The Origins of Capital Gains Taxation: What's Law Got to Do with It

Marjorie E. Kornhauser
THE ORIGINS OF CAPITAL GAINS
TAXATION: WHAT'S LAW GOT TO DO WITH IT?*

by

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THE proper treatment of capital gains is a recurrent issue in income tax reform. The recent proposals embodied in President Reagan's 1985 tax program1 are merely the latest round in a debate that predates the sixteenth amendment.2 That the capital gains issue persists is not surprising. The issue raises a host of questions ranging from the philosophical to the practical. It involves theoretical economic concepts of income as well as practical economic considerations concerning the distorting effects on marketplace decisions caused by capital gains taxation.3 Politically, the

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1. THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 164-73 (Prentice-Hall ed. 1985). President Reagan's proposal is known familiarly as Treasury II (or Son of Treasury) because it is a response to, or a modification of, the Treasury's proposals for reform submitted to the President, at his request, in November 1984. TREAS. DEP'T REPORT TO THE PRESIDENT, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 100-01 (Prentice-Hall ed. 1984) (Treasury I). Treasury I proposed the abolition of the preferential treatment of capital gains under current Code section 1202, under which 60% of net capital gains are excluded from the income of noncorporate taxpayers. Under the Treasury's proposal, capital gains would be taxed at ordinary income rates. The bases of capital assets, however, would be indexed for inflation. The President's proposal retained the exclusion but reduced it to 50%. Beginning in 1991 taxpayers could elect to index the bases of capital assets instead of using the exclusion.

2. The sixteenth amendment, ratified in 1913, states: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states and without regard to any census or enumeration." U.S. CONST. amend. XVI.

3. The two major areas of economic distortion are the lock-in effect and the preferential treatment of capital gains. Lock-in occurs because only realized gains are taxable. Thus, so long as a taxpayer retains his property the unrealized gain is not taxed. The longer the property has been held, the greater (potentially) the gains realized on disposition. Thus, a tax upon these gains creates a deterrence to changing capital assets. Because investments are frozen or locked-in to avoid taxation, assets may not be used efficiently. The capital gains tax preference mitigates the lock-in effect but creates market distortions and inefficiencies since an artificial
capital gains debate raises the issue of what income should be taxed, regardless of economic definitions, and in what manner. Political and economic analyses of these questions may differ from philosophic explorations of who should bear the burdens of taxation. Finally, at a purely administrative level, capital gains taxation creates problems for the tax system. It is the source of much of the complexity of the Code as Congress constantly enacts provisions to prevent the conversion of ordinary income into capital gains at a pace only slightly less frenetic than that of clever taxpayers (and their lawyers) who devise the schemes that Congress attempts to prevent.4

As Congress and the nation once again prepare to examine the capital gains issue, an historical look at the origins of capital gains taxation in the United States is appropriate. An historic perspective yields insights that can lead to better, more informed choices regarding proper treatment. It also provides important information on the nature of our tax system by examining in a specific instance how our courts and legislature perform in the tax area.

The standard view of capital gains is that they have always been taxable under the sixteenth amendment and the statutes enacted under it.5 This view distorts reality. Although every statute since the sixteenth amendment’s enactment has taxed gains from dealings in property, that these taxable gains included profits from the occasional sale of property outside the normal course of business was not clear at the outset. In March of 1921 the United States Supreme Court settled the issue in a series of four cases (the capital gains cases). These cases not only presented a common legal issue, but also raised economic, administrative, and constitutional problems. From an economic standpoint, the Court’s decision in the capital gains cases (regardless of whether that decision was ultimately for or against taxation) was destined to affect the income tax system’s revenue-producing capacity.

preference is created for those assets that produce capital income as opposed to ordinary income.


