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## Direct Taxes--Constitutional Law

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DIRECT TAXES—CONSTITUTIONAL LAW.—One of the fundamental weaknesses of the government under the Articles of Confederation was the lack of a power to tax. The revenue of the national government was secured from each state in such amounts as it was pleased to give. Many states failed to provide the central government with a sum in keeping with their size and wealth, with the result that the treasury was constantly in lack of funds.<sup>1</sup> In order to permit the central government to acquire needed funds, it was provided in the Constitution that Congress should enjoy the power to tax.<sup>2</sup> However, since the individual states depended for their revenue principally upon taxes upon land, it was further provided that the taxing power of Congress, although absolute,<sup>3</sup> was to be exercised primarily in the levying of indirect taxes, such as duties, imposts, and excises,<sup>4</sup> and that direct taxes might be levied only in accordance with the census.<sup>5</sup> The result of this provision was to leave to the individual states their sources of revenue from direct taxes, and to permit the national government to levy direct taxes only in a definite way.

The question as to what constitutes a direct tax requiring apportionment has not been clear at all times.<sup>6</sup> During the first century of our national life under the Constitution the Supreme Court upheld, as a duty or an excise, the validity of a tax upon carriages,<sup>7</sup> upon the income of insurance companies,<sup>8</sup> upon bank-notes,<sup>9</sup> upon the taking of title to land by will or descent,<sup>10</sup> and upon the gains,

<sup>1</sup> BURDICK, THE CONSTITUTION (1922) §12.

<sup>2</sup> UNITED STATES CONSTITUTION, Art. I, §8, cl. 1.

<sup>3</sup> "If Congress sees fit to impose a capitation or other direct tax, it must be laid in proportion to the census; if Congress determines to impose duties, imposts, and excises, they must be uniform throughout the United States. These are not strictly limitations of power. They are rules prescribing the mode in which it shall be exercised. It still extends to every object of taxation, except exports, and may be applied to every object of taxation to which it extends in such measure as Congress may determine." *Veazie Bank v. Fenno*, 8 Wall. 533, 541 (U. S. 1869).

<sup>4</sup> "The term 'excises' has generally the meaning of taxes on a privilege, such as that of being a corporation, or on some act or transaction, such as consumption, sale or manufacture. The terms 'imposts' and 'duties,' though sometimes used to include all taxes, are more properly applied to taxes on exports and imports." BURDICK, *op. cit. supra* note 1, at §80.

<sup>5</sup> "No capitation or other direct tax shall be laid unless in proportion to the census or enumeration hereinbefore directed to be taken." UNITED STATES CONSTITUTION, Art. I, §9, cl. 4.

<sup>6</sup> "From an economic viewpoint, direct taxes include those assessed upon the property, person, business, income, etc., of those who are to pay them, while indirect taxes are levied upon commodities before they reach the consumer, and are paid by those upon whom they fall, not as taxes, but as part of the market price of the commodity." COOLEY, TAXATION (4th ed.) §50.

<sup>7</sup> *Hylton v. United States*, 3 Dall. 171 (U. S. 1796).

<sup>8</sup> *Veazie Bank v. Fenno*, *supra* note 3.

<sup>9</sup> *Pacific Insurance Co. v. Soule*, 7 Wall. 433 (U. S. 1868).

<sup>10</sup> *Scholey v. Rew*, 23 Wall. 331 (U. S. 1874). The tax was held to be not a tax upon the property, but upon the exercise of the right to take property by descent and was therefore an excise tax, not a direct tax.

profits, and income of an individual.<sup>11</sup> It thus appeared that the only taxes to be considered direct taxes subject to the constitutional requirement that they be apportioned among the states according to the census were capitation taxes and taxes on land.<sup>12</sup>

