these exemptions under the general property tax we here offer no criticism. But we are now dealing with a tax which is designed to be a part of a new system of taxation, and it is evident that none of the considerations which led to the exemptions created under the general property tax are applicable to a personal income tax levied upon the principle we here advocate. The personal obligation of the citizen to contribute to the support of the government under which he lives should not be affected by the form his investments take, and to exempt any form of investment can only bring about an unequal, and therefore an unjust distribution of this tax. Our reasoning applies, of course, to the exemption which agencies of the federal government now enjoy. But that is a matter which is beyond the control of the states, and for the purposes of this report it will be considered a fixed datum which must be accepted.[1]

[1] We here follow the view that has long prevailed concerning existing

Our third specific recommendation is that the personal income tax should be levied upon net income defined substantially as a good accountant would determine it. We submit no formal definition at this time, and content ourselves with referring to the provisions of the Wisconsin and the Massachusetts income taxes. Our recommendation means that operating expenses and interest on indebtedness must be deducted, but we wish to call attention to the fact that the issue by the federal government of large amounts of bonds which are exempt from local taxation will make it necessary for the states to limit the interest deduction to an amount proportional to the income which the taxpayer derives from taxable sources. This would mean that if a person derives half of his income from taxable sources and one-half from tax-exempt federal bonds, he should be permitted to deduct but one-half of the interest that he pays upon his indebtedness. Any other procedure will tend to make the personal income tax a farce in many cases and will give occasion for legitimate complaint.

The fourth recommendation relates to the exemption of small incomes. The committee believes that the amount of income exempted from the personal income tax should not exceed $600 for a single person and $1200 for a husband and wife, with a further exemption of $200 for each dependent up to a number not to exceed three. This would give us a maximum exemption of $1,800 for a family consisting of husband, wife, and three children or other dependents. We recognize, however, that conditions may well differ in various states, and have decided to make no specific recommendations about the amount of the exemptions granted to persons having small incomes. We limit ourselves to the above statement of the maximum exemptions that should be granted and the further observation

restrictions on the taxing power of the states. In two recent cases (Peck v. Lowe and U. S. Glue Co. v. Oak Creek, 247 U. S.) the court has developed a doctrine which may justify the belief that a net income tax, levied upon state officials along with all other persons, with respect to their entire net incomes, might not be held to be a tax upon agencies of the federal government, and therefore forbidden by federal decisions.

that, under a democratic form of government, it is desirable to exempt as few people as possible from the necessity of making a direct personal contribution toward support of the state.[1]

Our fifth recommendation is that the rate of the income tax shall be the same for all kinds of income, that is, that it shall not be differentiated according to the sources from which income is derived. If the tax stood by itself, a strong argument could be made for imposing a higher rate upon funded than upon unfunded incomes. But the tax is, in fact, designed to be part of a system of taxation in which there will be a tax upon tangible property. Under this system there will be heavier taxation of the sources from which funded incomes are derived; and there will, therefore, be little if any ground for attempting to differentiate the rates of the personal income tax. Such differentiation, furthermore, would greatly complicate the administration of the tax, and would lead to numerous difficulties. Upon all accounts, therefore, we recommend that there shall be no differentiation of the rate.

In the sixth place we recommend that the rates of taxation shall be progressive, the progression depending upon the amount of the taxpayer's net income. Concerning the precise schedule of rates, we offer certain general recommendations. The lowest rate should not be less than one per cent, and under present conditions we regard it as inexpedient for any state to impose a rate higher than six per cent. The classes of taxable income to which the various rates apply need not be smaller than $1000, and probably should not be larger. It results from what has been said that if the exemption to a single person be placed at $600, we would recommend a tax of one per cent upon any amount of income between $600 and $1600; a tax of two per cent upon any amount of income betweeen $1600 and $2600; a tax of three per cent upon any amount of income

[1] For administrative convenience we recommend that, in order to minimize the number of very small tax bills, no person liable to pay an income tax shall be assessed for less than $1.00.

between $2600 and $3600; a tax of four per cent upon any amount of income between $3600 and $4600; a tax of five per cent upon any amount of income between $4600 and $5600; and a tax of six per cent upon all income in excess of $5600. We present these figures merely for the purpose of illustrating our preferences, and make no definite recommendation except that the rates of the personal income tax should be moderate, and should be, as nearly as practicable, uniform throughout the United States.

Our seventh suggestion concerns the administration of the proposed tax. No argument can be needed by the National Tax Association to support our recommendation that the administration of the personal income tax should be placed in the hands of state officials. This we regard as an indispensable condition for the successful operation of any state income tax, and we should be disinclined to recommend the adoption of an income tax by any commonwealth that is unwilling to turn over its administration to a well organized and properly equipped state tax department. Local administration of an income tax has never worked well, and in our opinion, never can operate satisfactorily. It is obvious, finally, that a state tax commission, or commissioner, is the proper agent to administer the proposed tax; and we desire to record our belief that satisfactory results are hardly to be expected if the administration is turned over to any other state officials. Upon this whole question of administration, which is of the most vital importance, we are fortunate in being able to rely upon the authority of the opinions repeatedly expressed by the conferences of the National Tax Association. We are glad also to point to the experience of Wisconsin and Massachusetts.