4. The classic example of complexity is § 341 of the Internal Revenue Code of 1954, as amended, dealing with collapsible corporations. Needless to say, many other sections also attempt to prevent the transmutation of ordinary income into capital gains, such as § 83 (restricted property transferred in connection with service), §§ 724 and 751 (dealing with partnerships and inventory items), and §§ 1239, 1245, and 1250 (depreciation recapture sections). Joseph Pechman, the noted Brookings Institute economist, stated recently in Pechman, An Overview of Current Tax Reform Plans, 27 TAX NOTES, Apr. 15, 1985, at 311: “The law has become completely incomprehensible to all but a few specialized tax lawyers and accountants.” Pechman was speaking of the Code generally, but his analysis is especially true of the capital gains provisions.

Similarly, the decision would have an impact on the administrative feasibility of the tax system by affecting the degree of flexibility and certainty that the system could provide. Finally, the decision would influence the balance of power between the Court and Congress.

The Court's decision was not an inevitable conclusion drawn from legal precedent since that precedent was so contradictory that a decision either way required a repudiation of some prior Supreme Court statements. Rather, contemporary economic and political considerations profoundly influenced the decision. The Court's ultimate decision, which it based on constitutional interpretation, was that capital gains constituted income. That decision provided the best resolution of the economic and administrative issues confronting the Court. More importantly, the decision clarified the roles that the Court and Congress would thereafter play in the tax area.

Prior to 1895, Supreme Court cases had indicated a general deference to Congress when the taxing power was involved. The relationship in the income tax area, however, was muddied by cases such as Pollock v. Farmers' Loan & Trust Co. and Eisner v. Macomber, in which the Court struck down on constitutional grounds congressional exercises of the taxing power. The capital gains cases restored the precarious balance of power and reestablished a pattern of behavior that still holds today: a deference of the Court to Congress and negligible constitutional restraint on the taxing power.

This Article has two interrelated narratives: the origins of capital gains taxation, and the relationship between the Supreme Court and Congress. The underlying theme of both narratives, however, is as important as the factual content. That theme, simply put, is that results can neither be understood nor judged independently of the context that created them. We tend to view taxation as an exact science because of its involvement with numbers and economics. In the tax area, however, as in other fields, an historical viewpoint is a necessity. In the words of Harold Groves: "Taxation is an art and a technique as well as science, and it always needs to be judged against the conditions of time and place."8

I. THE 1921 SUPREME COURT DECISIONS

A. Historical Setting

In 1921 the United States was troubled by the aftermath of World War I. Governmental demands for revenue remained high largely because of the need to pay off war debts. Inflation was high, as was unemployment; facto-

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7. 252 U.S. 189, 219 (1920) (declaring the income taxation of stock dividends unconstitutional).
9. E.g., SECRETARY OF THE TREASURY, ANNUAL REPORT 27-28, 47-49 (1920) [hereinafter cited as ANNUAL REPORT]; N.Y. Times, May 30, 1920, § 7, at 1, col. 5. The then current popular demand for an army bonus for soldiers would have put another strain on governmental resources. See The Treasury's Dilemma, N.Y. Times, Dec. 25, 1920, at 6, col. 2.
ries were idle. The country was, in fact, in the midst of a depression. Many viewed the income tax system as a prime cause of the depression. The highest marginal tax rate in 1921 was 73%. Popular commentary theorized that those high rates, coupled with the unsettled state of the tax law, stifled business transactions and caused capital to flow into tax-exempt securities instead of industry.

The nation was still operating under the Revenue Act of 1918. That Act, like its immediate predecessors, had been passed when wartime conditions created a pressing need for revenues. Consequently, the statutes had been passed hurriedly without any detailed study of what an income tax should be. The entire federal income tax system, in fact, was largely experimental. The first income tax acts had been revenue-producing measures, which were passed during the Civil War and had expired shortly thereafter. The next act, the Income Tax Act of 1894, was declared unconstitutional in 1895 on the ground that taxes on incomes from real and personal property were direct taxes, which the Act failed to apportion among the states by population as required by the Constitution. The sixteenth amendment, ratified in 1913, provided for a uniform system of income taxation.


