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CURRENT CONSTITUTIONAL PROBLEMS IN FEDERAL TAXATION

CHARLES L. B. LOWNDES *

The most significant constitutional problem in federal taxation today is the absence of constitutional problems. The federal income, estate and gift taxes all encountered an extremely critical reception at the hands of the courts and suffered serious constitutional set-backs early in their careers. Today, however, they function in a constitutional climate as benevolent as it was formerly hostile. A miscroscopic analysis of the present federal tax system may reveal minor irregularities which might conceivably be magnified into major constitutional issues. From a practical point of view, however, the chance of invalidating a federal tax assessment on constitutional grounds is infinitesimal.

There is no mystery about the radical about-face which has characterized the attitude of the judiciary toward the present federal tax system. Modern federal taxes are more than revenue measures. The federal income, estate and gift taxes represent the aggressive expression of an egalitarian philosophy of sharing the wealth which at first alarmed the courts. The early battles over the constitutionality of the principal federal taxes covertly reflected the more candid struggle which went on in the halls of Congress over the effort of the "have-nots" to shift the bulk of the tax burden to the "haves."[1] With the defeat of the reactionaries in Congress the scene of the struggle shifted to the courts, where a conservative judiciary strove to throw up constitutional barriers around the status quo.

As time went on several factors combined to ameliorate the attitude of the courts. A new generation of jurists came of age, who quite apart from any particular political predilections, saw the progressive principle at the heart of the present federal tax system as part of the established order rather than a dangerous innovation. An older judicial generation under the impact of two world wars and a great depression became reconciled to the necessity of a strong central government adequately financed and was therefore increasingly reluctant to interfere with federal fiscal powers. Presumably, the current international crisis with its grave financial tensions will cast a further damper on any lingering judicial ardor for constitutional tilting with federal taxes.

THE FEDERAL INCOME TAX

As the first of the modern federal taxes, the income tax offers the most complete illustration of the conflicting political and social forces which

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1. BLAKEY, THE FEDERAL INCOME TAX (1940).

have resulted in the present constitutional pattern of the tax. Although the present federal income tax starts with the Sixteenth Amendment, there is a significant page of constitutional history behind the Amendment.

The first federal income taxes were passed during the Civil War. There was never any question about the constitutional power of Congress to impose an income tax, and in *Springer v. United States*[2] the Supreme Court upheld the Civil War income taxes against the attack that they were direct and unapportioned taxes. In *Pollock v. Farmers' Loan and Trust Company*,[3] however, the Court turned its back upon the *Springer* case and invalidated the income tax of 1894 upon the ground that it was a direct and unapportioned tax.

It is extremely doubtful whether there was any new revelation about the constitutional conception of a direct tax between the two decisions. It is, perhaps, of greater significance that the Civil War income taxes were emergency measures, which lacked any particularly offensive political implications, and had been repealed by the time their constitutionality came before the Court. The income tax of 1894, on the other hand, was the product of a long period of depression and economic unrest and represented a conscious attempt to shift the tax burden to the wealthier group in the country, whom a substantial segment of the citizenry held responsible for their plight.[4] The political pressures behind the tax alarmed the Supreme Court. There is little doubt but that the aversion of the Court toward the 1894 tax was an instinctive conservative response to the social philosophy underlying the tax, rather than a reasoned deduction from any clear-cut constitutional definition of a direct tax.

After the *Pollock* case there was persistent popular pressure for a federal income tax which finally culminated in the ratification of the Sixteenth Amendment and the passage of the first federal income tax under the authority of the Amendment. In *Brushaber v. Union Pacific R.R.*,[5] the power of Congress to impose an effective income tax even under the Sixteenth Amendment was challenged. It is scarcely necessary to detail the ingenious arguments advanced against the tax in the *Brushaber* case and the no less ingenious answers of Mr. Justice White. The basis of the attack on the 1913 Act was the exemptions and discriminations, which usually accompany the effort to adjust an income tax to the varying ability to pay the tax of different classes of taxpayers, particularly the graduated rates. The 1913 Act was also challenged on the ground that it was fatally retroactive, since it was passed in October, but undertook to tax income from the previous March.

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2. 102 U.S. 586, 12 Sup. Ct. 586, 26 L. Ed. 253 (1880).
3. 157 U.S. 429, 15 Sup. Ct. 673, 39 L. Ed. 821 (1895).
4. Blakey, The Federal Income Tax 8-20 (1940).
5. 240 U.S. 1, 36 Sup. Ct. 236, 60 L. Ed. 493 (1916).

The taxpayer argued that the progressive rates and other alleged discriminatory features of the 1913 Act destroyed the uniformity of the tax and violated due process. Since the Supreme Court had held in the *Pollock* case that an income tax was a direct tax which must be apportioned, it would seem that the short answer to the uniformity argument would have been that the tax was not an indirect tax and need not be uniform. Mr. Justice White, however, advanced the somewhat startling proposition that an income tax is an indirect tax which also requires apportionment, although he did not undertake to explain how the same tax could be both uniform and apportioned. The Sixteenth Amendment abolished the necessity of apportioning an income tax, but as an indirect tax, it must still be uniform. Having worked up to this point, the Justice continued somewhat anticlimactically to point out that the only uniformity required under the federal constitution is geographic uniformity and the 1913 Act which applied in the same way throughout the several states met this requirement.

Mr. Justice White's disposition of the due process argument was equal to his effort in connection with uniformity. The discriminations of the 1913 Act did not violate due process, he declared, because the Constitution cannot conflict with itself, and what is done under the taxing power cannot be undone under the due process clause. After apparently opening the door to discriminatory taxation, Mr. Justice White prudently slammed it shut again by pointing out that a tax which was outrageously discriminatory would not be a true exercise of the taxing power, and could, therefore, be declared unconstitutional under the due process clause.

Mr. Justice White passed lightly over the attack on the retroactive operation of the 1913 tax by pointing out that since no attempt was made to tax income prior to the adoption of the Sixteenth Amendment, the retroactive operation of the tax was constitutional, inasmuch as it did not go back beyond the period when the Constitution authorized Congress to impose an unapportioned tax on income.

Regardless of the quality of the opinion in the *Brushaber* case, it is an important milestone in the constitutional jurisprudence of the income tax, which solidly establishes the power of Congress to impose such a tax under the Sixteenth Amendment. The attack on the income tax in the *Brushaber* case was cunningly contrived to nullify the Sixteenth Amendment by making it impossible for Congress to impose an income tax with progressive rates or any of the discriminations necessary to tailor the tax to the different taxable abilities of different classes of taxpayers. The decision is important since it upheld the power to Congress not only to impose an income tax, but to levy an effective income tax. It is also important to the extent that it foreshadowed the peculiarly unsympathetic attitude of the Court toward any attack on the income tax on the ground of retroactivity.

Although the *Brushaber* case established the power of Congress to impose an income tax, it did not foreclose constitutional objections to particular provisions of the tax. The Sixteenth Amendment itself opened up various possibilities of constitutional attack, and when they were exhausted, taxpayers could always fall back upon the due process clause.

The Meaning of Income in the Sixteenth Amendment

The Sixteenth Amendment provides: "The Congress shall have power to lay and collect taxes upon income, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." The Amendment recognizes a constitutional distinction between capital and income, because of the negative implication that Congress cannot tax capital without apportionment. However, the distinction between capital and income, which appears to promise such interesting possibilities for attacking the constitutionality of the income tax, has proved rather disappointing. Although the Supreme Court held in *Eisner v. Macomber*,[6] that the Sixteenth Amendment only authorizes Congress to tax income without apportionment, and that an unapportioned tax on capital is unconstitutional, this seems to be the only case which has actually invalidated a federal income tax on that ground. Moreover, recent decisions raise serious doubts about the authority of *Eisner v. Macomber*.[7]

The practical difficulty with attacking a particular application of the federal income tax as an unapportioned tax upon capital lies in raising the question to a constitutional level. The various federal income tax acts have taxed "income" without much specification of what is embraced by that term. Consequently, most of the litigation over what constitutes taxable income has been fought out as a matter of construction rather than constitutionality. The only time it has been possible to raise the constitutional issue directly appears to be where the particular statute has explicitly taxed something like stock dividends or capital gains as income, or has explicitly denied a deduction connected with capital, like depreciation or depletion, and the constitutionality of these provisions have been called into question. It is possible that the cases on the construction of "income" in a particular act have some bearing upon the meaning of income in the Sixteenth Amendment. This is, however, a problem which must be deferred until after a review of the decisions which have raised the constitutional issue squarely.

The only case in which the Supreme Court has declared part of the federal income tax unconstitutional as a tax upon capital rather than income seems to be *Eisner v. Macomber*. Although at the time the case was decided,

6. 252 U.S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521 (1919).