Our eighth recommendation is that the personal income tax be collected from taxpayers, upon the basis of strictly enforced and controlled returns, and without any attempt to collect it at the source. Upon this point there might have been doubt several years ago. But the experience of Wisconsin and Massachusetts shows conclusively that, with good administration, a reasonable tax upon incomes can be collected in the manner we have recommended, with the general cooperation of the taxpayers and with the minimum amount of evasion. Collection at source presents serious administrative difficulties, imposes unwarranted burdens upon third parties in respect of transactions which strictly concern only the taxpayers and the government, and not infrequently tends to shift the burden of the tax to the wrong shoulders. What we seek is a personal income tax which shall not be shifted and shall bring home to the taxpayer, in the most direct possible form, his personal obligation for the support of the government under which he lives. Collection at the source is plainly inconsistent with the purpose of such a tax. We recommend, however, that in certain cases information at the source be required as is now done under the Massachusetts and Wisconsin income taxes. Such information is helpful to the administrative officials, and does not alter the incidence or otherwise affect injuriously the operation of a personal income tax.

Section 13. The only remaining point is that of the proper disposition of the proceeds of this tax. So far as our general plan of taxation is concerned, it is immaterial whether the revenue from the personal income tax is retained in the state treasury, distributed to the local political units, or divided between the state and local governments. It is probable, furthermore, that the same solution may not be advisable in every state. If the state should keep the entire revenue, then every section of the state would benefit to the extent that such revenue might reduce the direct state tax. Upon the other hand, if the revenue from the income tax is distributed wholly to the local units, as is now the case in Massachusetts, the lightening of local burdens tends to reduce the pressure of the direct state tax. It seems probable that in most cases a division of the revenue would be considered preferable; and in such cases we suggest that the state governments might well retain a proportion corresponding to the proportion which state expenditures bear to the total of the state and local expenditures, and that the same principle should apply in determining the share received by each of the subordinate political units.

Thus in case state expenditures amount to one-fifth of the total, county expenditures to two-fifths, and municipal expenditures to two-fifths, the state should receive one-fifth of the revenue from the income tax, the counties two-fifths, and the municipalities two-fifths. Whether distribution to the local units should be made upon the basis of the amount of the tax collected in each unit, or whether the tax should be distributed upon some other basis, is also immaterial to our general plan of taxation. In states where domiciliary changes occurring under the general property tax have not produced an unnatural concentration of wealth in certain localities, it will probably be best to distribute the revenue according to the domicile of the taxpayers. But where, as in Massachusetts, under the operation of the general property tax, wealth has been greatly concentrated in a few localities, such a method of distribution is obviously impossible and some other method must be found. In such a case, the income tax revenue might be utilized for a state school fund, or might be distributed among the localities according to the proportions in which they are required to contribute to the direct state tax. Since this entire question of distribution must be so largely affected by local conditions, the committee prefers to do no more than to offer these general suggestions.

APPENDIX II

Draft of a Personal Income Tax Act

Prepared for the National Tax Association by the Committee Appointed to Prepare a Plan for a Model System of State and Local Taxation. January, 1921

Personal Income Tax

AN ACT PROVIDING FOR THE LEVYING, COLLECTING AND PAYING OF AN INCOME TAX ON INDIVIDUALS

Be it Enacted by the Legislature of the State of ———

Article I

SHORT TITLE AND DEFINITIONS

Section 1. **Short title.** This Act shall be known and may be cited as The Personal Income Tax Act of 192—.

Sec. 2. **Definitions.** For the purposes of this act and unless otherwise required by the context:

1. The words "tax commission" mean the state tax commission.

2. The word "taxpayer" includes any individual or fiduciary subject to the tax imposed by this act.

3. The word "individual" means a natural person.

4. The word "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person, whether individual or corporate, acting in any fiduciary capacity for any person, estate or trust.

5. The word "person" includes individuals, fiduciaries, partnerships and corporations.

6. The word "corporation" includes joint-stock companies or associations and insurance companies.

7. The words "tax year" mean the calendar year in which the tax is payable.

8. The words "income year" mean the calendar year or the fiscal year, upon the basis of which the net income is computed under this act; if no fiscal year has been established they mean the calendar year.

9. The words "fiscal year" mean an income year, ending on the last day of any month other than December.

10. The word "paid" for the purposes of the deductions under this act, means "paid or accrued" or "paid or incurred", and the words "paid or accrued", "paid or incurred" and "incurred" shall be construed according to the method of accounting upon the basis of which the net income is computed under this act. The word "received" for the purpose of the computation of the net income under this act means "received or accrued", and the words "received or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this act.

11. The word "resident" applies only to individuals and includes for the purpose of determining liability to the tax imposed by this act, with reference to the income of any income year, any individual who shall be a resident of the state on April 15 of the tax year.