11. The "normal" tax on net income above the personal exemption amounts for 1918 was 6% on the first $4,000 and 12% on income above that amount. For years following 1918 the percentages were reduced to 4% and 8% respectively. The personal exemptions consisted of $1,000 for single persons (or married persons living apart), $2,000 for husband and wife living together, and $200 for each dependent. In addition to the normal tax, a surtax was imposed on incomes greater than $5,000. The surtax was graduated from a low of 1% up to 65% on incomes greater than one million dollars. Revenue Act of 1918, Pub. L. No. 254, ch. 18, §§ 210(b), 211(a), 216, 40 Stat. 1057, 1062-64 (1919).

12. E.g., 61 Cong. Rec. 5135 (1921) (statement of Rep. Bacharach) (tax drives money out of business, deprives commerce of necessary capital; real estate and building industry are "starving" for lack of capital); see also, e.g., Editorial, Frozen Investments, N.Y. Times, Mar. 30, 1921, at 12, col. 2 (taxpayers afraid to invest due to uncertainty of tax consequences).

13. Hamel, The Joint Congressional Committee on Internal Revenue Taxation, 5 Nat'l Income Tax Mag. 161 (1927) (earlier statutes were "trial and error" experiments). The National Income Tax Magazine later became the present day Taxes. Hamel was legal counsel and chief of the Simplification Division of the Joint Committee on Internal Revenue Taxation.

14. The Civil War measures decreased after the war and finally expired in 1872. The tax rates varied, but at no time exceeded 10%. Further, less than 1% of the population was affected. 1 S. Surrey & W. Warren, Federal Income Taxation 4 (1972). The next income tax law, the short-lived 1894 Income Tax Act, taxed net income above $4,000 at 2%. For a recent, short history of the income tax, see S. Surrey & W. Warren, supra; Grossfeld & Bryce, A Brief Comparative History of the Origins of the Income Tax in Great Britain, Germany and the United States, 2 Am. J. Tax Pol'y 211, 237-50 (1983). Four older treatises are still extremely valuable: R. Blakey & G. Blakey, The Federal Income Tax (1940); R. Magill, Taxable Income (1936) (rev. ed. 1945); S. Ratner, American Taxation (1942); E. Seligman, The Income Tax (1911). J. Waltman, supra note 5, provides an in-depth analysis of the political origins of the income tax through 1921. For additional background, see 1 B. Bitker, supra note 5, ¶ 1.2; W. Hewett, The Definition of Income and Its Application in Federal Taxation 7 (1925) (Civil War and Reconstruction income tax laws).

1913, removed this constitutional barrier by granting Congress the power to collect taxes "on incomes from whatever source derived, without apportionment." Immediately thereafter Congress passed the Revenue Act of 1913. The income tax section of that act was a mere 15 pages long; it established a normal tax rate of 1% and a graduated surtax rising to 6%. Before much experience could be gained with the new law, war preparation and then World War I itself drastically increased the need for revenue. Congress met this need by enacting a variety of taxes: numerous excise taxes, an excess profits tax, a capital stock tax, and, most importantly, an ever-expanding income tax.

The patriotic fervor that had sustained the numerous taxes and their high rates during the war had waned by 1921. People wanted "the heavy burden of taxation caused by the war" reduced. The need for revenue, however, remained high. Analysts projected that at least 4 billion dollars would be required in 1922 and 1923. Consequently, even President Harding, who had been elected in 1920 on a Republican platform that favored reducing taxes and stimulating capital to flow into industry, recognized that the "most substantial relief from the tax burden must come from readjustment of internal taxes" rather than from an absolute reduction of taxes.