7. Helvering v. Griffiths, 318 U.S. 371, 63 Sup. Ct. 636, 87 L. Ed. 843 (1943); see also Helvering v. Sprouse, 318 U.S. 604, 63 Sup. Ct. 791, 87 L. Ed. 1029 (1943).

it looked as though the Court was ready to put some rather rigid constitutional restrictions on the income tax, the case has never lived up to its early promise. *Eisner v. Macomber* held that a provision taxing stock dividends as income was unconstitutional as applied to a dividend of common on common. It is, of course, well settled that a stock dividend which gives the stockholder a different proportional interest in the corporation is taxable as income,[8] and the Supreme Court has intimated that even a stock dividend which does not change the proportional interests of the stockholders may be income in the sense in which that term is used in the Sixteenth Amendment and that the decision in *Eisner v. Macomber* may no longer represent the law.[9] But even conceding that the precise point decided in *Eisner v. Macomber* is no longer law, the question remains as to whether or not the premise which the Court invented to reach the conclusion in that case is still valid. In order to reach the result in *Eisner v. Macomber,* the Court laid down the doctrine that an economic increment to be income in the constitutional sense must be "realized," that is, must be severed or divorced in some way from the capital which produced it. It would be perfectly possible for the Court to overrule *Eisner v. Macomber* on the ground that the conclusion derived from the major premise in the case was erroneous, without overruling the premise itself. That is, the Court may now doubt the soundness of the case and feel that a stock dividend does result in a realization of income, without questioning the doctrine that income must be realized in order to be income in the constitutional sense.

As far as the present tax law is concerned, the requirement that income must be realized before it becomes income in the constitutional sense is not very material, because with one possible exception,[10] the statute in its present form is confined to taxing income which meets the requirement of realization. There are, however, several possible reforms in connection with the income tax which may be open to serious constitutional objections if the realization requirement still persists.

One suggested solution for taxing capital gains, for example, is to require taxpayers to inventory their assets at the beginning and at the end of the taxable year and return any increase in inventory values as ordinary income. Apart from the administrative feasibility of this scheme, it appears to involve taxing an unrealized gain as income and to be unconstitutional, if there is a constitutional requirement that gain must be realized to constitute income in the sense in which the term is used in the Sixteenth Amendment.

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8. Koshland v. Helvering, 298 U.S. 441, 56 Sup. Ct. 767, 80 L. Ed. 1268 (1936). See also Helvering v. Sprouse, 318 U.S. 604, 63 Sup. Ct. 791, 87 L. Ed. 1029 (1943).

9. Helvering v. Griffiths, 318 U.S. 371, 63 Sup. Ct. 636, 87 L. Ed. 843 (1943).

10. United States stockholders in foreign personal holding companies are taxed on their distributive shares of the corporation's income, regardless of whether it is distributed to them or not. INT. REV. CODE § 337.

Again from a theoretical point of view, the fairest way to tax corporate income is to treat corporations like partnerships, and instead of taxing the corporation upon its income, to tax the stockholders upon their distributive shares of the corporate income, regardless of whether it is distributed to them or not. In *Collector v. Hubbard*[11] the Supreme Court upheld this method of taxing corporate income under the Civil War income tax acts. *Collector v. Hubbard,* however, conflicted with *Eisner v. Macomber* and was overruled by that case.[12] It is difficult to see how corporate income could be taxed directly to the stockholders in the case of large corporations whose stock is widely held and frequently changes hands. However, this might be a satisfactory method of taxing closely held family corporations which are partnerships in everything except name. It would be interesting to see whether such a tax would founder on the requirement of realization. The income of United States shareholders from foreign personal holding companies has been taxed in this way for some time[13] without apparently being challenged on constitutional grounds. The cases sustaining the constitutionality of the undistributed profits tax[14] and the penalty surtax on unreasonable accumulations of surplus[15] may indicate that despite the decision in *Eisner v. Macomber,* corporate income may be taxed distributively to the shareholders of the corporation. It may well be doubted whether the requirement of realization is the eternal constitutional verity it is assumed to be, since it is difficult to see any sensible reason for realization as a constitutional mandate.

From a practical point of view, since the income tax is imposed on a particular person and for a particular period of time, there has to be some criterion to determine to whom a gain shall be taxed and when it shall be taxed. Realization serves a useful administrative function in connection with the income tax by defining the point in time at which, and the person to whom, gain is taxed. It would appear, however, that administrative convenience should be a matter of legislative discretion rather than constitutional necessity. If Congress chooses to treat a particular gain as sufficiently realized to be taxable, the courts should respect its judgment. To be specific, if Congress decides that corporate income should be taxed distributively to the

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11. 12 Wall. 1, 20 L. Ed. 272 (1871).
12. "In so far as this seems to uphold the right of Congress to tax without apportionment a stockholder's interest in accumulated earnings prior to dividend declared, it must be regarded as overruled by . . . Pollock v. Farmers' Loan & T. Co. . . ." Eisner v. Macomber, 252 U.S. 189, 218, 40 Sup. Ct. 189, 64 L. Ed. 521 (1919).
13. See note 10 *supra.*
14. Helvering v. Northwest Steel Rolling Mills, 311 U.S. 46, 61 Sup. Ct. 109, 85 L. Ed. 29 (1940).
15. Helvering v. National Grocery Co., 304 U.S. 282, 58 Sup. Ct. 932, 82 L. Ed. 1346 (1938). Apparently, there is no objection to taxing the corporate income to a sole stockholder. The Court said: "Kohl, the sole owner of the business, could not, by conducting it as a corporation, prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits." *Id.* at 288.

stockholders instead of to the corporate entity, this looks like a decision which might well be left up to the legislature.

One of the manifest injustices of the federal income tax is the failure of the tax to reach the value which a taxpayer derives from the personal use of property which he owns. For example, suppose that two men each have $20,000. *A* invests his money in 5% bonds and he uses the $1,000 which he receives from this investment to rent a residence for himself and his family. He will be taxed upon the income from the bonds and he will not be allowed any deduction for the rent which he pays for his residence. *B* invests his $20,000 in a residence for himself and his family. The economic benefit which he receives from occupying the property is not taxed as income. Apart from administrative difficulties, it is apparent that any attempt to remedy this injustice by taxing the personal benefits which taxpayers get from property which they own will encounter constitutional difficulties. It would certainly be contended that such a tax is a direct tax upon the ownership of property, rather than a tax upon income from property. It would also doubtless be contended that any advantage which an owner gets from using his property is not a gain which is "realized" so that it can be taxed as income under the Sixteenth Amendment. The Supreme Court has intimated that such a tax would be unconstitutional.[16] One sure way to find out how serious this intimation is would be to pass such a tax and put it to the test.

Apart from the requirement of realization, which may be more of an imaginary than an actual hazard, the Supreme Court has been extremely liberal in its construction of income in the Sixteenth Amendment. With the exception of the stock dividend taxed in *Eisner v. Macomber,* it has never held that anything which Congress taxed as income was not income in the constitutional sense. In *Merchants' Loan & Trust Company v. Smietanka,*[17] the Court held that capital gains are taxable as income under the Sixteenth Amendment. Moreover, in the cases dealing with deductions, the Court seems to have held that a tax which was pretty clearly a tax upon capital was a tax on income. In the deduction cases[18] the doctrine was laid down that deductions are a matter of legislative grace rather than constitutional right. This seems sound enough as far as deductions which do not represent a recovery of capital are concerned. There is no particular reason why Congress should grant a deduction for things like charitable contributions or medical expenses. There are other deductions, however, which are con-

16. Helvering v. Independent Life Ins. Co., 292 U.S. 571, 54 Sup. Ct. 758, 78 L. Ed. 1311 (1934).

17. 255 U.S. 509, 41 Sup. Ct. 386, 65 L. Ed. 751 (1921).

18. Helvering v. Independent Life Ins. Co., 292 U.S. 571, 54 Sup. Ct. 758, 78 L. Ed. 1311 (1934); Stanton v. Baltic Mining Co., 240 U.S. 103, 36 Sup. Ct. 278, 60 L. Ed. 546 (1916). See MAGILL, TAXABLE INCOME, c. 9 (Rev. ed. 1945).

nected with the exhaustion or return of capital and are necessary to reflect the true profit or income from a transaction. Denying deductions such as depreciation or depletion appears to impose an indirect tax upon capital and to go beyond the unapportioned tax upon income authorized by the Sixteenth Amendment. Curiously enough, however, the cases which have declared that deductions are a matter of legislative grace, which Congress is free to grant or withhold, have involved depreciation and depletion.[19] If there is a constitutional distinction between the various types of deductions which Congress may deny, the Court has yet to recognize it.

Most of the cases involving the question of what constitutes taxable income have turned upon the construction of the various tax acts and involved the problem of whether or not the item in question was income in the sense in which that term was used in the statute, rather than whether it was income in the constitutional sense. The extent to which the cases on construction are constitutional precedents appears to depend upon the intent of Congress to use income in a taxing act in the same sense in which it is used in the Sixteenth Amendment.

