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THE SECRETARY OF THE TREASURY  
WASHINGTON

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My dear Mr. President:

The investigation of the income tax returns for each successive year reveals the increasingly stubborn fight of wealthy individuals and corporations against the payment of their fair share of the expenses of their Government. Although Mr. Justice Holmes said: "Taxes are what we pay for civilized society," too many citizens want the civilization at a discount. We are eliminating, one by one, devices for tax avoidance and evasion and loopholes in the law, but each one eliminated seems to cause an increased use of the remaining schemes. Sales between husbands and wives are no longer popular, since the Mitchell case; legislation following the Pecora investigation largely stopped tax evasion through security partnerships; and educational trusts of the pictures kept in one's house had too much publicity in the Mellon case to commend them to further use. But we still have too many cases of what I may call moral fraud -- that is, the defeat of taxes through doubtful legal devices which have no real business purpose nor utility, and to which a downright honest man would not resort to reduce his taxes.

Your Administration has been notable for demanding a higher standard of morality in commercial dealings. We need a higher standard of morality in the dealings of the citizen with his Government.

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Taxes

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To give point to my statements, I want to list below some of the devices which have caused our 1937 revenues to be less than they should have been, and the names of the taxpayers employing them. Our audit of the 5,500,000 returns for 1936 is only beginning, but our initial check has revealed these facts, which I believe you ought to know at once.

1. 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 by means of many trusts may effect a greater saving, while leaving the money actually in the same hands. Thus, Mr. Louis Blaustein of Baltimore has established 64 different trusts in favor of his wife and three children. The beneficiaries thereby claimed a tax saving in one year of \$485,257. Mr. Charles E. Merrill and Mr. Edwin C. Lynch of Merrill, Lynch & Company, 40 Wall Street, New York, have 40 trust funds, as well as 23 personal holding corporations. They operate a great many numbered brokerage accounts and only at the end of the year identify for whose benefit the account has been operated. In this way innumerable transactions are carried on between the different corporations and trusts which have no effect upon the beneficial interest of Merrill and Lynch, but which are designed to reduce their tax liability very greatly. Grenville Clark of Root, Clark, Buckner & Ballantine, and his wife, have 16 trusts. There are undoubtedly a great many more instances of the same sort which will be disclosed in our audit of the 1936 returns.

2. Foreign personal holding corporations organized in the Bahamas, Panama, and Newfoundland, where taxes are low and corporation laws lax.

Americans have formed 64 such companies in the Bahamas alone in the last two years and 22 more were organized by Americans in the Bahamas during the past six weeks. 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. Thus, Mrs. Dorothy Whitney Elmhirst originally organized her personal holding company in the Island of Guernsey and then moved it to Panama; and the corporate books are kept in Newfoundland. George Westinghouse, Jr. has a \$3 million Bahamas corporation and in an attempt to prevent the Bureau of Internal Revenue from catching up with him, moves his home address from one small hamlet to another each year. He reported from Saanichton, Vancouver Island, British Columbia one year; the year before he reported from Seabold, Washington. The Bureau having secured access to the records of the International Corporation Company of New York, which is active in forming Bahamas and Panama corporations, it now organizes such corporations through its Paris subsidiary, International Corporation Company S. A., free from the possibility of our investigations.

Wallace Groves of the General Investment Corporation has two Bahamas corporations with a nominal capitalization. His General Investment Corporation, which is reported to have cost the public a loss of \$67 millions between 1932 and 1936 out of total assets of \$77 millions, is under investigation by the SEC, and Mr. Groves seems to have left the country. One of the transactions disclosed by the investigation was the sale of

the Buenos Aires subway, on which one Philip De Ronde was paid a commission of \$250,000. De Ronde caused the commission to be paid to his Bahamas Company and is defying us to collect the tax upon it. By way of insult he has offered to compromise his admitted tax liability of \$33,000 for past years by a payment of \$1,700.

Another indication of the magnitude which this avenue of tax avoidance may assume is afforded by the case of Jules S. Bache of New York. Mr. Bache's personal return showed no taxable income for 1936. We have discovered, however, that Mr. Bache, his two daughters, and trusts in favor of the daughters own the Wenonah Development Company, Ltd. of Canada, which had income from American dividends in the amount of \$1,606,000. No return has yet been filed for this corporation. It is interesting to note further that Mr. Bache deducted \$89,400 on his personal return as interest on a loan made to him by his personal holding company.