12. The words "foreign country" mean any jurisdiction other than one embraced within the United States. The words "United States", when used in a geographical sense, include the states, the territories of Alaska and Hawaii, the District of Columbia and the possessions of the United States.

Article II

Imposition of Tax

Sec. 200. **Individuals.** 1. A tax is hereby imposed upon every resident of the state, which tax shall be levied, collected and paid annually, with respect to his entire net income as herein, computed at the following rates, after deducting the exemptions provided in this act:

On the first $1000 of net income or any part thereof, one per cent;

On the second $1000 of net income or any part thereof, two per cent;

On the third $1000 of net income or any part thereof, three per cent;

On the fourth $1000 of net income or any part thereof, four per cent;

On the fifth $1000 of net income or any part thereof, five per cent;

On all net income in excess of $5000, six per cent.

2. Such tax shall first be levied, collected and paid in the year 1921 and with respect to the net income received during the calendar dear 1920 or during any income year ending during the twelve months ending March 31, 1921.

Sec. 201. **Fiduciaries.** 1. The tax imposed by this act shall be imposed upon resident fiduciaries, which tax shall be levied, collected and paid annually with respect to:

(a) That part of the net income of estates or trusts which has not been distributed or become distributable to beneficiaries during the income year. In the case of two or more joint fiduciaries, part of whom are non-residents of the state, such part of the net income shall be treated as if each fiduciary had received an equal share;

(b) The net income received during the income year by deceased individuals who, at the time of death were residents and who have died on or after April 15 of the tax year without having made a return;

(c) The entire net income of resident insolvent or incompetent individuals, whether or not any portion thereof is held for the future use of the beneficiaries, where the fiduciary has complete charge of such net income.

2. The tax imposed upon a fiduciary by this act shall be a charge against the estate or trust.

Article III

COMPUTATION OF TAX

Sec. 300. **Net income defined.** The words "net income" means the gross income of a taxpayer less the deductions allowed by this act.

Sec. 301. **Gross income defined.** 1. The words "gross income" includes gains, profits and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, business, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income of the income year in which received by the taypayer, unless, under the methods of accounting permitted under this act, any such amounts are to be properly accounted for as of a different period.

2. The words "gross income," does not include the following items, which shall be exempt from taxation under this act:

(a) The proceeds of life-insurance policies and contracts paid upon the death of the insured to individual beneficiaries or to the estate of the insured;

(b) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract;

(c) The value of property acquired by gift, bequest, devise or descent (but the income from such property shall be included in gross income);

(d) Interest upon the obligations of the United States or its possessions;

(e) Salaries, wages and other compensation received from the United States by officials or employees thereof, including persons in the military or naval forces of the United States;

(f) Any amounts received through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received, whether by suit or agreement, on account of such injuries or sickness.

Sec. 302. **Basis of return of net income.** 1. Taxpayers who customarily estimate their income on a basis other than that of actual cash receipts and disbursements may, with the approval of the tax commission, return their net income under this act upon a similar basis. Taxpayers who customarily estimate their income on the basis of an established fiscal year instead of on that of the calendar year, may, with the approval of the tax commission, and subject to such rules and regulations as it may establish, return their net income under this act on the basis of such fiscal year, in lieu of that of the calendar year.

2. A taxpayer may, with the approval of the tax commission and under such regulations as it may prescribe, change his income year from fiscal year to calendar year or otherwise, in which case his net income shall be computed upon the basis of such new income year.

3. An individual carrying on business in partnership shall be liable for income tax only in his individual capacity and shall include in his gross income the distributive share of the net income of the partnership received by him or distributable to him during the income year.

4. Every individual, taxable under this act, who is a beneficiary of an estate or trust, shall include in his gross income the distributive share of the net income of the estate or trust, received by him or distributable to him during the income year. Unless otherwise provided in the law, the will, the deed or other instrument creating the estate, trust or fiduciary relation, the net income shall be deemed to be distributed or distributable to the beneficiaries (including the fiduciary as a beneficiary, in the case of income accumulated for future distribution) ratably, in proportion to their respective interests.

Sec. 303. **Determination of gain or loss.** For the purpose of ascertaining the gain or loss from the sale or other disposition of property, real, personal or mixed, the basis shall be, in the case of property acquired before January 1, ——, the fair market price or value of such property as of that date, if such price or value exceeds the original cost, and in all other cases, the cost thereof; *Provided,* that in the case of property which was included in the last preceding annual inventory used in determining net income in a return under this act, such inventory value shall be taken in lieu of cost or market value. The final distribution to the taxpayer of the assets of a corporation shall be treated as a sale of the stock or securities of the corporation owned by him and the gain or loss shall be computed accordingly.

Sec. 304. **Exchanges of property.** 1. When property is exchanged for other property, the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash to the amount of its fair market value, provided a market exists in which all the property so received can be disposed of at the time of exchange, for a reasonably certain and definite price in cash; otherwise such exchange shall be considered as a conversion of assets from one form to another, from which no gain or loss shall be deemed to arise.

2. In the case of the organization of a corporation, the stock or securities received shall be considered to take the place of property transferred therefor and no gain or loss shall be deemed to arise therefrom.