Dissatisfaction with the income tax system went beyond protests against rates or particular sections of the law. Basic questions concerning the nature and limits of income taxation existed. Also, the constant enactment of tax legislation produced uncertainty as to exactly what the law taxed. At a more basic level, the confusion extended beyond what the statute said; it reached to what the statute could say. The sixteenth amendment granted Congress the constitutional power to tax income. But what was income? Although the need for the refinement of the term might be ignored in wartime, it could

16. U.S. Const. amend. XVI.
18. 61 Cong. Rec. 5125 (1921) (statements of Rep. Fordney). In fact, relatively few people paid income taxes. In 1916, only 437,036 returns were filed. By 1918 the number had increased to 4,425,114. Adams, Fundamental Problems of Federal Income Taxation, 35 Q.J. Econ. 527, 531 (1921). S. Surrey & W. Warren, supra note 14, at 12, states that about 5 1/2 million individual returns were filed for 1920 out of a population of 106 million (5% of the total population). This figure appears to represent the returns for the taxable year 1919 filed in 1920. See 2 Bureau of the Census, Historical Statistics of the United States 1110 (1975 ed.) (Table Y 402-411). Of that figure, approximately 33% had no tax owing. Id. For the taxable year 1920, 7,259,944,000 returns were filed with approximately 24% being nontaxable. Id. The total labor force (those over 14 years of age) was approximately 42 million in 1920. 1 id. at 126 (Table D 1-10). Thus, approximately 13% of the labor force paid taxes.
20. Id. Both party platforms in 1920 were for tax reform. Nevertheless, as Senator Underwood said, political differences existed on some issues because the parties were "trained in different schools of finance to view the question from different standpoints." 61 Cong. Rec. 6476 (1921). Since tax burdens were merely to be shifted rather than alleviated, the question became who was to bear the burden—the rich or the poor. See the statements of Representative Garner, id. at 5130-34. Garner, a Democrat, characterized the differing views of the two political parties as follows: The Republicans wanted to shift the tax away from big business whereas the Democrats believed in paying taxes according to one's ability to pay. Id. at 5131; see infra note 235 and accompanying text.
not be avoided in 1921. Post-war income taxpayers, wearied of war sacrifices, viewed a tax on income as burdensome and a cause of economic depression. Resolution of the meaning of income, therefore, was important. The respective roles of Congress and the Court in this resolution were not clearly defined. The income tax itself was a result of a duel between the two branches of point and counterpoint: point (the 1894 Act), counterpoint (Pollock), and point (the sixteenth amendment).

Eisner v. Macomber,\textsuperscript{21} decided by the Supreme Court a year before the capital gains cases, illustrates much of the confusion surrounding the tax area. In Macomber the Court held that although Congress had clearly intended in the Revenue Act of 1916 to tax stock dividends as income, such taxation was unconstitutional under the sixteenth amendment.\textsuperscript{22} Today, scholars view Eisner v. Macomber as a case concerning the requirement of "realization," the separation of income from capital before taxation.\textsuperscript{23} In 1920 and 1921, however, commentators viewed the cases as concerning more basic questions: What was income, and what were the respective roles of Congress and the Supreme Court in answering this question?\textsuperscript{24}

In summary, the Supreme Court made its capital gains decision in the context of a post-war country in the midst of a depression. Governmental demands for revenue remained high despite the public cry for relief from a tax system that, some said, had led to the current depression. The newness of the income tax, coupled with the constantly changing income tax laws, created a general air of confusion that further hindered business. People generally had little tax expertise; even the experts' level of sophistication was low. The uncertainty as to the balance of power between Court and Congress in the tax area added further complexity to an already confusing income tax system. Income taxation created problems at several levels. From an economic standpoint, the definition of income was unresolved;\textsuperscript{25} administratively, the income tax created numerous and complex issues;\textsuperscript{26} but the issues of "commanding importance"\textsuperscript{27} were the legal and constitutional