The most flagrant case of this character is perhaps that of Jacob Schick, formerly a Lieutenant Colonel in the United States Army. Schick was the owner of all the stock of the Schick Dry Shaver Company of Connecticut. On December 18, 1935, he became a British subject through naturalization in Canada. He had been drawing a pension from the United States Army and he inquired from the Secretary of War if he could continue to draw his pension. The Secretary advised him on February 5, 1936 that he was no longer entitled to a pension and he was directed to return the retirement pay checks he had received after December 18th. On December 24, 1935, six days after his naturalization, Schick formed Schick Industries, Ltd. in the Bahamas and transferred to it his stock in the Connecticut

company. He thereby evaded the provision of our laws imposing a 25 percent tax on transfers of securities to foreign corporations. He owns the stock of three other Bahamas corporations, the purpose of which is not yet clear. The Intelligence Unit is now investigating Colonel Schick's case with a view to fraud charges.

3. Bahamas insurance companies

A New York insurance agent caused the organization of two insurance companies in the Bahamas with a view to enabling taxpayers to secure fake deductions for interest through an ingenious scheme for the issuance of large 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 "policy-holder" sought to obtain a large deduction for interest on this loan, although the fact was that no interest was really paid. By this means six Americans, Mr. Richard E. Dwight, Henry W. Lowe, Mr. Jacob Schwab, Mr. Lawrence Marx, Mr. George Thoms, and Dr. Winfield Ayres sought to evade nearly \$550,000 in income taxes in the years 1932 to 1936. The fraud was discovered by the Special Intelligence Unit and all of the taxpayers have now submitted offers to pay the full amount of taxes evaded, plus interest. Mr. Dwight is a senior partner in the law firm of Hughes, Schurman & Dwight, 100 Broadway, New York.

4. Domestic personal holding companies

The rates of tax applicable to personal holding companies were reduced in 1936 and are not now sufficiently high to discourage the use of such companies as a valuable means of avoiding the surtaxes. The personal

holding companies that we have examined would have paid 81.7 percent more in taxes on their 1936 returns if the applicable tax rates had not previously been reduced. Thus, the personal holding company owned by the late Mr. Charles Hayden distributed none of its income in 1936; and Mr. Hayden thereby saved \$322,958 in taxes. Mr. and Mrs. Alfred P. Sloan had their personal holding companies distribute a portion of the corporate earnings; but the use of the companies saved the Sloans \$791,054 in 1936. Mr. and Mrs. Roy W. Howard have employed a personal holding company to great advantage in the purchase of additional newspaper properties. In 1936, their personal holding company reported over \$500,000 of net income but the total taxes paid by the two Howards were less than \$60,000. If the personal holding company were not in existence, they would have had to pay over \$200,000 in additional taxes. The Schaefer Brewing Company of Brooklyn, an operating company owned by two brothers and their wives, showed an increase of net income from \$1,050,204 in 1935 to \$1,825,460 in 1936; but distributed only \$300,000 in dividends in 1936 as against \$500,000 in 1935. If the dividends had kept pace with the increased earnings, the Treasury would have collected \$246,073 additional in taxes.

Another favorite device is to organize a considerable number of personal holding companies for the sake of reducing the tax and of increasing the Treasury's difficulties in auditing transactions between companies. I have already referred to the 23 personal holding companies of Mr. Charles E. Merrill and Mr. Edwin C. Lynch. According to our last

report (for 1933), Mr. William Randolph Hearst was interested in some 96 companies scattered all over the United States and England. We have not yet been able to discover how many companies he now utilizes, for their returns are filed all over the country, and the job of auditing their tangled transactions is tremendous.

5. Incorporated yachts and country places

Mr. Alfred P. Sloan's yacht is owned by Rene Corporation, one of his personal holding companies, along with \$3 million in securities. He rents the yacht from his company and the company uses its income from securities to pay depreciation on the yacht, the wages of the captain and crew, and the expenses of operating the yacht. None of these items would be deductible if Mr. Sloan owned the yacht personally. A great many wealthy taxpayers are utilizing a similar arrangement for the operation of their country places. Other wealthy taxpayers using this method, the value of their country places and the tax savings they are effecting, are:

|                                  | Value of<br>country place | Tax<br>savings |
|----------------------------------|---------------------------|----------------|
| Alfred I. Du Pont (now deceased) | \$1,039,521               | \$59,000       |
| Mr. & Mrs. Myron C. Taylor       | 1,000,000                 | 15,000         |
| Wm. H. Crocker & family          | 750,000                   | 40,000         |
| Wilhelmina Du Pont Ross          | 421,000                   | 80,000         |
| Harvey D. Gibson                 | 978,000                   | 20,000         |
| Jacob Aron                       | 1,166,457                 | 20,000         |
| Mr. & Mrs. Henry Ittelson        | 565,000                   | 30,000         |

Mrs. Ross has improved on the general plan by causing her personal holding company which owns her country place to pay her husband a salary for managing it. She thereby supplies him with pocket money, and in effect secures a deduction for the expense of maintaining him.