3. When, in connection with the reorganization, merger or consolidation of a corporation, a taxpayer receives, in place of stock or securities owned by him, new stock or securities, the basis of computing the gain or loss if any shall be, in case the stock or securities owned were acquired before January 1, ——, the fair market price or value thereof as of that date, if such price or value exceeds the original cost, and in all other cases the cost thereof.

Sec. 305. **Inventory.** Whenever in the opinion of the tax commission the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer, upon such basis as the tax commission may prescribe, conforming as nearly as may be to the best accounting practice in the trade or business and most clearly reflecting the income, and conforming so far as may be, to the forms and methods prescribed by the United States Commissioner of Internal Revenue, under the acts of Congress then providing for the taxation of incomes.

Sec. 306. **Deductions.** In computing net income there shall be allowed as deductions:

(a) All the ordinary and necessary expenses paid during the income year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession, for the purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity;

(b) All interest paid during the income year on indebtedness;

(c) Taxes paid or accrued within the income year, imposed by the authority of the United States or of any of its possessions or of any state, territory or the District of Columbia or of any foreign country; except inheritance taxes, and except income taxes imposed by this act and taxes assessed for local benefits, of a kind tending to increase the value of the property assessed;

(d) Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in trade or business;

(e) Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business;

(f) Losses sustained during the income year, of property not connected with the trade or business, if arising from fires, storms, shipwreck or other casualty, or from theft, and not compensated for by insurance or otherwise;

(g) Debts ascertained to be worthless and charged off within the income year, if the amount has previously been included in gross income in a return under this act;

(h) A reasonable allowance for the depreciation and obsolescence of property used in the trade or business; and, in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion; *Provided*, That in computing the deductions allowed under this paragraph, the basis shall be the cost (including in the case of mines, oil and gas wells and other natural deposits, the cost of development, not otherwise deducted), and in the case of property acquired prior to January 1, ——, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date. The reasonable allowances under this paragraph shall be made under rules and regulations to be prescribed by the tax commission. In the case of leases the deductions allowed may be equitably apportioned between the lessor and lessee;

(i) In the case of taxpayers who keep regular books of account, upon an accrual basis and in accordance with standard accounting practice, reserve for bad debts and for contingent liabilities, under such rules and restrictions as the tax commission may impose. If the tax commission shall at any time deem the reserve excessive in amount, it may restore such excess to income, either in a subsequent year or as a part of the income of the income year and assess it accordingly.

Sec. 307. **Items not deductible.** In computing net income no deduction shall in any case be allowed in respect of:

(a) Personal, living or family expenses;

(b) Any amount paid out for new buildings or for permanent improvements or betterments, made to increase the value of any property or estate;

(c) Any amount expended in restoring property for which an allowance is or has been made;

(d) Premiums paid on any life-insurance policy covering the life of any officer or employee or of any individual financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

Sec. 308. **Exemptions.** 1. There shall be deducted from the net income the following exemptions:

(a) In the case of a single individual, a personal exemption of $1000;

(b) In the case of the head of a family, or a married individual living with husband or wife, a personal exemption of $2000. A husband and wife living together shall receive but one personal exemption of $2000 against their aggregate net income; and in case they make separate returns, the personal exemption of $2000 may be taken by either or divided between them;

(c) $200 for each individual (other than husband and wife) dependent upon and receiving his chief support from the taxpayer, if such dependent individual is under eighteen years of age or is incapable of self-support, because mentally or physically defective;

(d) In the case of a fiduciary; if taxable under clause (a) of paragraph 1 of section 201, a personal exemption of $1000; if taxable under clause (b) of said paragraph, the same exemption as would be allowed the deceased, if living; if taxable under clause (c) of said paragraph, the same exemptions to which the beneficiary would be entitled.

2. The status on the last day of the income year shall determine the right to the exemptions provided in this section; *Provided* that a taxpayer shall be entitled to such exemptions for husband or wife or dependent who has died during the income year.

Article IV

Returns

Sec. 400. **Individual returns.** 1. Every resident, having a net income during the income year of $1000 or over, if single, or if married and not living with husband or wife; or having a net income for the income year of $2000 or over, if married and living with husband or wife; shall make a return under oath, stating specifically the items of his gross income and the deductions and exemptions allowed by this act.

2. If a husband and wife living together have an aggregate net income of $2000 or over, each shall make such a return, unless the income of each is included in a single joint return.

3. If the taxpayer is unable to make his own return, the return shall be made by a duly authorized agent or by a guardian or other person charged with the care of the person or property of such taxpayer.

Sec. 401. **Fiduciary returns.** 1. Every fiduciary subject to taxation under the provisions of this act, as provided in section 201 hereof, shall make a return under oath, for the individual, estate, or trust for whom or for which he acts, if the net income thereof amounts to $1000 or over.

2. The return made by a fiduciary shall state specifically the items of gross income, and the deductions and exemptions allowed by this act and such other facts as the tax commission may prescribe. Under such regulations as the tax commission may prescribe, a return may be made by one of two or more joint fiduciaries.