Thus the matter stood until the decisions in the famous case of *Pollock v. Farmers' Loan and Trust Co.*<sup>13</sup> It was there held by a divided court that a tax on the rents or income of real estate and on personal property or the income thereof was a direct tax requiring apportionment. Had the court expressly overruled the earlier cases, the decision might have been more favorably received. Certainly there appeared to be much in the political and economic background of the framing of the section in question to support the decision reached.<sup>14</sup> However, it contented itself with trying to distinguish the earlier cases when no reasonable distinction could be drawn between them and the case at hand.<sup>15</sup>

The rigor of the decision in the *Pollock* case was lessened by subsequent decisions<sup>16</sup> which held to be excise taxes certain taxes which might, by a strict construction, have been held to be direct taxes, and it was finally abrogated by the Sixteenth Amendment,<sup>17</sup> in so far as it concerned a tax upon income.

<sup>11</sup> *Springer v. United States*, 102 U. S. 586 (1880). The opinion contained the following significant *dictum*: "Our conclusions are, that direct taxes within the meaning of the Constitution, are only capitation taxes, as expressed in that instrument, and taxes on real estate."

<sup>12</sup> "The foregoing line of cases, concluding with the emphatic assertion of a unanimous court in *Springer v. United States*, justly gave rise to the general opinion that the only taxes to be deemed direct taxes within the constitutional meaning of that term were capitation taxes and taxes on real estate." WILLOUGHBY, *THE CONSTITUTION* (2d ed.) §398.

<sup>13</sup> 157 U. S. 429, 15 Sup. Ct. 373 (1895); 158 U. S. 601, 15 Sup. Ct. 912 (1895).

<sup>14</sup> The briefs of counsel and the court's opinion on the first hearing abound with references to political and economic beliefs at the time of the adoption of the Constitution. See 157 U. S. 429, 452-469, 558-572, 15 Sup. Ct. 373 (1895).

<sup>15</sup> 34 Am. Law Reg. 380 (1895).

<sup>16</sup> *Nicol v. Ames*, 173 U. S. 509, 19 Sup. Ct. 522 (1899) (a tax levied on sales of goods at exchanges is not a direct tax, but an excise tax on the privilege of doing business at such places); *Knowlton v. Moore*, 178 U. S. 41, 20 Sup. Ct. 747 (1900) (an inheritance tax is a tax not on the property, but on the right to receive it); *Spreckels Sugar Refining Co. v. McClain*, 192 U. S. 397, 24 Sup. Ct. 376 (1904) (a tax on the sugar refining business is an excise tax on the right to carry on such business even though the amount of the tax is based on the income of the company); *Flint v. Stone Tracy Co.*, 220 U. S. 107, 31 Sup. Ct. 342 (1911) (a tax on corporations computed on the basis of its net income is an excise tax on the privilege of doing business in the corporate character). See also *Stratton's Independence v. Howbert*, 231 U. S. 399, 34 Sup. Ct. 136 (1913) and *Anderson v. Forty-Two Broadway Co.*, 239 U. S. 69, 36 Sup. Ct. 17 (1915).

<sup>17</sup> "The Congress shall have power to lay and collect taxes on incomes, from whatever sources derived, without apportionment among the several States, and without regard to any census or enumeration." UNITED STATES CONSTITUTION, Art. XVI. *Brushaber v. Union Pacific R. Co.*, 240 U. S. 1, 36 Sup. Ct. 230 (1916); Note (1916) 29 HARV. L. REV. 536.

Recently the question of direct taxation requiring apportionment has again engaged the attention of the courts in connection with the taxes levied upon the net income of life insurance companies. Beginning with the Revenue Act of 1921 a special mode of taxation for these companies was provided since it was found difficult to apply to such organizations the general methods of corporation taxation.<sup>18</sup> The gross income of a life insurance company was declared to be the total of interest, dividends, and rents. From the gross income the company might deduct several items, including taxes upon buildings owned by it, together with a reasonable allowance for cost of operation and depreciation in value. It was further provided that in those cases in which a building owned by a life insurance company was occupied in part by the company and in part by other tenants, the aforementioned deductions should not be allowed, unless there were included in the gross income the rental value of the space occupied by the insurance company. This figure was to be a sum, which, when added to the rents received from the tenants, would give a four per cent return on the book value of the building, after the deductions for taxes, expenses, and depreciation were made.<sup>19</sup> The result of the calculation prescribed by the statute was to arrive at a rental value of the company's space which was wholly arbitrary and bore no direct relation to the actual value of such space.<sup>20</sup>

