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## **Beware Income-Tax Casuistry, Part 2**

**by Sheldon Richman**

The United States got its first income tax during the War Between the States, again demonstrating that war harms ordinary people in more ways than militarily. During any war government becomes an especially voracious consumer of the people's resources and dissent is stifled or suppressed. So it is no surprise that the first income tax came when it did, or that Abraham Lincoln, a devotee of mercantilism, was the father of the tax.

Several successive wartime bills enacting progressive income taxes were passed by Congress, and when the war ended, the income tax did not. Changes to the law got rid of the progressive rate structure, but the tax continued. A flat rate of 5 percent was levied on incomes over \$1,000. The tax, however, was set to expire in 1870. Out of a population of 39.5 million, no more than 250,000 people paid it. But it would not end in 1870. The pro-income-tax forces rallied, and Congress passed a 2.5 percent tax with a \$2,000 exemption. Then, two years later, that tax was allowed to expire. For the first time since the war, (wealthy) Americans did not see their incomes taxed.

The big budget surplus was a major reason the tax was permitted to die. Meanwhile, the pro-tax lobby kept at work, prompting the introduction of 68 bills from 1874 to 1894. A big selling point for populists was that the income tax would permit large reductions in tariffs, which harmed working people for the benefit of wealthy manufacturers. Their wish to relieve workers of the burden of protectionism was admirable, but their strategy was flawed. Eventually, Americans would have an income tax and high tariffs. There's a lesson in that for all would-be tax reformers.

Congress next passed an income tax in 1894, during a depression that ate up the budget surplus. President Grover Cleveland, who said he opposed the tax, let it become law without his signature. The law imposed a 2 percent tax on "gains, profits and incomes" over \$4,000 during a five-year period. Few people would have paid it — and it had a short life, because it was successfully challenged by a bank stockholder, Charles Pollock, who objected that taxation of dividend income as written in the law was unconstitutional because it was not apportioned

among the states. His landmark U.S. Supreme Court case, *Pollock v. Farmers' Loan & Trust Co.* (1895), paved the way for the Sixteenth Amendment.

### ***Pollock and the Supreme Court***

To cut to the chase, the Supreme Court struck down the unapportioned tax. This has led people to conclude that the Court held income taxation itself unconstitutional. But, as we will see, the Court did not say that.

The case had to be argued twice. In the first instance, the Court declared most of the bill unconstitutional, but split 4-4 on the question of whether a tax on general income was also unconstitutional. (One justice was ill.) On rehearing, the Court voted 5-4 to affirm its earlier decision and to add that income taxation per se was not barred by the Constitution.

The majority opinion, written by Chief Justice Melville Fuller, who has a classical-liberal reputation, is instructive. Recall our discussion from Part 1 that the Constitution distinguishes between direct taxes, such as a head, or poll, tax, and “Duties, Imposts and Excises,” presumably indirect taxes. Direct taxes must be apportioned among the states according to the census. Indirect taxes do not have to be apportioned, but must be uniform throughout the country. Recall also that from the beginning, there was no general agreement on precisely which taxes were direct and which were indirect. No less an authority on the Constitution than Fisher Ames said, “It was difficult to define whether a tax is direct or not.” Alexander Hamilton expressed similar uncertainty.

The 1894 tax was comprehensive, which led the Court to consider the nature of the tax as it affected different sources of income. Taking the two rulings together, the Court concluded that a general tax on income, being indirect, was constitutional without apportionment among the states, but that a tax on income from real and personal property, being indistinguishable from a tax on the property itself, was direct taxation and thus required apportionment. Regarding the second point, the Court held,

[Can] it be properly held that the constitution, taken in its plain and obvious sense, and with due regard to the circumstances attending the formation of the government, authorizes a general unapportioned tax on the products of the farm and the rents of real estate, although imposed merely because of ownership, and with no possible means of escape from payment, as belonging to a totally different class from that which includes the property from whence the income proceeds?

... Nor can we perceive any ground why the same reasoning does not apply to capital in personalty held for the purpose of income, or ordinarily yielding income, and to the income therefrom.

Thus the Court said that some taxes on income, depending on the source from which it derives, are direct taxes requiring apportionment. This did not mean that all income taxes were in that category. Determining whether a given tax is direct requires an examination of the income's source.

As to taxation of other income, the Court said it had

not commented on so much of it [the law] as bears on gains or profits from business, privileges, or employments, in view of the instances in which taxation on business, privileges, or employments has assumed the guise of an excise tax and been sustained as such.

In other words, a general income tax is an excise (indirect) tax and does not require apportionment. “[There] is no question as to the validity of this act except [the sections on real and personal property].” Thus the tax on wages, salaries, and profits was held to be constitutional. But this created a problem. If the provisions that taxed income from real estate and securities were stricken, the Court said,

this would leave the burden of the tax to be borne by professions, trades, employments, or vocations; and in that way what was intended as a tax on capital would remain, in substance, a tax on occupations and labor. We cannot believe that such was the intention of congress.

Thus, concluded the Court, “[The] scheme must be considered as a whole.” The entire act was stricken. This is what leads people to believe that income taxation in general was voided, but as we've seen, that is not the case.

The Court stressed that it was not its job to say whether an income tax was desirable. Nevertheless, it reminded the county that “the instrument [Constitution] defines the way for its amendment.”

To summarize, the *Pollock* Court did *not* hold general income taxation unconstitutional. Quite the contrary. It acknowledged that in the United States income taxation was regarded as indirect and not subject to the apportionment rule. All that it found unconstitutional was unapportioned taxation of the income from real estate, stocks, and bonds on grounds that to tax such income was to tax the property itself, hence making the tax direct and in need of apportionment.

Was the Court correct? I don't think so. Surely there is a difference between taxing real-estate holdings and taxing the *income* from such holdings. If one rents a house to someone, the rent is income that would be covered by an income tax. But if one stops renting the house, the income would cease and thus no tax would apply. The same would hold for stock: no dividends,

no tax. Tax would be paid only on the gain at sale. Bonds might be the only exception, since they are held only for the interest income.

So the Court seems to have gotten it mostly wrong. But that's academic. It has been speculated that the conservative Court ruled the way it did because it was partial to the capitalists and did not want income from capital taxed. Who knows? Its ruling was law, leaving to the proponents of full income taxation only one recourse, a constitutional amendment.

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