3. Fiduciaries required to make returns under this act shall be subject to all the provisions of this act which apply to individuals.

Sec. 402. **Information at source.** 1. Every individual, partnership, corporation, joint stock company or association or insurance company, being a resident or having a place of business in this state, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers and all officers and employees of the state or of any political subdivision of the state, having the control, receipt, custody, disposal or payment of interest (other than interest coupons payable to bearer), rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments or other fixed or determinable annual or periodical gains, profits and income, amounting to $1000 or over, paid or payable during any year to any taxpayer, shall make complete return thereof under oath, to the tax commission, under such regulations and in such form and manner and to such extent as may be prescribed by it.

2. Every partnership, having a place of business in the state, shall make a return, stating specifically the items of its gross income and the deductions allowed by this act, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed, and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

3. Every fiduciary shall make, under oath, a return for the individual, estate or trust for whom or for which he acts, if the net income thereof, distributed or distributable to beneficiaries during the year is $1000 or over, in which case the fiduciary shall set forth in such return the items of the gross income, the deductions allowed by this act, the net income, the names and addresses of the beneficiaries, the amounts distributed or distributable to each and the amount, if any, lawfully retained by him for future distribution. Such return may be made by one of two or more joint fiduciaries.

Sec. 403. **Time and place of filing returns.** Returns shall be in such form as the tax commission may from time to time prescribe and shall be filed with the tax commission, at its main office or at any branch office which it may establish, on or before the fifteenth day of the fourth month next after the preceding calendar year or any income year ending after such calendar year and on or before the thirty-first day of March. In case of sickness, absence or other disability, or whenever in its judgment good cause exists, the tax commission may allow further time for filing returns. There shall be annexed to the return the affidavit or affirmation of the taxpayer making the return, to the effect that the statements contained therein are true. The tax commission shall cause to be prepared blank forms for the said returns and shall cause them to be distributed throughout the state and to be furnished upon application, but failure to receive or secure the form shall not relieve any taxpayer from the obligation of making any return herein required.

Sec. 404. **Failure to file returns; supplementary returns.** If the tax commission shall be of the opinion that any taxpayer has failed to file a return, or to include in a return filed, either intentionally or through error, items of taxable income, it may require from such taxpayer a return, or a supplementary return, under oath, in such form as it shall prescribe, of all the items of income which the taxpayer received during the year for which the return is made, whether or not taxable under the provisions of this act. If from a supplementary return, or otherwise, the tax commission finds that any items of income, taxable under this act, have been omitted from the original return it may require the items so omitted to be disclosed to it, under oath of the taxpayer, and to be added to the original return. Such supplementary return and the correction of the original return shall not relieve the taxpayer from any of the penalties to which he may be liable under any provision of this act. The tax commission may proceed under the provisions of section 502 of this act whether or not it requires a return or a supplementary return under this section.

Article V

COLLECTION AND ENFORCEMENT OF TAX

Sec. 500. **Time and place of payment of tax.** 1. The full amount of the tax payable, as the same shall appear from the face of the return, shall be paid to the tax commission at the office where the return is filed, at the time fixed by law for filing the return. If the time for filing the return shall be extended, interest at the rate of 6 per cent per annum, from the time when the return was originally required to be filed, to the time of payment, shall be added and paid.

2. The tax may be paid with uncertified check, during such time and under such regulations as the tax commission shall prescribe, but if a check so received is not paid by the bank on which it is drawn, the taxpayer by whom such check is tendered shall remain liable for the payment of the tax and for all legal penalties, the same as if such check had not been tendered.

Sec. 501. **Examination of returns.** 1. As soon as practicable after the return is filed, the tax commission shall examine it and compute the tax, and the amount so computed by the tax commission shall be the tax. If the tax found due shall be greater than the amount theretofore paid, the excess shall be paid to the tax commission within ten days after notice of the amount shall be mailed by the tax commission.

2. If the return is made in good faith and the understatement of the tax is not due to any fault of the taxpayer, there shall be no penalty or additional tax added because of such understatement, but interest shall be added to the amount of the deficiency at the rate of 1 per cent for each month or fraction of a month.

3. If the understatement is due to negligence on the part of the taxpayer, but without intent to defraud, there shall be added to the amount of the deficiency 5 per cent thereof, and in addition, interest at the rate of 1 per cent per month or fraction of a month.

4. If the understatement is false or fraudulent, with intent to evade the tax, the tax on the additional income discovered to be taxable shall be doubled and an additional 1 per cent per month or fraction of a month shall be added.

5. The interest provided for in this section shall in all cases be computed from the date the tax was originally due to the date of payment.

6. If the amount of tax found due as computed shall be less than the amount theretofore paid, the excess shall be refunded by the tax commission out of the proceeds of the tax retained by it as provided in this act.