<sup>18</sup> REPORT No. 275, Finance Comm., U. S. Senate, 67th Cong., 1st Sess., p. 20 (1921); REPORT No. 350, Comm. on Ways and Means, House of Rep., 67th Cong., 1st Sess., p. 14 (1921). HOLMES, FEDERAL INCOME TAX (6th ed.) §165.

<sup>19</sup> REV. ACT OF 1921, §245, 42 Stat. 227, 261, "(a) That in the case of a life insurance company the term 'net income' means the gross income less—

"(6) Taxes and other expenses paid during the taxable year exclusively upon or with respect to the real estate owned by the company. \* \* \*

"(7) A reasonable allowance for the exhaustion, wear and tear of property, including a reasonable amount for obsolescence \* \* \*.

"(b) No deduction shall be made under paragraphs (6) and (7) of subdivision (a) on account of any real estate owned or occupied in whole or in part by a life insurance company unless there is included in the return of gross income the rental value of the space so occupied. Such rental value shall be not less than a sum which in addition to any rents received from other tenants shall provide a net income (after deducting taxes, depreciation and all other expenses) at the rate of 4 per cent. per annum of the book value at the end of the taxable year of the real estate so owned or occupied." Similar provisions are found in the REV. ACT OF 1924, §245 (a) (6), (7), (b), 43 Stat. 253, 289, 26 U. S. C. §1004 (a) (6), (7), (b); REV. ACT OF 1926, §245 (a) (6), (7), (b), 44 Stat. 9, 47, 26 U. S. C. §1004 (a) (6), (7), (b); REV. ACT OF 1928, §203 (a) (6), (7), (b), 45 Stat. 791, 843, 26 U. S. C. §2203 (a) (6), (7), (b).

<sup>20</sup> The operation of the statute may be expressed by the following formula: Rents from tenants + rental value of company's space — expenses = Taxable Income. The rental value of the company's space was arrived at by subtracting from the expenses of the building the amount of rents received from tenants and adding to that result a sum equal to four per cent. of the book value of the building.

The formula may then be expressed as: Rents + (expenses — rents + four per cent. of book value) — expenses = Taxable Income. The result of this formula is to arrive at a taxable income which is equal to four per cent. of the

The legislation was attacked by the insurance companies on the ground that to require them to include in their gross income a figure representative of the rental value of space occupied by them in their own buildings amounted to the levying of a tax upon such rental value and was unconstitutional within the rule of the *Pollock* case. The lower courts were inclined to support that view and held that inasmuch as the rental value of space occupied by the companies did not constitute "income" within the meaning of the Sixteenth Amendment,<sup>21</sup> the tax was unconstitutional as a direct tax which had not been apportioned.<sup>22</sup>

Reliance was also placed upon the decision in *National Life Insurance Co. v. United States*<sup>23</sup> which held to be invalid a provision of a federal tax statute which, although permitting an insurance company to deduct from its gross income the dividends received on municipal and state bonds, required it to deduct from a lawful deduction a sum equal to the deduction already allowed on the tax-exempt securities. This requirement nullified the exemption granted in the first case and resulted in the imposition of a tax on the income of tax-exempt bonds.<sup>24</sup> It was felt that the requirement that an insurance company include in its gross income the rental value of space occupied by it was equivalent to a tax upon the rental value of that space and was unconstitutional within the rule of the *National Life Insurance Co.* case in that an attempt was made to do indirectly that which might not be done directly.