In *Eisner v. Macomber,* Mr. Justice Pitney, speaking for the majority, said that in taxing income under the Sixteenth Amendment Congress intends to "exert its power to the extent permitted by the Amendment,"[20] and, therefore, income in a statute means the same thing as income in the Sixteenth Amendment. In *Towne v. Eisner,*[21] however, Mr. Justice Holmes said that "it is not necessarily true that income means the same thing in the Constitution and the act,"[22] and along with Mr. Justice Brandeis, he proceeded to back up this dictum by dissenting in *Eisner v. Macomber.*[23] The question of whether or not income in a tax act means the same thing as income in the Sixteenth Amendment has both an affirmative and a negative aspect. Although Congress in taxing income may elect to refrain from exerting its full power under the Sixteenth Amendment, it seems clear that it does not intend to exceed its constitutional powers and to tax something which is not income under the Amendment. The term income in a tax statute may not be as broad as income in the Sixteenth Amendment, but it certainly is no broader. It seems to follow, therefore, that a decision holding that a

19. *Ibid.*
20. 252 U.S. at 203.
21. 245 U.S. 418, 38 Sup. Ct. 158, 62 L. Ed. 372 (1918).
22. *Id.* at 425. Holmes added: "A word is not a crystal, transparent and unchanged; it is the skin of a living thought and may vary greatly in color and content according to the circumstances and time in which it is used." Without taking issue with the Justice's generalization, it is difficult to see any change of circumstances which would lead Congress to employ "income" in a different sense in a statute passed under the authority of the Sixteenth Amendment from the sense in which the term is used in the amendment.
23. Although Holmes wrote the opinion in *Towne v. Eisner,* holding that stock dividends were not income as a matter of construing a statute taxing "income," he dissented from the majority opinion in *Eisner v. Macomber,* that stock dividends were not income within the meaning of that term in the Sixteenth Amendment.

particular item constitutes income as a matter of statutory construction is a precedent for the proposition that the item is income in the constitutional sense. However, a more difficult problem is presented by the effect of a decision that an item is not income in the statutory sense, and the question of whether or not such a decision means that the item is not income in the constitutional sense.

Of course, the statute may indicate that Congress used income in the taxing act in a more limited sense than that in which it is used in the Sixteenth Amendment. Where this occurs, a decision to the effect that something is not taxable as income under a particular statute clearly has no bearing upon constitutionality. For example, the cases holding that property acquired by gift or inheritance[24] does not constitute income under a particular act are not precedents under the Sixteenth Amendment, because the various income tax acts have explicitly excluded gifts and inheritances from taxable income.[25] On the other hand the Court has held that contributions to capital[26] are not income as far as the statutory definition of income is concerned, after a consideration of the nature of taxable income, rather than any peculiar provisions of the statute. It is difficult to see why Congress would use income in an act passed under the authority of the Sixteenth Amendment in any different sense than that in which it is used in the Amendment, and why a decision of this kind is not a precedent for the constitutionality, or rather the unconstitutionality, of the tax. This is, of course, the point at which Pitney and Holmes disagree. However, Mr. Justice Holmes was in the minority on this point in *Eisner v. Macomber,* and although he suggested that income in a taxing act and income in the Sixteenth Amendment do not necessarily mean the same thing, he offered no convincing reason for this position.

This analysis is not inconsistent with the apparent constitutionality of the tax on alimony paid to a divorced spouse as income.[27] In *Gould v. Gould,*[28] the Supreme Court held that alimony could not be taxed as income of a divorced spouse under a statute which merely taxed income, without mentioning alimony specifically, because alimony is not in its nature income, but merely the commuted value of the spouse's right to support. The constitutionality of the tax on alimony, however, does not necessarily support Justice Holmes' position that income in a tax statute means something different than

24. Lyeth v. Hoey, 305 U.S. 188, 59 Sup. Ct. 155, 83 L. Ed. 119 (1938); Bogardus v. Comm'r, 302 U.S. 34, 58 Sup. Ct. 61, 82 L. Ed. 32 (1937); United States v. Merriam, 263 U.S. 179, 44 Sup. Ct. 69, 68 L. Ed. 240 (1923).

25. INT. REV. CODE § 22(b)(3).

26. Edwards v. Cuba R.R., 268 U.S. 628, 45 Sup. Ct. 614, 69 L. Ed. 1124 (1925); *cf.* Texas & Pacific Ry. v. United States, 286 U.S. 285, 52 Sup. Ct. 528, 76 L. Ed. 1108 (1932).

27. INT. REV. CODE § 22(k). The tax on alimony was held constitutional in Manhana v. United States, 88 F. Supp. 285 (Ct. Cl. 1950).

28. 245 U.S. 151, 38 Sup. Ct. 53, 62 L. Ed. 211 (1917).

income in the Sixteenth Amendment. An alternative ground of the *Gould* case was that Congress did not intend to tax alimony as income of the divorced spouse, because the statute made no provision for a deduction on the part of the spouse paying the alimony, and such a tax would lead to a double tax on the same income. The decision may, therefore, be explicable on the ground that income did not include alimony in the sense in which it was used in the taxing act, because Congress showed an intent to exclude alimony from the statutory definition of income.

Limitations on the Taxation of Income Because of Source

With the solitary exception of *Eisner v. Macomber* and the doctrine that income in order to be income within the meaning of the Sixteenth Amendment must be realized, the Supreme Court has refused to lay down any rigid constitutional definitions of income, which might hamper the effectiveness of the income tax. The Court has been less forbearing, however, in construing that part of the Amendment which authorizes Congress to tax income "from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." Does this mean that Congress may tax incomes regardless of source? Or, does it merely mean that Congress need not apportion an income tax because of the source of the income? Either interpretation is plausible if one starts with the premise that the Sixteenth Amendment was designed, as it undoubtedly was, to reverse the decision in the *Pollock* case. The *Pollock* case held that a tax upon income from property was a direct tax because of the source of the income. From this angle it may be argued that the purpose of the Amendment was to dispense with any necessity of apportioning an income tax because of the source of the income. However, the *Pollock* case also held that a tax upon interest from municipal bonds was an unconstitutional burden upon the borrowing power of the states. If the Sixteenth Amendment intended to repudiate the *Pollock* case, it might well be contended that it was designed to repudiate the decision in its entirety, and not merely to dispense with the requirement of apportionment, but to give Congress affirmative power to tax income regardless of the source of the income.

With the solitary exception of a contrary observation by Mr. Justice Black, concurring in *Helvering v. Gerhardt*,[29] the Supreme Court has consistently held that the Sixteenth Amendment merely relieves Congress from the necessity of apportioning a tax upon income because of the source of the income and does not affirmatively authorize Congress to tax income regardless of source. However, after the Court built up a number of limitations on Congress' power to tax income under this doctrine, it promptly

29. 304 U.S. 405, 427, 58 Sup. Ct. 969, 82 L. Ed. 1427 (1938).

proceeded to demolish them again, with the somewhat ironic result that with one possible exception,[30] Congress may now tax the same incomes under the narrower interpretation that it could have taxed if the Amendment had been initially interpreted more broadly.

The first case to raise the question of the meaning of the constitutional phrase, "from whatever source derived," was *Peck & Co. v. Lowe*,[31] which involved the application of the federal income tax to income from exporting. The Court sustained the constitutionality of the tax. It was careful to point out, however, that the basis of the decision was that a net income tax on income from exporting is too remote from the source of the income to be an unconstitutional tax upon articles "exported from any state," and that the Sixteenth Amendment did not give Congress power to tax income regardless of source.

Two years later in *Evans v. Gore*,[32] the Court affirmed the dictum in *Peck & Co. v. Lowe*, when it held that the federal income tax could not be applied constitutionally to the salary of a federal judge appointed prior to the passage of the Amendment, because this would unconstitutionally diminish his stipend during his continuance in office. Although the Court followed *Peck & Co. v. Lowe* to the extent that it refused to construe the Sixteenth Amendment as granting any power to Congress to tax incomes from sources which it could not reach independently of the Amendment, it did not feel that a net income tax upon the income of a judge was as remote from the source of the income as a net income tax upon income from exporting. In *Miles v. Graham*,[33] the Court held that the federal income tax could not be applied constitutionally even to the salary of a judge appointed after the passage of the tax because if this did not diminish his stipend it rendered it uncertain and the provision against diminishing judicial stipends guarantees a certain stipend.

Another byproduct of the thesis that the Sixteenth Amendment does not authorize Congress to tax incomes from any source was the importation of the doctrine of intergovernmental immunities into the income tax, with the result that the Supreme Court held that the federal income tax could not be applied constitutionally to salaries of state officers and employees[34] and Congress explicitly provided that interest from state and municipal bonds should be excluded from gross income.[35]

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30. The taxation of interest from state and municipal bonds.

