

Symposium

FOREWORD: 100 YEARS UNDER THE INCOME TAX

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This past year was the hundredth year that the modern income tax has been collected. No one, critics or fans alike, can deny the importance of this institution in shaping the political landscape of the United States in the twentieth century. One can speculate that the income tax has been the focus of more political energy, both inside and outside Washington, than any other single topic during those hundred years. To mark this anniversary, on April 5, 2013, the *Northwestern University Law Review* and the Tax Program at Northwestern sponsored a symposium at which the papers in this volume were presented.

Together these papers explore the introduction and evolution of the income tax as a political and legal institution. The modern income tax has been remarkably durable. This was not inevitable. Indeed, Congress first used an income tax (along with a wide variety of other tax instruments) to fund the Civil War. Once that conflict was over, the early income tax was allowed to expire. But over the next decades, demand grew for a tax that would effectively reach more sources of wealth than were touched by the traditional state property taxes. Demand also grew for an approach to funding the federal government that avoided the political morass associated with the tariff. These pressures together resulted in the 1898 income tax, which was struck down on constitutional grounds in *Pollock v. Farmers' Loan & Trust Co.*¹ before it could have much practical impact. The tax nevertheless had become a fixture in the political imagination of the nation.

The movement in support of a federal income tax swelled again a decade later. Perhaps as much at the urging of income tax opponents (who hoped the delay involved in ratifying a constitutional amendment would sap the movement's strength) as at the insistence of its supporters, the provision that would become the Sixteenth Amendment was sent to the states for ratification in 1909. It was adopted by the states relatively quickly, with a sufficient number of states reporting their ratification to allow its enactment in the spring of 1913. Eric Jensen's contribution to this volume, *Did the Sixteenth Amendment Ever Matter? Does It Matter*

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¹ 157 U.S. 429, *modified on reh'g*, 158 U.S. 601 (1895).

Today?, reminds us of the constitutional backdrop for these political developments and its continued relevance today.

Tax historians have typically identified the political pressure leading to the income tax as coming largely from progressives and populists, who sought to broaden the tax base beyond real and personal property (the base relied upon with decreasing success by the states) and tariffs on imports (relied upon by the federal government not only for revenue but also for trade and economic policy). With a broader base than could effectively be tapped by these older measures and with an appropriately progressive set of rates, the income tax was seen not just as a tool for raising revenue but also as a tool for income redistribution.

Robin Einhorn, in *Look Away Dixieland: The South and the Federal Income Tax*, adds to this standard story the politics of the South in the twilight of the nineteenth century. Although the progressive political movement may have created a rift in the Republican Party great enough to allow Democratic gains in Congress as Woodrow Wilson became President, the ratification and enactment of the income tax could never have been accomplished without the support of the South. A shift from the tariff to the income tax was anticipated as a double victory by most of the South: first, the tax allowed the lessening of the protectionist tariff and its perceived unfair burdens on the Southern economy, and second, the tax could replace the tariff with a source of federal money that was highly likely to result in payments made by the industrial North that would fund increased federal spending in the South.

The onset of World War I only a few years after the enactment of the 1913 tax undoubtedly contributed to its acceptance. The role of the federal government and therefore its revenue needs underwent dramatic changes in these years, and the reach of the income tax was broadened in response. But the permanence of the tax as a political institution would not be established until the decade after the War had ended, when the tax, albeit contracted, remained in place. In *The Consistency of Conservative Tax Policy*, Marjorie Kornhauser examines the political debates of the 1920s regarding the advisability of retaining the tax. She finds remarkable continuity between those debates and the debates surrounding the tax today: liberals tend to want to deal with the tax as an institution entirely separate from the spending it enables, while conservatives continue to question its place in the free market, federalist system they endorse.

The income tax was expected by its supporters to be both broad based and progressive. The contributions of Henry Ordower, *Schedularity in U.S. Income Taxation and Its Effect on Tax Distribution*, and Tracey Roberts, *Brackets: A Historical Perspective*, examine the extent to which these expectations have been fulfilled. The expansion of the tax base itself meant that the tax would shift the overall financial burden of government in the United States. Ordower demonstrates that although the tax is often touted as being imposed on “income from all sources,” in reality it is more

schedular (that is, imposed differently on income from different sources) than most observers realize. This characteristic also undermines the extent to which the tax is as progressive as its nominal rate structures might suggest.

Roberts examines the history of the income tax's rate structure and how the rates have responded to various political changes, documenting the income tax's shift from a progressive tax on a limited number of taxpayers to a mass tax on most wage earners. She reveals that it is starkly less progressive now than at many times during its history, both when one looks at the level at which no higher bracket exists (holding steady at under \$500,000 since the early 1990s, in contrast to above \$1,500,000 until the early 1960s) and at the level at which a taxpayer leaves the lowest brackets (starting at about \$70,000 in the first income tax and dropping to about \$10,000, where it has been since the late 1960s).² In the same vein, she notes that in the political debates about the appropriate rate structure, discussions of its use as a tool of economic policy have increasingly displaced debates about equity and the redistribution of resources.