The Supreme Court, when faced with the problem, admitted two of the main arguments of the insurance companies. It admitted that a tax upon the rental value of land is a direct tax requiring apportionment, and it admitted that the rental value of a building does not constitute "income" within the meaning of the Sixteenth Amendment. Further than that it refused to go. It decided<sup>25</sup> that

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book value of the building, regardless of the amount of rents collected and expenses disbursed. See *infra* note 30.

<sup>21</sup> "Income may be defined as the gain derived from capital, from labor, or from both combined." *Eisner v. Macomber*, 252 U. S. 189, 207, 40 Sup. Ct. 189 (1920).

<sup>22</sup> *Independent Life Ins. Co. v. Commissioner of Int. Rev.*, 17 B. T. A. 757 (1929), *aff'd*, 67 F. (2d) 470 (C. C. A. 6th, 1933); *Reserve Loan Life Ins. Co. v. Commissioner*, 18 B. T. A. 359 (1929); *Two-Republics Life Ins. Co. v. Commissioner*, 21 B. T. A. 1335 (1931); *Jefferson Standard Life Ins. Co. v. Commissioner*, 25 B. T. A. 1335 (1932); *Volunteer State Life Ins. Co. v. Commissioner*, 27 B. T. A. 1149 (1933); *Missouri State Life Ins. Co. v. Commissioner*, 29 B. T. A. 401 (1933). *Contra*: *Commissioner v. La Fayette Life Ins. Co.*, 67 F. (2d) 209 (C. C. A. 7th, 1933); *Commissioner v. Rockford Life Ins. Co.*, 67 F. (2d) 213 (C. C. A. 7th, 1933); see Note (1934) 82 U. OF PA. L. REV. 408; Note (1934) 43 YALE L. J. 664.

<sup>23</sup> 277 U. S. 508, 48 Sup. Ct. 591 (1928).

<sup>24</sup> A tax upon the principal or interest of a state or municipal obligation is a tax upon an instrumentality of such state or municipality and is void. *Pollock v. Farmers' Loan and Trust Co.*, *supra* note 12, at 584, 15 Sup. Ct. 373.

<sup>25</sup> *Helvering v. Independent Life Ins. Co.*, 292 U. S. 371, 54 Sup. Ct. 758 (1934). Mr. Justice McReynolds dissented from the decision.

since Congress has power to grant or withhold deductions from gross income,<sup>26</sup> it may grant a deduction upon condition that the deduction allowed by law be diminished by the inclusion in the gross income of a sum equal to the rental value of the space occupied by the company. The court does not look upon the addition of such sum to the gross income as a real addition to the latter figure, but merely as a mathematical calculation employed for a concededly lawful purpose, that of reaching the net income which Congress desires to tax.<sup>27</sup>

The *National Life Insurance Co.* case was distinguished upon the ground that in that case a real tax burden was sought to be levied by a condition that a lawful exemption be lessened to the extent that a previous exemption had been given. In the instant case the effect of the statute was merely to create a tax burden which, although on its face a real burden by virtue of the inclusion of the rental value of the company's space in the gross income, does not constitute a burden at all by reason of the exemption granted in the deduction permitted to reach the net income.

The decision appears to be correctly arrived at when one considers the absolute power of Congress to tax, its discretion to grant or withhold exemptions where the withholding of exemptions will not result in taxation of something which Congress may not lawfully tax, and the fact that the inclusion of a sum in gross income does not necessarily make such sum taxable.

In this connection it is interesting to note that Congress, in enacting the Revenue Act of 1932, saw fit to change the sections of the prior acts which gave rise to the litigation discussed above,<sup>28</sup>

<sup>26</sup> Citing *Burnet v. Thompson Oil and Gas Co.*, 283 U. S. 301, 51 Sup. Ct. 418 (1931) which held to be lawful a tax which was imposed upon the net income of a corporation even though the deduction from gross income allowed by the statute for depletion was less than the actual depletion.