31. 247 U.S. 165, 38 Sup. Ct. 432, 62 L. Ed. 1049 (1918).

32. 253 U.S. 245, 40 Sup. Ct. 550, 64 L. Ed. 887 (1920).

33. 268 U.S. 501, 45 Sup. Ct. 601, 69 L. Ed. 1067 (1925).

34. Brush v. Comm'r, 300 U.S. 352, 57 Sup. Ct. 495, 81 L. Ed. 691 (1937); *cf.* Collector v. Day, 11 Wall. 113, 20 L. Ed. 122 (1871).

35. INT. REV. CODE § 22(b)(4).

However, the limitations on the power of Congress to tax income because of the source of the income had scarcely been articulated before the Court proceeded to demolish them.

In laying down the rule that the federal income tax could not be applied constitutionally to salaries of state officers and employees, the Court worked out qualifications to the rule, which may have been sound as a matter of abstract political theory, but which proved a continuing embarrassment in the administration of the tax. In *Metcalf & Eddy v. Mitchell*,[36] it was held that the prohibition against taxing compensation from a state did not apply to the compensation of an independent contractor as distinguished from a state officer or employee. Moreover, the compensation of state officers or employees was not tax free, unless they were engaged in performing an essential governmental, as distinguished from a proprietary, function for the state.[37] It is not necessary to detail the confusion which arose in attempting to distinguish independent contractors from officers and employees, and proprietary and governmental functions, since *Helvering v. Gerhardt*[38] repudiated the federal income tax immunity of compensation received from a state entirely. In *Helvering v. Gerhardt,* the Court suddenly found that there was no evidence that the burden of an income tax upon a state employee would be shifted to the governmental employer and such a tax was not, therefore, an unconstitutional burden upon the governmental employer.

In the following year, the Court discovered that the Constitution does not forbid a federal income tax upon the stipends of federal judges of constitutional courts and the chief executive. After the decision in *Miles v. Graham,* Congress temporarily abandoned any attempt to tax judicial and presidential salaries. In 1932, however, it was provided that judges and presidents taking office after the passage of the 1932 Act should be subject to the income tax, and that the tax should be an amendment to the statutes fixing their stipends. The obvious intent of the 1932 Act was to justify the tax on the theory that it did not unconstitutionally diminsh the stipends of these officers but merely reduced the salaries at which they were appointed. In *O'Malley v. Woodrough*,[39] the Supreme Court upheld the constitutionality of the 1932 Act as applied to the salary of a judge appointed after the enactment of the Act. Instead of sustaining the tax upon the narrow ground that a federal income tax does not unconstitutionally diminish the stipend of a

36. 269 U.S. 514, 46 Sup. Ct. 172, 70 L. Ed. 384 (1926). See also James v. Dravo Contracting Co., 302 U.S. 134, 58 Sup. Ct. 208, 82 L. Ed. 155 (1937).

37. Helvering v. Therrell, 303 U.S. 218, 58 Sup. Ct. 539, 82 L. Ed. 758 (1938). *Compare* Helvering v. Powers, 293 U.S. 214, 55 Sup. Ct. 171, 79 L. Ed. 291 (1934), which held that the operation of an elevated railway was not a governmental function, *with* Brush v. Comm'r, 300 U.S. 352, 57 Sup. Ct. 495, 81 L. Ed. 691 (1937), which held that the operation of a waterworks was.

38. 304 U.S. 405, 58 Sup. Ct. 969, 82 L. Ed. 1427 (1938).

39. 307 U.S. 277, 59 Sup. Ct. 838, 83 L. Ed. 1289 (1939).

judge appointed after the tax, however, the Court declared that a general nondiscriminatory income tax is not within the purview of the constitutional guaranty against the reduction of judicial and presidential stipends. There was a clear invitation to Congress to tax all judicial and presidential salaries, which Congress promptly accepted in the Public Salary Act of 1939.[40]

The only remnant of the limitations on Congress' power to tax income because of the source of the income is a possible constitutional prohibition against taxing interest from state and municipal bonds. Apparently the only Supreme Court decision which directly recognizes such an immunity is *Pollock v. Farmers' Loan & Trust Co.*, which, of course, antedates the Sixteenth Amendment. The Court has held that it is constitutional to tax gains from the sale of tax-exempt securities under the income tax[41] and to deny any deduction for interest on indebtedness incurred to purchase or carry tax-exempt bonds.[42] There seems to be little doubt, moreover, that a federal franchise tax measured by interest from tax-exempt securities is constitutional.[43] These cases should probably, however, be regarded as an implied recognition of the constitutional immunity of interest from state and municipal bonds from the federal income tax, rather than as a repudiation of such an immunity. Moreover, *Helvering v. Gerhardt* is not directly in point. The tax on salaries of state officers and employees was sustained in that case in the absence of evidence to show that the burden of the tax was shifted from the employee to the governmental employer. It is reasonably clear, however, that a tax upon interest from state and municipal bonds would require governmental borrowers to pay a higher rate of interest. It is possible that a tax levied upon a private person may be constitutional, regardless of the actual economic incidence of the tax.[44] However, until the statutory immunity of interest from state and municipal bonds, which prevents a judicial determination of any constitutional immunity, is repealed, the constitutional immunity seems destined to remain a subject for interesting speculation.[45]

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40. 53 STAT. 575 (1939), 26 U.S.C.A. § 22(a) (1948). The tax on the salary of a judge appointed prior to the passage of the act taxing such salaries is constitutional. Baker v. Comm'r, 149 F.2d 342 (4th Cir. 1945).

41. Willcuts v. Bunn, 282 U.S. 216, 51 Sup. Ct. 125, 75 L. Ed. 304 (1931).

42. Denman v. Slayton, 282 U.S. 514, 51 Sup. Ct. 269, 75 L. Ed. 500 (1931).

43. Flint v. Stone Tracy Co., 220 U.S. 107, 31 Sup. Ct. 342, 55 L. Ed. 389 (1911).

44. In Alabama v. King & Boozer, 314 U.S. 1, 62 Sup. Ct. 43, 86 L. Ed. 3 (1941), the Court held that a state sales tax could be imposed constitutionally upon sales to a contractor engaged in constructing an army camp for the United States government under a "cost-plus-a-fixed fee" contract. The Court said that the contractor was not relieved from liability for the tax "because the economic burden of the tax imposed upon the purchaser would be shifted to the Government by reason of its contract to reimburse the contractors." *Id.* at 12.

45. See Comm'r v. Shamberg's Estate, 144 F.2d 998 (2d Cir. 1944), *cert. denied*, 323 U.S. 792 (1945); and Comm'r v. White's Estate, 144 F.2d 1019 (2d Cir. 1944), *cert. denied*, 323 U.S. 792 (1945).

Due Process Objections to the Income Tax

The constitutionality of the federal income tax has been attacked under the due process clause of the Fifth Amendment with a distinguished lack of success. It has been contended that the tax violated due process because it undertook to tax income which Congress had no jurisdiction to tax. It has also been contended that particular provisions of the tax were unconstitutional because they discriminated arbitrarily between different classes of taxpayers, or because they undertook to tax income to the wrong taxpayer, or because they imposed a retroactive tax.

The federal income tax is imposed upon the entire income of a resident alien or citizen regardless of the source of the income,[46] and upon the income of nonresident aliens from sources within the United States.[47] The tax on the basis of jurisdiction over the person of the taxpayer was sustained in *Cook v. Tait,*[48] in which the Supreme Court held that the federal income tax could be constitutionally applied to the income of a non-resident citizen from foreign sources; and in *DeGanay v. Lederer,*[49] the Court remarked that "there can be no question of the power of Congress" to tax income from domestic sources.

The attack on the provisions of the federal income tax on the ground that they arbitrarily discriminate between different classes of taxpayers was successfully repulsed in *Brushaber v. Union Pacific R.R.,*[50] which upheld the principle of a progressive income tax and the discriminations which accompany the effort of the legislature to adapt the tax to the varying taxable abilities of different classes of taxpayers. It is conceivable that Congress might enact an income tax which discriminated so outrageously against some class of taxpayers that it would offend due process. However, it seems reasonably certain that the genuine efforts of Congress to work out an equitable system of taxing income run little risk of being frustrated on this ground.

Although the Supreme Court held, in connection with a state income tax, that it violates due process to tax *A*'s income to *B*,[51] it has been remarkably tolerant of Congressional efforts in this direction. This is probably due to some pointed remarks by Mr. Justice Holmes about the nature of taxable income and the fact that the problem of taxing *A*'s income to *B* usually arises against a background of tax avoidance, which tends to predispose the Court in favor of the tax.