6. Deductions for non-business interests, losses, etc.

Taxpayers are still taking large deductions for interest on loans to them by their own personal holding companies or on loans to them by their family trusts. I have already mentioned the deduction of \$39,400

which Mr. Jules S. Bache took on the loan to him by his Canadian corporation. Mrs. Nathan L. Miller, wife of former Governor Miller, took a deduction of \$35,639 in her 1936 return for a loan to her by her husband as trustee for their seven daughters.

7. Percentage depletion

This is perhaps the best example of legalized theft from the United States Treasury which the revenue laws still permit. Since 1928, the large oil and mining corporations have been entitled to deduct from 5 to 27½ percent 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, the Homestake Mining Company deducted \$2,922,722 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 the revenue that we lost thereby was \$818,517. The similar loss of revenue in the case of the Gulf Production Company of Pittsburgh was \$584,955 (1935); Texas Gulf Sulphur Company, \$413,009 (1935), \$557,487 (1936); Shell Oil Company, \$512,452 (1935); Sun Oil Company, \$272,041 (1934), \$267,091 (1935); Stanolind Oil & Gas Company, \$202,244 (1934); Amerada Petroleum Corporation, \$152,025 (1935). I recommended in 1934 that this provision be eliminated but nothing was done, presumably because of the heavy pressure from the large oil and mining companies which are profiting immensely at the expense of other taxpayers.

8. Division of income between husband and wife, particularly in the 8 community property states

This is another legalized fraud on the revenues 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 \$32,525 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 loss of revenue due to the refusal of members of Congress from the community property states to permit the taxation of their citizens on the same basis as citizens from the other 40 states runs into the millions.

The existence of this legalized discrimination has stimulated the formation of fake partnerships between husbands and wives and their children in other states. Thus, at the end of 1935, Granberry & Company, a New York brokerage firm, took into partnership the four minor children (two boys and two girls) of C. K. Reynolds, one of the partners. The tax saving to Mr. Reynolds in 1936 amounted to \$55,000.

9. Increasing purchases of tax-exempt bonds by wealthy citizens

The last statistics which we have show enormous holdings of tax-exempt state and municipal bonds by our wealthiest citizens. Our records are very incomplete since these individuals do not report fully what their actual holdings are, but our last compilation shows that John D. Rockefeller, Jr. owned over \$32 millions of state and municipal bonds; Frederick W. Vanderbilt, \$28,700,000; E. Sylvia Wilks, \$31,895,000; Mary G. Thompson, \$17,778,000; the late E. H. R. Green, \$14,254,000. Such returns as we have been able to check for 1936 indicate a gradual increase in these holdings.

One of the most disheartening facts disclosed by our investigation is that lawyers of high standing at the bar are advising their clients to utilize devious tax avoidance devices, and they are actively using them themselves. Mr. Dwight and Mr. Clark, prominent New York lawyers, are mentioned above. Among the New York law firms which have formed Panama, Bahamas, or Newfoundland corporations for their clients, are: Sullivan & Cromwell; Palmer & Searles; White, Sims & Houston; and Davis, Polk, Wardwell, Gardiner and Reed.

A recent case decided by the Sixth Circuit, Morsman v. Commissioner, illustrates the same point, and also the long struggle which the Treasury confronts in ferreting out tax evaders and in collecting from them. One Morsman, desired to sell two lots of stock in 1929 at a large profit. Advised by his lawyer brother, he transferred the stock to himself as trustee to accumulate the income for his own benefit for five years, and thereafter to distribute it to himself. He was, therefore, not only settlor and trustee, but sole beneficiary. Having sold the stock during the next week as "trustee" at a profit, he contended that the trust, not he, was taxable thereon. The court has just now, eight years later, decided in favor of the Treasury, and we can now collect the tax and interest. Even so, one dissenting circuit judge could not see Morsman, the individual, behind the legal mask of Morsman, the trustee, for Morsman the sole beneficiary.

In conclusion, I have two observations to make from the evidence before me. In the first place, the instances I have given above were disclosed by a quick check of comparatively few returns. Most of the

large corporation returns have not yet been filed. The general audit of 1936 returns is just beginning. I regret to say that I am afraid the cases I have digested above are symptomatic of a large number of others which will be disclosed by a careful audit. 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 the revenues; it is 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 taxpayers. We have a right to expect higher standards of morality in high places than the 1936 returns disclose.

Faithfully,

*Henry Magrath Jr.*

*May 21<sup>st</sup> 1937.*

The President,

The White House.