<sup>27</sup> The court refers with approval to the dissenting opinion of Tuttle, J., in *Commissioner v. Independent Life Ins. Co.*, *supra* note 22, at 473 of 67 F. (2d) wherein it is said: "Congress had the power to impose a tax upon *A*, the gross income, and to provide for *C*, the gross deduction permitted by the act, and to reduce that deduction by subtracting therefrom *B*, the rental value of the property. The resulting remainder to be taxed is the same whether we add *B*, the rental value, to the subtrahend *A*, or subtract it from the minuend *C*. Neither imposes a tax upon the use or value of real estate. Both take the 'rental value' of such use, as measured by the act, into account in determining the deduction permitted. The only difference is in the means of doing the same arithmetical problem. The act provides for adding *A* and *B* and then subtracting *C* which, it seems to me, as it evidently did to Congress, is more simple than subtracting *B* from *C* and then subtracting the remainder so obtained from *A*."

<sup>28</sup> "The deduction under subdivision (a) (6) or (7) of this section on account of any real estate owned and occupied in whole or in part by a life insurance company, shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this section) as the rental value of the space not so occupied bears to the rental value of the entire property." REV. ACT OF 1932, §203 (b), 47 Stat. 169, 225, 26 U. S. C. §203 (b).

partly on the ground that it feared the sections in the old act to be invalid and partly on the ground that the depressed condition of the real estate market made the rental value of the company's space, as defined in the statutes, a figure not representative of the true state of affairs,<sup>29</sup> since the rental value of the company's space varied inversely with the rents received from other tenants.<sup>30</sup> The company is no longer required to include in its gross income the rental value of space occupied by it but its deduction for taxes, expenses, and depreciation is limited to a sum which bears the same ratio to the total of taxes, expenses, and depreciation as the rental value of the space not occupied by the company bears to the rental value of the entire property.<sup>31</sup> This provision appears to be more reasonable and equitable than the former one which was purely arbitrary and bore no real relation to the facts of each case.

JOHN F. MITCHELL.

THE TAXATION OF CORPORATE INCOME—UNIFORMITY UNDER EQUAL PROTECTION CLAUSE.—In a recent decision of the United States Supreme Court<sup>1</sup> determining the validity of a tax measure, the Court was confronted with the problem of whether it should be guided by the nature of the tax imposed, or the name assigned to the tax by the taxing statute. It appears that the state of Illinois levied a tax on the net receipts of foreign corporations engaged in fire, marine and inland navigation insurance business. The net re-

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<sup>29</sup> "The Board of Tax Appeals has held that this limitation or condition upon the deduction is unconstitutional, and that the company may still deduct the entire amount of depreciation, taxes and other expenses upon its whole property notwithstanding there is included in its gross income rent from only a part of the property. Without regard to the legality of the present provisions, your committee believes that these provisions would operate somewhat severely in present depressed condition of real estate, and that is more equitable merely to allow so much of these deductions as pertain to the part of the property which is occupied by the company than to allow such deductions in full upon condition of including in gross income a more or less arbitrary determination of rental value." REPORT No. 665, Finance Comm., U. S. Senate, 72d Cong., 1st Sess., p. 36 (1932).

<sup>30</sup> See *Helvering v. Independent Life Insurance Co.*, *supra* note 25, in which case the operation of the old statute resulted in the rental value of the taxpayer's space being \$14,784 in 1923 and \$34,400 in 1924, although there had been only small changes in the taxes, expenses, and depreciation and in the book value of the building while rents from tenants showed a slight decline.

<sup>31</sup> REGULATIONS 77, Art. 976 (1933) in explaining the operation of the new section states: "For example, if the rental value of the space not occupied by the company is equal to one-half of the rental value of the entire property, the deduction for taxes, expenses and depreciation is one-half of the taxes, expenses and depreciation on account of the entire property."

<sup>1</sup> *Concordia Fire Ins. Co. v. Illinois*, 292 U. S. 535, 54 Sup. Ct. 830 (1934).