Since the federal income tax is a progressive tax the amount of the tax depends not only upon the amount of income which is taxed, but the person to whom it is taxed. The tax upon ten $10,000 incomes, for example, is

46. INT. REV. CODE §§ 11, 12; U.S. Treas. Reg. 111, § 29.11-2.
47. INT. REV. CODE § 212.
48. 265 U.S. 47, 44 Sup. Ct. 444, 68 L. Ed. 895 (1924).
49. 250 U.S. 376, 382, 39 Sup. Ct. 524, 63 L. Ed. 1042 (1919).
50. 240 U.S. 1, 36 Sup. Ct. 236, 60 L. Ed. 493 (1916).
51. Hoeper v. Tax Commission, 284 U.S. 206, 52 Sup. Ct. 120, 76 L. Ed. 248 (1931).

roughly one-third of the tax upon a single income of $100,000. Taxpayers have been quick to capitalize upon this mathematical quirk by trying to divide large incomes taxable in high brackets into smaller incomes taxable in lower brackets for tax purposes, without relinquishing substantial control over the income or the property which produced it. Many of these schemes have been frustrated by the courts without explicit legislative assistance, by a flexible definition of income. Thus, for example, it has been held that a person cannot assign income from personal services so as to shift the tax on the income to the assignee.[52] In connection with the assignment of income from property a fine distinction has developed between an assignment of a right to income, which does not shift the liability for the tax to the assignee,[53] and an assignment of an interest in the property which produces the income, which does.[54] The taxation of income from family partnerships to the substantial owner of the partnership[55] and the taxation of income from irrevocable trusts to the substantial owner of the trust[56] are extreme examples of the lengths to which the courts will go to prevent tax avoidance by taxing income to one other than the technical legal owner of the income without the aid of explicit legislation.

The same attitude has characterized the courts' treatment of the constitutionality of an explicit statutory provision taxing income to one other than the legal owner of the income. The outstanding cases are *Corliss v. Bowers*[57] and *Burnet v. Wells*.[58]

One of the more obvious ways of dividing a large income into smaller incomes without actually relinquishing control over the source of the income is to create a revocable trust in favor of some dependent of the taxpayer who would naturally receive part of his income. The federal income tax, therefore, provides explicitly that the income from a revocable trust shall be taxed to the grantor of the trust.[59] In *Corliss v. Bowers*,[60] the Supreme Court upheld the constitutionality of this provision. Mr. Justice Holmes delivered the opinion of the Court and pointed out that the control retained by the settlor over the trust justified taxing the income from the trust to him. In words which have been quoted in nearly every subsequent decision involving the nature of tax-

52. Helvering v. Eubank, 312 U.S. 122, 61 Sup. Ct. 149, 85 L. Ed. 81 (1941); Lucas v. Earl, 281 U.S. 111, 50 Sup. Ct. 241, 74 L. Ed. 731 (1930); *cf.* Jones v. Page, 102 F.2d 144 (5th Cir. 1939), *cert. denied*, 308 U.S. 562 (1939).
53. Harrison v. Schaffner, 312 U.S. 579, 61 Sup. Ct. 759, 85 L. Ed. 1055 (1941); Helvering v. Horst, 311 U.S. 112, 61 Sup. Ct. 144, 85 L. Ed. 75 (1940).
54. Blair v. Comm'r, 300 U.S. 5, 57 Sup. Ct. 330, 81 L. Ed. 465 (1937).
55. Comm'r v. Culbertson, 337 U.S. 733, 69 Sup. Ct. 1210, 93 L. Ed. 1659 (1949); Comm'r v. Tower, 327 U.S. 280, 66 Sup. Ct. 532, 90 L. Ed. 670 (1946); Lusthaus v. Comm'r, 327 U.S. 293, 66 Sup. Ct. 539, 90 L. Ed. 679 (1946).
56. Helvering v. Clifford, 309 U.S. 331, 60 Sup. Ct. 554, 84 L. Ed. 788 (1940).
57. 281 U.S. 376, 50 Sup. Ct. 336, 74 L. Ed. 916 (1930).
58. 289 U.S. 670, 53 Sup. Ct. 761, 77 L. Ed. 1439 (1933).
59. INT. REV. CODE § 166.
60. 281 U.S. 376, 50 Sup. Ct. 336, 74 L. Ed. 916 (1930).

able income, Holmes declared: "But taxation is not so much concerned with refinements of title as it is with actual command over the property taxed—the actual benefit for which a tax is paid."[61] By repudiating "refinements of title" as a test of taxability and phrasing the problem in terms of substantial control, Holmes by a single sentence wrecked innumerable tax avoidance schemes based upon technical property conceptions.

Another noteworthy decision in this field is *Burnet v. Wells*,[62] in which Mr. Justice Cardozo speaking for the majority of the Court held that the provisions of the federal income tax taxing the income from a funded insurance trust to the insured who created the trust were constitutional. Since the trust was irrevocable, the tax could not be sustained on the basis of the settlor's legal control over the trust property. After paying his respects to Mr. Justice Holmes by quoting his repudiation of "refinements of title" Cardozo concluded that the tax was constitutional on the basis of benefit. "Congress did not play the despot," the Justice declared in taxing the income from a funded insurance trust to the settlor who gets the benefit of the insurance for his dependents, even though the trust is irrevocable and he has parted with all title to the property. Mr. Justice Sutherland, along with Justices Van Devanter, McReynolds and Butler, who fought a consistently losing battle against abandoning refinements of title as a test of taxability, dissented on the ground that "Congress may not tax the property of *A* as the property of *B*, or the income of *A* as the income of *B*."[63]

It seems pretty clear that Congress can tax *A*'s income to *B* where this is necessary to prevent tax avoidance and to preserve the integrity of the principle of a progressive tax. It is barely possible that a proposal which has been suggested from time to time which would require married couples to file compulsory joint returns and base the rate of tax upon the aggregate income shown by the return might be held unconstitutional on the authority of *Hoeper v. Tax Commission*,[64] as an attempt improperly to tax *A*'s income to *B*. Actually, of course, since under this scheme, each spouse would be individually liable for his or her proportionate part of the tax, it would not involve taxing *A*'s income to *B*, but merely determining the rate of tax on *B*'s income by taking *A*'s income into consideration. Although it would appear to be permissible to regard a husband and wife as a single taxable entity for the purpose of determining the rate of tax upon their incomes, this seems to be precisely what the Wisconsin statute which was outlawed in *Hoeper v. Tax Commission* did. Probably the present Court would sustain the constitutionality of a provision in the federal income tax requiring compulsory joint returns. If it did, however, it should overrule the *Hoeper* case.

61. *Id.* at 378.
62. 289 U.S. 670, 53 Sup. Ct. 761, 77 L. Ed. 1439 (1933).
63. *Id.* at 683.
64. 284 U.S. 206, 52 Sup. Ct. 120, 76 L. Ed. 248 (1931).

The Supreme Court has worried much more about retroactive death and gift taxes than it has about the retroactive provisions of the federal income tax. Apparently there is no constitutional prohibition against a retroactive income tax, if the tax does not attempt to reach back beyond the ratification of the Sixteenth Amendment which gave Congress power to impose an unapportioned tax. In *Brushaber v. Union Pacific R.R. Co.*,[65] the Supreme Court held that the provisions of the 1913 Act, which was passed in October 1913, and taxed income realized after the first of March of that year was constitutional, since Congress had not attempted to tax income realized before the ratification of the Sixteenth Amendment. It is possible to distinguish the type of retroactivity which merely goes back to the beginning of the taxable year, like a statute passed in June which provides that rates shall be increased and applies the higher rates to income realized from the beginning of the year, from a tax applying to income of a previous taxable period, on the ground that income cannot be finally determined until the close of the taxable year and a statute which does not go back beyond the taxable period in which the tax is passed is not really retroactive. The Supreme Court has held, however, that a retroactive state income tax is constitutional even though it goes back and taxes income realized in a taxable period previous to the period in which the tax was passed.[66] Moreover, in *Burnet v. Wells*,[67] the Court held that income from a funded insurance trust was constitutionally taxable to the creator of the trust, although the trusts were created in 1922 and 1923 and the taxing act was not passed until 1924. The Court in *Burnet v. Wells* passed over the retroactive point by observing that the tax was not retroactive since only the income for 1924 and the succeeding years was taxed to the settlor of the trust. This rather cavalier consideration seems to iguore the real point in issue. The settlor of the trust was led into creating trusts under the belief that he would not be taxed upon the income from them. He made the trusts irrevocable, and when the law was changed there was no way in which he could change the trusts and extricate himself from the tax trap in which the new law had involved him. It is very difficult to see any difference between the income tax in *Burnet v. Wells* and the situation in *Nichols v. Coolidge*,[68] where the Supreme Court held that an estate tax could not be applied constitutionally to an irrevocable transfer completed prior to the passage of the tax.