Sec. 502. **Additional taxes.** If the tax commission discovers from the examination of the return or otherwise that the income of any taxpayer, or any portion thereof, has not been assessed, it may, at any time within two years after the time when the return was due, assess the same and give notice to the taxpayer of such assessment, and such taxpayer shall thereupon have an opportunity, within thirty days, to confer with the tax commission as to the proposed assessment. The limitation of two years to the assessment of such tax or additional tax shall not apply to the assessment of additional taxes upon fraudulent returns. After the expiration of thirty days from such notification the tax commission shall assess the income of such taxpayer or any portion thereeof which it believes has not theretofore been assessed and shall give notice to the taxpayer so assessed, of the amount of the tax and interest and penalties if any, and the amount thereof shall be due and payable within ten days from the date of such notice. The provisions of this act with respect to revision and appeal shall apply to a tax so assessed. No additional tax amounting to less than one dollar shall be assessed.

Sec. 503.. **Warrant for the collection of taxes.** If any tax imposed by this act or any portion of such tax be not paid within sixty days after the same becomes due, the tax commission shall issue a warrant under its hand and official seal directed to the sheriff of any county of the state, commanding him to levy upon and sell the real and personal property of the taxpayer, found within his county, for the payment of the amount thereof, with the added penalties, interest and the cost of executing the warrant and to return such warrant to the tax commission and pay to it the money collected by virtue thereof by a time to be therein specified, not less than sixty days from the date of the warrant. The sheriff shall within five days after the receipt of the warrant, file with the clerk of his county a copy thereof, and thereupon the clerk shall enter in the judgment docket, in the column for judgment debtors, the name of the taxpayer mentioned in the warrant, and in appropriate columns the amount of the tax or portion thereof and penalties for which the warrant is issued and the date when such copy is filed, and thereupon the amount of such warrant so docketed shall become a lien upon the title to and interest in real property or chattels real of the taxpayer against whom it is issued in the same manner as a judgment duly docketed in the office of such clerk. The said sheriff shall thereupon proceed upon the same in all respects, with like effect, and in the same manner prescribed by law in respect to executions issued against property upon judgments of a court of record, and shall be entitled to the same fees for his services in executing the warrant, to be collected in the same manner. If a warrant be returned not satisfied in full, the tax commission shall have the same remedies to enforce the claim for taxes against the taxpayer as if the people of the state had recovered judgment against the taxpayer for the amount of the tax.

Sec. 504. **Tax a debt.** Every tax imposed by this act, and all increases, interest and penalties thereon, shall become, from the time it is due and payable, a personal debt, from the person or persons liable to pay the same, to the state of ———.

Sec. 505. **Action for recovery of taxes.** Action may be brought at any time by the attorney general of the state, at the instance of the tax commission, in the name of the state, to recover the amount of any taxes, penalties and interest due under this act.

Sec. 506. **Tax upon settlement of fiduciary's account.** 1. No final account of a fiduciary shall be allowed by the probate court unless such account shows, and the judge of said court finds, that all taxes imposed by the provisions of this act upon said fiduciary, which have become payable, have been paid, and that all taxes which may become due are secured by bond, deposit or otherwise. The certificate of the tax commission and the receipt for the amount of the tax therein certified shall be conclusive as to the payment of the tax, to the extent of said certificate.

2. For the purpose of facilitating the settlement and distribution of estates held by fiduciaries, the tax commission, with the approval of the attorney general, may, on behalf of the state agree upon the amount of taxes at any time due or to become due from such fiduciaries under the provisions of this act, and payment in accordance with such agreement shall be full satisfaction of the taxes to which the agreement relates.

Article VI

PENALTIES

Sec. 600. **Penalties.** 1. If any taxpayer, without intent to evade any tax imposed by this act shall fail to file a return of income or pay a tax, if one is due, at the time required by or under the provisions of this act, but shall voluntarily file a correct return of income and pay the tax due within sixty days thereafter, there shall be added to the tax an additional amount equal to five per cent thereof, but such additional amount shall in no case be less than one dollar and an additional one per cent for each month or fraction of a month during which the tax remains unpaid.

2. If any taxpayer fails voluntarily to file a return of income or to pay a tax if one is due within sixty days of the time required by or under the provisions of this act, the tax shall be doubled, and such doubled tax shall be increased by one per cent for each month or fraction of a month from the time the tax was originally due to the date of payment.

3. The tax commission shall have power, upon making a record of its reasons therefor, to waive or reduce any of the additional taxes or interest provided in subdivisions 1 and 2 of this section or in subdivisions 2, 3 and 4 of section 501.

4. If any taxpayer fails to file a return within sixty days of the time prescribed by this act, any judge of the ——— court, upon petition of the tax commission, or any ten taxable residents of the state, shall issue a writ of mandamus requiring such person to file a return. The order of notice upon the petition shall be returnable not later than ten days after the filing of the petition. The petition shall be heard and determined on the return day or on such day thereafter as the court shall fix, having regard to the speediest possible determination of the case, consistent with the rights of the parties. The judgment shall include costs in favor of the prevailing party. All writs and processes may be issued from the clerk's office in any county and, except as aforesaid, shall be returnable as the court shall order.