Among the factors that contributed to the dissatisfaction with pre-income tax revenue measures was the extent to which the evolution of the American economy had enabled taxpayers to avoid paying them. By the late nineteenth century, the real property taxes imposed by the states no longer captured the wealth of the richest Americans, which was increasingly held in corporate stocks and bonds. Taxes on this wealth, whether in the form of intangible property taxes or excise taxes on paid-in capital, could easily be frustrated by changes in the situs of the entities and by other innovations in their organization. Although state-based property taxes could not tap into the wealth associated with growing and moving business enterprises, through an income tax, a portion of the income flows generated by such enterprises could be diverted as government revenues. There is therefore considerable irony in the fact that the income tax has endured as a revenue source in large part because of its ability to so divert wage income (but not capital income) as a result of reliance on withholding. In *What a History of Tax Withholding Tells Us About the Relationship Between Statutes and Constitutional Law*, Anuj Desai examines the experience of the United States with withholding, a practice that in earlier implementations included payments of interest and dividends, not just payments by employers to employees. In Desai's view, the introduction of wage withholding and the enlistment by the federal government of employers in the revenue-generating process marked an important step in establishing the current fiscal foundations both for Social Security and for the general revenue needs of the United States, even

² These figures are all in inflation-adjusted dollars. The analysis of the lowest bracket takes into account only those items usually included in discussions of the "zero-bracket" amount, and not the interaction with the earned income credit.

though the practice may not have become a quasi-constitutional entrenched institution. Much remains for others to explore about the World War II developments through which the federal government enlisted large employers motivated by provisions in the income tax law as the mechanism for the distribution of social benefits, including retirement income and healthcare, especially when contrasted with the government's failed attempts to similarly enlist financial institutions in the administration of the tax.

Although the fiscal challenges faced by the states in the early decades of the twentieth century may have contributed to the acceptance of new federal sources of revenue, there was little appetite for abandoning the states either as separate fiscal entities or as the source of most substantive law. Although many have suggested that the success of the income tax as a revenue source has precluded the states from maintaining their own fiscal policies, Brian Galle's findings in *Does Federal Spending "Coerce" States? Evidence from State Budgets* suggest that the federal government's financial strength does not need to come at the cost of the fiscal incapacitation of the states.

Even more certainly, the increasing fiscal strength of the federal government did not result in an abandonment of the states as the source of most substantive law. The extent to which the federal income tax has operated primarily as an overlay on state law relationships and institutions has raised continual challenges for the income tax. The income tax statute has always been written as if such things as "interest," "equity," "gifts," and "employee" had some intrinsic and unavoidable meaning. Taxpayers have always had an incentive to relabel and even to restructure their relationships in ways that do not fit easily into the categories the statute as written relies on. Indeed, taxpayers are likely to seek the assistance of state courts and state legislatures to help them in this restructuring. Such incentives led to the major alterations in state community property laws that occurred during the 1940s, aimed at allowing income splitting by married couples, and, more recently, to the wholesale revisions of the laws governing business entities through the invention of LLCs in the first decade of the twenty-first century. In *A Bundle of Confusion for the Income Tax: What It Means to Own Something*, Stephanie McMahon outlines the early attempts of the income tax to classify state law relationships and to identify property, the "owner" of that property, and the income streams related to it, a quest that remains elusive today. In *Tax-Free Reorganizations: The Evolution and Revolution of Triangular Mergers*, Stephanie Hoffer and Dale Oesterle examine the difficulties inherent when federal tax concepts must be superimposed on ever-changing state law rules regarding the restructuring of corporate holdings. Both of these inquiries point out the difficulty encountered by the federal income tax when it is expected to take state law concepts and definitions of economic relationships "as it finds them."

Perhaps more troubling than the tax-induced shifts in state law concepts has been the tax-induced shifts in economic behavior. In the early years of the income tax, these shifts were largely the unintended consequence of the need to draw arbitrary lines, for instance between long- and short-lived assets or between ordinary taxable consumption and expenditures triggered by catastrophic events. But Congress has since become accustomed to manipulating the income tax for purposes other than revenue raising, as the 22 (as of this writing) separate credit provisions following Sections 45 and 48 of the Internal Revenue Code now attest.

As a result of these shifts in its effects and its uses, the income tax, like the tariff a century ago, can no longer claim to be primarily serving its originally intended purposes. It can no longer (if it ever could) be viewed simply as a mechanism whereby a portion of what would otherwise be flows of capital between private parties are diverted to the government. And, like the impact of the tariff at the time of its demise, its overall effect on the economy remains uncertain. The international mobility of capital in the twenty-first century presents challenges for the income tax strikingly similar to those faced by state property tax schemes as they chased intangible wealth across state borders 100 years ago. Neither the impact of the income tax on individual taxpayer behavior nor its ultimate economic incidence is clearly understood, perhaps in part because they are changing too frequently.

It may well be time to drop at least some of the rhetoric that has accompanied the income tax as a political institution, design variants that openly deal with its shortcomings, and reconfigure it to serve broader social goals more effectively. Adam Rosenzweig's offering, *A Corporate Tax for the Next One Hundred Years: A Proposal for a Dynamic, Self-adjusting Corporate Tax Rate*, is an example of such a potential repurposing of the income tax. Although his suggested tax would rely on a deceptively familiar concept of corporate income as its base, by altering its rate in response to the employment practices of taxpayers rather than simply according to their income level, the tax could "self-adjust" its ultimate incidence from employees to equity owners.

Time will only tell what will become of the federal income tax, but there can be no doubt that it was part of an enormous change in the way the American public viewed the federal government over the course of the last one hundred years.