Perhaps the case which throws the most light on the Court's attitude toward retroactive income taxes is *United States v. Hudson*.[69] The Silver

65. 240 U.S. 1, 36 Sup. Ct. 236, 60 L. Ed. 493 (1916).
66. Welch v. Henry, 305 U.S. 134, 59 Sup. Ct. 121, 83 L. Ed. 87 (1938).
67. 289 U.S. 670, 53 Sup. Ct. 761, 77 L. Ed. 1439 (1933).
68. 274 U.S. 531, 47 Sup. Ct. 710, 71 L. Ed. 1184 (1927).
69. 299 U.S. 498, 57 Sup. Ct. 309, 81 L. Ed. 370 (1937).

Purchase Act,[70] which was passed on June 19, 1934, imposed a tax on the transfer of any interest in silver bullion of 50% of the amount of the gain from the transfer. The tax in terms applied to transfers made on or after May 15, 1934. The taxpayer purchased future's contracts for the sale of silver on May 3, 1934 and sold them on May 23 and May 29, 1934. The Court held that he was liable for the tax although the purchases and sales occurred prior to the passage of the taxing act. If the Court had chosen to regard the tax as a transfer tax, it would have fitted almost perfectly into the pattern of *Untermyer v. Anderson*,[71] and would have been unconstitutional. The Court said, however, that the tax was an income tax and that retroactivity in an income tax is all right as long as "the period of retroactivity fixed in the act is not unreasonable."[72] The *Hudson* case does not shed much light on how far back an income tax must go to be unreasonably retroactive. It appears, however, that Congress will have to be more unreasonable than it has been in the past to persuade the Court to declare an income tax unconstitutional on this ground.

The Federal Estate and Gift Taxes

The first federal estate tax was passed in 1916 on the eve of the entry of the United States into the first World War. Although the immediate occasion of the tax was the emergency created by the world crisis, the federal estate tax is based upon essentially the same social premise as the income tax, and with incidental fiscal effects, is primarily designed to discourage large accumulations of inherited capital.

The constitutionality of the estate tax, like the income tax, was challenged upon the ground that the tax was a direct and unapportioned tax. However, the Supreme Court, which had previously sustained a federal inheritance tax against a similar attack,[73] held that the federal estate tax was also an indirect tax,[74] in an opinion chiefly notable for Mr. Justice Holmes' apposite observation that "Upon this point a page of history is worth a volume of logic."[75] The conception of the estate tax as an indirect tax upon transfer, rather than a direct tax upon the property transferred also led the Court to reject the doctrine of intergovernmental immunities in connection with the estate tax. In *Greiner v. Lewellyn*,[76] Mr. Justice Brandeis sustained the application of the tax to a bequest of municipal bonds, declaring that

70. 48 Stat. 1179 (1934), 26 U.S.C.A. § 1805 (1948).
71. 276 U.S. 440, 48 Sup. Ct. 353, 72 L. Ed. 645 (1928).
72. United States v. Hudson, 299 U.S. 498, 501, 57 Sup. Ct. 309, 81 L. Ed. 370 (1937).
73. Knowlton v. Moore, 178 U.S. 41, 20 Sup. Ct. 747, 44 L. Ed. 969 (1900).
74. New York Trust Co. v. Eisner, 256 U.S. 345, 41 Sup. Ct. 506, 65 L. Ed. 963 (1921).
75. *Id.* at 349.
76. 258 U.S. 384, 42 Sup. Ct. 324, 66 L. Ed. 676 (1922).

"The transfer upon death is taxable, whatsoever the character of the property transferred and to whomsoever the transfer is made."[77]

As an indirect tax, the federal estate tax is subject to the constitutional requirement of uniformity. It is well established, however, that the only uniformity required by the federal constitution is geographic, and in *Florida v. Mellon*[78] even this requirement was watered down by the holding that the credit allowed against the federal tax for state death taxes does not destroy the uniformity of the tax. Although this means that taxpayers in different states with estates of the same size incur different federal tax liabilities, the Court declared that the lack of uniformity was due to divergence in the state taxes, rather than the federal law.

With these constitutional preliminaries out of the way, taxpayers settled down to a long wrangle with their government over the particular provisions of the federal estate tax. A brief survey of the conflict underlying the legal developments in connection with the tax affords valuable insight into these developments. The estate tax is vulnerable because it fails to take into account all gratuitous transfers and is limited to testamentary and intestate dispositions, with a narrow fringe of protective taxes on intervivos transfers designed to prevent avoidance of the tax. The gift tax, which is supposed to deter taxpayers from disposing of their property during their lives, affords no real protection against avoidance of the estate tax, because of the differential between the two taxes. The estate tax, consequently, offers an almost irresistible challenge to ingenious conveyancers to devise ways of passing property which will have the substantial advantages of a will and still fall without the orbit of the tax. Most of the litigation over the estate tax centers about the efforts of the Government to tax these transfers. The initial defense against such taxes is construction; while the last ditch stand is usually made on constitutional grounds.

Parts of the federal estate tax, like those taxing transfers in contemplation of death[79] or transfers intended to take effect in possession or enjoyment at or after death,[80] are vague and ambiguous. This is probably due to conscious intention as much as to legislative inability to articulate plainly. Nothing is dearer to the heart of the tax planner than a tidy tax statute replete with rigid detail and pointers showing how the tax can be avoided. However, the ambiguity in the estate tax which was designed to ensnare the tax avoider proved a potent weapon in the hands of a hostile court. Some notable victories were won by taxpayers along lines of construction in the early days of the tax. Thus, for example, the Supreme Court held that a transfer with a reser-

77. *Id.* at 387.
78. 273 U.S. 12, 47 Sup. Ct. 265, 71 L. Ed. 511 (1927).
79. INT. REV. CODE § 811(c).
80. *Ibid.*

vation of a life estate[81] and a transfer with a reservation of a possibility of reverter[82] were not taxable as transfers taking effect at death; and a trust revocable by the grantor in her capacity as trustee instead of her capacity as grantor was not taxable as a revocable trust.[83]

Taxpayers who lose upon the construction frequently fall back upon the Constitution. In the early days of the estate tax there was a constant recurrence of constitutional objections to the tax. The sequence of events leading up to litigation over the estate tax usually follows a fairly conventional pattern. Congress passes an estate tax. An ingenious taxpayer uncovers what appears to be a loophole in the tax and attempts to pass his property free of tax through the loophole. A court may later hold that properly construed there is no loophole in the statute and that the transfer is really taxable. Or, before the transferor's death Congress may have discovered the loophole and amended the statute by explicitly taxing the transfer which had been previously overlooked. In either event the representatives of the decedent will attack the statute on the ground that Congress lacked constitutional power to tax the transfer under an estate tax. Moreover, if the tax is imposed under an amendment to the statute passed after the transfer was made, a further objection will be made on the ground that it is unconstitutional because it is retroactive.

The initial hostility of the Supreme Court to the estate tax is perhaps more clearly visible in the decisions construing the tax than in those dealing with constitutionality. Oddly enough, there seems to be but one decision holding that Congress had attempted to tax a transfer which it lacked constitutional power to tax under the estate tax,[84] and one decision holding that the retroactive application of the tax was unconstitutional.[85] Although both cases apparently left the tax vulnerable to constitutional attack, they never lived up to their early promise.

Most of the litigation over the constitutionality of federal estate tax involves the provisions taxing intervivos transfers, since this is one of the main ways of avoiding the tax.[86] In *Heiner v. Donnan*,[87] the Supreme Court

81. May v. Heiner, 281 U.S. 238, 50 Sup. Ct. 286, 74 L. Ed. 826 (1930), *overruled by* Comm'r v. Estate of Church, 335 U.S. 632, 69 Sup. Ct. 322, 93 L. Ed. 288 (1949).

82. Helvering v. St. Louis Union Trust Co., 296 U.S. 39, 56 Sup. Ct. 74, 80 L. Ed. 29 (1935); and Becker v. St. Louis Union Trust Co., 296 U.S. 48, 56 Sup. Ct. 78, 80 L. Ed. 35 (1935), *overruled by* Helvering v. Hallock, 309 U.S. 106, 60 Sup. Ct. 444, 84 L. Ed. 604 (1940).

83. White v. Poor, 296 U.S. 98, 56 Sup. Ct. 66, 80 L. Ed. 80 (1935), repudiated by § 805 of the 1936 Act, which is now § 811(d) of the Internal Revenue Code, and which imposes a tax where the decedent has power to revoke or change the trust "in whatever capacity exercisable" and "without regard to when or from what source decedent acquired such power."

84. Heiner v. Donnan, 285 U.S. 312, 52 Sup. Ct. 358, 76 L. Ed. 772 (1932).

85. Nichols v. Coolidge, 274 U.S. 531, 47 Sup. Ct. 710, 71 L. Ed. 1184 (1927).

86. The other method of minimizing the tax is by means of successive estates, which avoids a second tax. With the exception of the tax on powers of appointment [INT. REV. CODE § 811(f)], however, Congress has made no effort to tax successive estates.