5. Any person who, without fraudulent intent, fails to pay any tax or to make, render, sign or verify any return, or to supply any information, within the time required by or under the provisions of this act, shall be liable to a penalty of not more than $1000, to be recovered by the attorney general, in the

name of the people, by action in any court of competent jurisdistion.

6. Any person or any officer or employee of any corporation, or member or employee of any partnership, who, with intent to evade any requirement of this act or any lawful requirement of the tax commission thereunder, shall fail to pay any tax or to make, sign or verify any return or to supply any information required by or under the provisions of this act, or who, with like intent, shall make, render, sign or verify any false or fraudulent return or statement, or shall supply any false or fraudulent information, shall be liable to a penalty of not more than $1000, to be recovered by the attorney general in the name of the people, by action in any court of competent jurisdiction, and shall also be guilty of a misdemeanor and shall, upon conviction, be fined not to exceed $1000 or be imprisoned not to exceed one year, or both, at the discretion of the court.

7. The attorney general shall have the power, with the consent of the tax commission, to compromise any penalty for which he is authorized to bring action under subdivisions 5 and 6 of this section. The penalties provided by such subdivisions shall be additional to all other penalties in this act provided.

8. The failure to do any act required by or under the provisions of this act shall be deemed an act committed in part at the office of the tax commission in ———. The certificate of the tax commission to the effect that a tax has not been paid, that a return has not been filed or that information has not been supplied, as required by or under the provisions of this act, shall be prima-facie evidence that such tax has not been paid, that such return has not been filed or that such information has not been supplied.

9. If any taxpayer, who has failed to file a return or has filed an incorrect or insufficient return and has been notified by the tax commission of his delinquency, refuses or neglects within twenty days after such notice to file a proper return, or files a fraudulent return, the tax commission shall determine the income of such taxpayer according to its best information

and belief and assess the same at not more than double the amount so determined. The tax commission may in its discretion allow further time for the filing of a return in such case.

Article VII

REVISION AND APPEAL

Sec. 700. **Revision by tax commission.** A taxpayer may apply to the tax commission for revision of the tax assessed against him, at any time within one year from the time of the filing of the return or from the date of the notice of the assessment of any additional tax. The tax commission shall grant a hearing thereon and if, upon such hearing, it shall determine that the tax is excessive or incorrect, it shall resettle the same according to the law and the facts and adjust the computation of tax accordingly. The tax commission shall notify the taxpayer of its determination and shall refund to the taxpayer the amount, if any, paid in excess of the tax found by it to be due. If the taxpayer has failed, without good cause, to file a return within the time prescribed by law, or has filed a fraudulent return or, having filed an incorrect return, has failed, after notice, to file a proper return, the tax commission shall not reduce the tax below double the amount for which the taxpayer is found to be properly assessed.

Sec. 701. **Appeal.** The determination of the tax commission upon any application made by a taxpayer for revision of any tax, may be reviewed in any court of competent jurisdiction by a complaint filed by the taxpayer against the tax commission in the county in which the taxpayer resides or has his principal place of business, within thirty days after notice by the tax commission of its determination, given as provided in section 700 of this act. Thereupon, appropriate proceedings shall be had and the relief, if any, to which the taxpayer may be found entitled may be granted and any taxes, interest or penalties paid, found by the court to be in excess of those legally assessed, shall be ordered refunded to the taxpayer, with interest from time of payment.

Article VIII

ADMINISTRATION

Sec. 800. **Tax commission to administer this act; districts.** The tax commission shall administer and enforce the tax herein imposed, for which purpose it may divide the state into districts, in each of which a branch office of the tax commission may be established. It may from time to time change the limits of such districts.

Sec. 801. **Powers of tax commission.** The tax commission, for the purpose of ascertaining the correctness of any return or for the purpose of making an estimate of the taxable income of any taxpayer, shall have power to examine or cause to be examined by any agent or representative designated by it for that purpose, any books, papers, records or memoranda, bearing upon the matters required to be included in the return, and may require the attendance of the taxpayer or of any other person having knowledge in the premises, and may take testimony and require proof material for its information, with power to administer oath to such person or persons.

Sec. 802. **Officers, agents and employees.** 1. The tax commission may appoint and remove a person to be known as the income tax director who, under its direction shall have supervision and control of the assessment and collection of the income taxes provided in this act; the tax commission may also appoint such other officers, agents, deputies, clerks and employees as it may deem necessary, such persons to have such duties and powers as the tax commission may from time to time prescribe.

2. The salaries of all officers, agents and employees employed by the tax commission shall be such as it may prescribe, not to exceed such amounts as may be appropriated therefor by the legislature, and the members of the tax commission and such officers, agents and employees shall be allowed such reasonable and necessary traveling and other expenses as may be incurred in the performance of their duties, not to exceed the amounts appropriated therefor by the legislature.

3. The tax commission may require such of the officers, agents and employees as it may designate, to give bond for the faithful performance of their duties in such sum and with such sureties as it may determine, and all premiums on such bonds shall be paid by the tax commission out of monies appropriated for the purpose of this act.