87. 285 U.S. 312, 52 Sup. Ct. 358, 76 L. Ed. 772 (1932).

held that a conclusive presumption that gifts made within two years of death were in contemplation of death was unconstitutional, since this resulted in taxing transfers which had no connection with death, and it violated due process to select a single class of intervivos transfers which had no connection with the death of the transferor for taxation under the estate tax. The plain implication of *Heiner v. Donnan* was that only "testamentary transfers" may be taxed constitutionally under the estate tax. If *Heiner v. Donnan* were to be taken seriously, it cast doubt upon all the taxes imposed under the federal estate tax, except those limited to transfers by will and intestacy. However, the Court never carried through with the implications of that decision. Most of the provisions of the tax were upheld by a liberal construction of a testamentary transfer to include not only situations where there was a technical transfer of title at the transferor's death, but also transfers involving a shift of substantial advantages at death.[88] When the Court reached the harder cases, which would have been difficult to justify even under a liberal definition of a testamentary transfer, its attitude toward the estate tax had become much more conciliatory. Consequently, it jettisoned the "testamentary transfer" test in favor of the "penumbra test," which had previously found favor only with the dissenters.[89] The turning point came in *Helvering v. City Bank Farmers Trust Company,*[90] where the Court held that the federal estate tax could be applied constitutionally to an intervivos trust revocable by the deceased grantor only in conjunction with one having a substantial adverse interest in the trust. The Court said that Congress may tax an intervivos transfer under the estate tax, if this is reasonably necessary to prevent avoidance of the tax, without bothering about whether or not there was a testamentary transfer. In *Helvering v. Bullard,*[91] the Court reaffirmed its rejection of the testamentary transfer theory by holding that it was constitutional to tax a transfer with a reservation of a life interest under the estate tax, because this was reasonably necessary to prevent avoidance of the tax. Since the Court could have found a testamentary transfer in the change of

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88. United States v. Jacobs, 306 U.S. 363, 59 Sup. Ct. 551, 83 L. Ed. 763 (1939) (joint tenancy); Milliken v. United States, 283 U.S. 15, 51 Sup. Ct. 324, 75 L. Ed. 809 (1931) (transfer in contemplation of death); Tyler v. United States, 281 U.S. 497, 50 Sup. Ct. 356, 74 L. Ed. 991 (1930) (tenancy by the entirety); Chase National Bank v. United States, 278 U.S. 327, 49 Sup. Ct. 126, 73 L. Ed. 405 (1929) (insurance); Mayer v. Reinecke, 130 F.2d 350 (7th Cir. 1942), *cert. denied,* 377 U.S. 684 (1942) (dower).

89. The "penumbra" theory means briefly that Congress may tax intervivos transfers under the estate tax if this is reasonably necessary to prevent avoidance of the tax. It takes its name from a figure employed by Mr. Justice Holmes, who in dissenting from the decision in Schlesinger v. Wisconsin, 270 U.S. 230, 46 Sup. Ct. 260, 70 L. Ed. 557 (1926), which held that a conclusive presumption in a state statute that transfers made within a specified period of death were in contemplation of death was unconstitutional, said in part: "But the law allows a penumbra to be embraced that goes beyond the outline of the object in order that the object may be secured." *Id.* at 241. The dissenters in *Heiner v. Donnan* based their dissent on the same theory.

90. 296 U.S. 85, 56 Sup. Ct. 70, 80 L. Ed. 62 (1935).

91. 303 U.S. 297, 58 Sup. Ct. 565, 82 L. Ed. 852 (1938).

possession or enjoyment taking place at the transferor's death, the fact that it preferred to base its decision on the "penumbra theory" may be significant.

Although the Court has never explicitly overruled *Heiner v. Donnan,* it is hard to believe that a conclusive presumption that a transfer made within some reasonable period of the transferor's death is in contemplation of death would be held unconstitutional. Despite Mr. Justice Roberts' distinction of *Heiner v. Donnan* in *Helvering v. City Bank Farmers Trust Company,*[92] it is difficult to believe that the conclusion in that case can stand after the definite rejection of the premise upon which it was based.

It is, of course, quite possible that the Supreme Court may yet assert that any intervivos transfer can be taxed under the estate tax because Congress has power to impose a gift tax as well as an estate tax and it is not the function of the Court to quibble about labels. The constitutional objection to taxing intervivos transfers under the estate tax is not, however, that Congress lacks power to tax intervivos transfers, but that such a tax creates an arbitrary classification by singling out one class of intervivos transfers for taxation under the estate tax, while other intervivos transfers are not taxed at all or are taxed on more favorable terms under the gift tax. It is true that Mr. Justice Roberts in upholding the constitutionality of the estate tax on a transfer with a reservation of a life interest said in *Helvering v. Bullard* that "Since Congress may lay an excise upon gifts it is of no significance that the exaction is denominated an estate tax or is found in a statute purporting to levy an estate tax."[93] And he added: "Moreover, Congress having the right to classify gifts of different sorts might impose an excise at one rate upon a gift without a reservation of a life estate and at another rate upon a gift with such reservation."[94] Torn from its context, this may seem to justify indiscriminate taxation of intervivos transfers under the estate tax. However, Mr. Justice Roberts was careful to quality these generalizations by pointing out that the classification of gifts for taxation under the estate tax must not be arbitrary or unreasonable and that the classification of gifts with a reservation of a life interest for taxation under the estate tax was not arbitrary or unreasonable because, "The legislative history . . . demonstrates that the purpose of the legislation was to prevent avoidance of estate taxes."[95] It remains to be seen whether the Court will sustain the taxation of an intervivos transfer which has no relation to the death of the transferor and whose taxation is not necessary to prevent avoidance of the tax under the estate tax.[96]

92. Roberts said that a conclusive presumption that transfers within a certain period of death were in contemplation of death was "so grossly unreasonable as to violate the due process clause of the Fifth Amendment." Helvering v. City Bank Farmers Trust Co., 296 U.S. 85, 92, 56 Sup. Ct. 70, 80 L. Ed. 62 (1935).

93. 303 U.S. 297, 301, 58 Sup. Ct. 565, 82 L. Ed. 852 (1938).

94. *Ibid.*

95. *Id.* at 302.

96. Lowndes, *The Constitutionality of the New Federal Estate Tax Definition of a Transfer Taking Effect at Death,* 3 VAND. L. REV. 203 (1950).

The retroactive provisions of the federal estate tax have been attacked on the grounds of both construction and constitutionality. Although there is no provision in the federal constitution which explicitly forbids a retroactive tax, it is clear that retroactive excise taxation involves a serious element of unfairness. A taxpayer can justly claim that he is entitled to be informed of the tax consequences of a transaction when he enters into it. To permit a transfer to be made tax free and then to turn around and later tax it involves somewhat the same sort of indecent conduct as inviting a friend to dinner and presenting him with a bill for the evening's entertainment when he is about to depart.

It is fairly well settled that a court will not construe a provision of the estate tax as retroactive unless clear and unambiguous language forces it to do so,[97] and even in comparatively recent times the Supreme Court has gone to remarkable lengths to construe a particular provision of the estate tax as purely prospective.[98]

Since there is no explicit constitutional mandate against a retroactive excise tax, the constitutionality of a retroactive provision of the federal estate tax has to be attacked under some general constitutional guaranty. The usual arguments against the retroactive provisions of the federal estate tax are that the tax is a direct tax which is bad because it is not apportioned; or that the tax is so unfair that it violates due process. The direct tax argument has a surface plausibility which will not withstand careful analysis. The basic premise upon which the argument proceeds is that a tax on a transfer which is imposed after the transfer is completed cannot be a tax upon the transfer because the transfer took place before the tax was passed. Therefore, the tax is necessarily a tax upon the property transferred and a direct tax. The fallacy, of course, is in the major premise. There is no reason why a transfer cannot be taxed by a statute passed after the transfer is made as well as a statute passed before the transfer is made. The real issue in connection with a retroactive transfer tax is not whether the tax is a tax upon a transfer, but whether a tax upon a transfer completed before the taxing act was passed is so unfair that it violates due process.

In *Nichols v. Coolidge*,[99] the first case before the Supreme Court involving the constitutionality of a retroactive estate tax, the grantor prior to the passage of the federal estate tax had conveyed property on an irrevocable trust for the benefit of her children, reserving the income from the trust

97. In Shwab v. Doyle, 258 U.S. 529, 42 Sup. Ct. 391, 66 L. Ed. 747 (1922), a statute taxing transfers made at "any time" was construed to tax transfers made at any time after the enactment of the taxing act.

98. In Hassett v. Welch, 303 U.S. 303, 58 Sup. Ct. 559, 82 L. Ed. 859 (1938), a provision taxing transfers made "before or after the enactment of this Act" did not impose a tax upon transfers taxed under an amendment added after the enactment of the general retroactive clause, when the transfers preceded the amendment.

99. 274 U.S. 531, 47 Sup. Ct. 710, 71 L. Ed. 1184 (1927).

during her life. Although the grantor released her life estate before her death (and even if she had not released her life estate it was held shortly afterwards[100] that a transfer with a reservation of a life estate was not taxable under the federal estate tax as a transfer taking effect at death), the Supreme Court held that the statute was unconstitutional as an attempt to tax a transfer completed before the federal estate tax was passed.[101] *Nichols v. Coolidge* apparently established the proposition that a tax upon a transfer completed before the passage of the taxing act violates due process, even though the transferor dies after the passage of the taxing act.[102]

Nichols v. Coolidge was scarcely decided, however, before the Supreme Court started to qualify it. In *Reinecke v. Northern Trust Co.*,[103] it was held that a revocable trust created before the passage of the estate tax could be taxed constitutionally under the estate tax. If the trust is freely revocable, there seems to be no unfairness about the tax, since the grantor may revoke the trust after the taxing act is passed and avoid the tax. Moreover, it can be argued that the tax upon such a transfer is not really retroactive, because the taxable transfer occurs not when the trust is created, but when the power to revoke the trust lapses at the grantor's death after the enactment of the tax. A trust which can only be revoked with the consent of a person possessing a substantial adverse interest in the trust is closer, however, to an irrevocable trust than it is to a revocable trust, and the Court has intimated that such a trust cannot be taxed retroactively,[104] which seems sound enough if *Nichols v. Coolidge* still represents the law. In *Milliken v. United States*,[105] the Court further qualified the rule of *Nichols v. Coolidge* by holding that an irrevocable transfer may be taxed under a statute passed after the transfer and in effect at the transferor's death, provided that the transfer was taxable at the time it was made. The fact that the statute in effect at the transferor's death imposed a tax at a higher rate than the statute in effect when the transfer was made did not invalidate the tax, said the Court, because the decedent should have foreseen a change in rates.

Both the *Reinecke* case and the *Milliken* case are consistent with *Nichols v. Coolidge*. There are other decisions of the Court, however, which are very hard to square with the *Coolidge* case. In *United States v. Jacobs*,[106] for

100. May v. Heiner, 281 U.S. 238, 50 Sup. Ct. 286, 74 L. Ed. 826 (1930).

101. The value of *Nichols v. Coolidge* as a constitutional precedent seems open to attack on the ground that there was no reason to hold that the statute was unconstitutional since the transfer in question was not taxable under the statute.

102. In Coolidge v. Long, 282 U.S. 582, 51 Sup. Ct. 306, 75 L. Ed. 562 (1931), the Court held that the applieation of a Massachusetts succession tax to the same transfer was unconstitutional, since the transfer was made before the tax was passed. Four of the Justices dissented, however, on the ground that the Massachusetts tax was a succession tax rather than a transfer or estate tax.

103. 278 U.S. 339, 49 Sup. Ct. 123, 73 L. Ed. 410 (1929).

104. Helvering v. Helmholz, 296 U.S. 93, 56 Sup. Ct. 68, 80 L. Ed. 76 (1935).

105. 283 U.S. 15, 51 Sup. Ct. 324, 75 L. Ed. 809 (1931).

106. 306 U.S. 363, 59 Sup. Ct. 551, 83 L. Ed. 765 (1939).

example, it was held that the entire property held by a joint tenancy, created prior to the passage of the federal estate tax, was constitutionally taxable to the estate of the tenant who furnished the consideration for the property, on the theory that there was a transfer not only of the deceased tenant's half of the property, but of the survivor's moiety as well at the decedent's death, and the tax was not, therefore, retroactive. In *Binney v. Long*[107] it was held that a transfer with a reservation of a life estate, which was made before the passage of a Massachusetts succession tax, was constitutionally taxable under such a tax passed after the transfer was made but before the transferor died, on the theory that the remainders vested on the transferor's death, and, therefore, there was a taxable transfer after the passage of the statute, which saved the tax from being retroactive. Although in these cases it may be possible to find some sort of transfer after the passage of the taxing act, which distinguishes them from *Nichols v. Coolidge,* it is difficult to see any substantial distinction. Moreover, as far as a transfer taking effect after the statute is concerned, it could be argued that even though the remainders vested in *Nichols v. Coolidge* before the estate tax was passed, there was a change of possession or enjoyment after the enactment of the tax which was the taxable transfer, so that the statute was not really retroactive.[108] It is difficult to believe, however, that the due process depends upon the fine distinctions of the medieval conveyancer. The significant thing about *Nichols v. Coolidge* is that the grantor in that case had made an *irrevocable* transfer prior to the passage of the taxing act. Since as far as the grantor was concerned there was no way in which she could recall the transfer after the tax was passed and avoid the tax, it was unfair to impose a tax upon the transfer. Regardless of the existence of some technical transfer after the passage of the taxing act in *United States v. Jacobs* and *Binney v. Long,* the transfers in those cases were irrevocable and it was just as fair or unfair to tax them as it was to tax the transfer in *Nichols v. Coolidge.* The only sound justification for *United States v. Jacobs* and *Binney v. Long* is not that the taxes were not retroactive in those cases, but that they were not so unfair that they violated due process. There are two sides to the fairness of a retroactive estate tax. If a death tax does not reach transfers made prior to the tax but before the transferor dies, this means that two men who have made exactly the same type of transfers and die on the same day will be taxed differently, because one man transferred his property before the taxing act was passed and another transferred it after the Act was passed. It seems possible that the real explanation of *Binney v. Long* and *United States v. Jacobs* is that the Supreme Court after taking a second look at the estate tax has decided

107. 299 U.S. 280, 57 Sup. Ct. 206, 81 L. Ed. 239 (1936).

108. Assuming, of course, as the Court apparently did, that Mrs. Coolidge retained her life estate in the trust property up until the date of her death.

that it is not the social monstrosity that it seemed to be at first, and that instead of trying to sabotage the tax the Court should do all that it can to further its development. The Court may have decided that in order to treat all taxpayers equally, a retroactive tax upon a transfer made prior to the passage of the taxing act and before the transferor dies should be upheld, even though this works an individual injustice to the transferor. If this assumption is sound and *Binney v. Long* and *United States v. Jacobs* are to be upheld on grounds more substantial than a fine conveyancing technicality, *Nichols v. Coolidge* is no longer law; and there is no constitutional prohibition against taxing a transfer under the federal estate tax, which was made before the tax was passed, provided the tax is in effect at the grantor's death.

The Supreme Court has never been greatly concerned with the constitutionality of the gift tax, probably because the gift tax is a supplement to the estate tax and there was no substantial reason for contesting its constitutionality after the constitutionality of the estate tax was established. In *Bromley v. McCaughn*,[109] the Court held that the tax was an indirect tax upon the transfer of property and was constitutional even though unapportioned. In *Untermyer v. Anderson*,[110] the Court held that the application of the gift tax to a gift made prior to the passage of the taxing act was unconstitutional, even though the tax had been introduced in Congress, and the taxpayer presumably had warning of its imminence. Congress has been so scrupulous about avoiding any taint of retroactivity in connection with the gift tax since *Untermyer v. Anderson*, that the soundness of that decision has never been called into question. Even if *Nichols v. Coolidge* is no longer law, however, it is quite possible that *Untermyer v. Anderson* can stand independently of that decision, because of certain factual differences between the two taxes. In the case of a retroactive gift tax every aspect of the gift is completely consummated before the tax is passed. There is no question of equalizing the position to two taxpayers who made gifts on the same day. The retroactive estate tax in the situation typified by *Nichols v. Coolidge* is not, however, completely retroactive because the death of the transferor takes place after the passage of the taxing act. The retroactivity of the estate tax may be justified, therefore, in order to equalize the tax positions of decedents dying at the same time.

In broad outline the judicial history of the estate tax follows that of the income tax. The social implications of the tax originally aroused the antagonism of the courts, which did all that they could within the limits of judicial good manners to frustrate the tax by hostile construction and constitutional restrictions. Then as the courts became reconciled to the tax, the judicial

109. 280 U.S. 124, 50 Sup. Ct. 46, 74 L. Ed. 226 (1929).
110. 276 U.S. 440. 48 Sup. Ct. 353, 72 L. Ed. 645 (1928).

attitude changed. The errors of construction which were not changed by Congress were overruled by the Supreme Court. It was decided, for example, that a transfer with a reservation of a possibility of reverter[111] and a transfer with a reservation of a life interest,[112] really were transfers taking effect at death after all. The testamentary transfer test of the constitutionality of the taxes on intervivos transfers under the estate tax gave way to a more rational "penumbra" theory. Almost imperceptibly the authority of *Nichols v. Coolidge* has been undermined, until it would seem that there are no serious constitutional objections to a retroactive tax.

111. Helvering v. Hallock, 309 U.S. 106, 60 Sup. Ct. 444, 84 L. Ed. 604 (1940).
112. Comm'r v. Estate of Church, 335 U.S. 632, 69 Sup. Ct. 322, 93 L. Ed. 288 (1949).