Sec. 803. **Oaths and acknowledgments.** The members of the tax commission and such officers, as it may designate, shall have the power to administer an oath to any person or to take the acknowledgment of any person in respect of any return or report required by this act or the rules and regulations of the tax commission.

Sec. 804. **Publication of statistics.** The tax commission shall prepare and publish annually statistics reasonably available, with respect to the operation of this act, including amounts collected, classifications of taxpayers, income and exemptions, and such other facts as are deemed pertinent and valuable.

Sec. 805. **Secrecy required of officials; penalty for violation.** 1. Except in accordance with proper judicial order or as otherwise provided by law, it shall be unlawful for the members of the tax commission, any deputy, agent, clerk or other officer or employee, to divulge or make known in any manner the amount of income or any particulars set forth or disclosed in any report or return required under this act. Nothing herein shall be construed to prohibit the publication of statistics, so classified as to prevent the identification of particular reports or returns and the items thereof, or the inspection by the attorney general or other legal representatives of the state, of the report or return of any taxpayer who shall bring action to set aside or review the tax based thereon, or against whom an action or proceeding has been instituted to recover any tax or any penalty imposed by this act. Reports and returns shall be preserved for three years and thereafter, until the tax commission orders them to be destroyed.

2. Any offense against subdivision one of this section shall be punished by a fine of not exceeding one thousand dollars or by imprisonment not exceeding one year, or both, at the

discretion of the court, and if the offender be an officer or employee of the state, he shall be dismissed from office and be incapable of holding any public office in this state for a period of five years thereafter.

3. Notwithstanding the provisions of this section, the tax commission may permit the commissioner of internal revenue of the United States, or the proper officer of any state imposing an income tax upon the incomes of individuals, or the authorized representative of either such officer, to inspect the income tax returns of any individual, or may furnish to such officer or his authorized representative an abstract of the return of income of any taxpayer or supply him with information concerning any item of income contained in any return, or disclosed by the report of any investigation of the income or return of income of any taxpayer; but such permission shall be granted or such information furnished to such officer or his representative, only if the statutes of the United States or of such other state, as the case may be, grant substantially similar privileges to the proper officer of this state charged with the administration of the personal income tax law thereof.

Sec. 806. **Regulations.** The tax commission may from time to time make such rules and regulations, not inconsistent with this act, as it may deem necessary to enforce its provisions.

Article IX

MISCELLANEOUS

Sec. 900. **Distribution of the income tax.**

[Provision should be made whereby the proper officials shall be notified concerning the amount each locality is to receive from the income tax, in time to enable them to take account of such receipts when determining the amount of the local tax levied in each year.

Care should be taken to provide that a reasonable amount be withheld from distribution to the state or to the localities, in order to enable the commission to promptly make refunds to which taxpayers are found to be entitled.

For purposes of reference, the following methods of distribution contained in the statutes of various states having income tax laws, may be useful:

Delaware, L. 1917, Ch. 8; 1919, Ch. 157, Art. 14, § 212.

Mass., L. 1917, Ch. 209, 317, 339; 1918, Ch. 107, 154, 219; 1919, Ch. 314, § 1; Ch. 363, Part I.

N. Y., L. 1920, Ch. 694.

Wisc., L. 1917, Ch. 485.]

Sec. 901. **Exemption of intangible personal property from taxation.**

[Provision should be made for exempting intangible personal property from taxation under the property tax, as recommended in the Preliminary Report of the committee. The wording of such a provision will necessarily have to depend upon the language employed in the tax law of each state, and no provision can possibly be drawn which will be applicable to all states. The importance of providing for such exemption is so great that the committee feels obliged to record here its belief that a personal income tax cannot be expected to operate satisfactorily in a state which continues to tax intangible personal property under the property tax.

For purposes of reference, the following exemption provisions, contained in the statutes of various states having income tax laws, may be useful:

Mass., L. 1918, Ch. 257, § 69.

N. Y., L. 1920, Ch. 120.

No. Dak., L. 1919, Spec. Sess., Ch. 62.

Wis., L. 1911, Ch. 658, Secs. 2 & 3 (p. 999).]

Sec. 902. **Contract to assume tax illegal.** It shall be unlawful for any person to agree or contract directly or indirectly to pay or assume or bear the burden of any tax payable by any taxpayer under the provisions of this act. Any such contract or agreement shall be null and void and shall not be enforced or given effect by any court.

Sec. 903. **Unconstitutionality or invalidity.** If any clause, sentence, paragraph, or part of this act shall, for any reason, be adjudged by any court of competent jurisdiction to be invalid, such judgment shall not affect, impair, or invalidate the remainder of this act, but shall be confined in its operation to the clause, sentence, paragraph or part thereof directly involved in the controversy in which such judgment shall have been rendered. No caption of any section or set of sections shall in any way affect the interpretation of this act or any part thereof.

Sec. 904. **Taking effect of the act.** This act shall take effect on ———.

[Since several months are required for the work preliminary to the assessment of an income tax, the date at which the law becomes effective ought to be such as to leave sufficient time for such work.]

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INDEX

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