\begin{itemize}
  \item \textsuperscript{21} 252 U.S. 189 (1920).
  \item \textsuperscript{22} \textit{Id.} at 219.
  \item \textsuperscript{23} At the time, the case was generally understood to constitutionally mandate realization. \textit{See}, e.g., Rothschaeffer, \textit{The Concept of Income in Federal Taxation}, 13 MINN. L. REV. 637, 645 (1929). Helvering v. Bruun, 309 U.S. 461 (1940), marked a step away from that position. In Bruun a lessee had erected a building upon rented property. \textit{Id.} at 464. In 1933 the lease was cancelled, for failure to pay rent, and the lessor-taxpayer obtained possession of the building. \textit{Id.} The Court upheld the Commissioner's determination that obtaining possession was a taxable event. \textit{Id.} at 467. Surrey, \textit{The Supreme Court and The Federal Income Tax}, 35 ILL. L. REV. 779, 783 (1941), viewed the case as eliminating any constitutional requirement of realization. Section 109 of the Internal Revenue Code now reverses the Bruun result. I.R.C. § 109 (1982). Today, the realization requirement is generally adhered to for administrative convenience since the taxation of unrealized gain would require complex annual valuations. Exceptions to the realization rule exist to prevent blatant abuses. \textit{See}, e.g., \textit{Id.} § 1256 (contracts marked to market and profits taxed despite lack of realizing event).
  \item \textsuperscript{24} The case was much discussed at the time of its decision and was still an issue in 1921. \textit{See infra} notes 317-25 and accompanying text.
  \item \textsuperscript{25} \textit{See infra} notes 82-124 and accompanying text.
  \item \textsuperscript{26} \textit{See}, e.g., Montgomery, \textit{Reorganizations and the Closed Transaction}, in \textit{The Federal Income Tax} (R. Haig ed. 1921).
  \item \textsuperscript{27} Seligman, \textit{Introduction}, in \textit{The Federal Income Tax} ix (R. Haig ed. 1921).
\end{itemize}
B. History of the Cases

Since the Revenue Act of 1913, the federal tax laws have provided, with slight variation, that income includes "gains, profits, and income derived from salaries, trade, commerce, or sales, or dealings in property, whether real or personal . . . or gains or profits and income from any source whatever." 28 Since 1914, the Treasury had interpreted such a provision as applying to gains from the sale of capital assets. On August 14, 1914, the Treasury issued a private letter stating that gain from the sale of securities by a beneficiary of a will was taxable. 29 In December of that year an official Treasury decision required taxation of profits from the sale of real estate. 30 In 1919 the Treasury finally promulgated a regulation providing that income included "gains derived from the sale or other disposition of capital assets." 31

Thus, by 1920 the Bureau of Internal Revenue had already been treating capital gains as income for several years. These gains were subject, under the Bureau's interpretation, to the same tax rates as other income since no statutory provision provided special treatment for them. The fact that the Treasury considered gains from the sale of property income, however, did not mean that the populace did. In its 1921 book, Income in the United States, the National Bureau of Economic Research reported:

It seems certain, for example, that most of the farmers who sold land at the high prices of 1918-19 failed to report their profits for taxation, perhaps telling their consciences that those profits were not income but increase of capital. Doubtless, thousands of owners of other kinds of property did likewise. . . . So it happens that the "Profits from sales of real estate, stocks, bonds, etc.," reported to the Internal Revenue Bureau make but a minor item in their tables of total net income—less than 3 per cent. in 1917 and less than 2 per cent. in 1918. 32
In 1920 several taxpayers contested the Treasury's practice regarding capital gains in federal court. These challenges culminated in the four Supreme Court decisions of 1921.  

Why a challenge to capital gains taxation arose at this time, but not previously, is unclear. Perhaps cases were, in fact, brought in earlier years, dismissed without written opinion at the district court level, and never appealed, thus leaving no record for later jurists. Unwritten opinions were common at the time. Three of the four 1920 cases had been dismissed at the district court level with nothing more than a judgment ordering dismissal. Only the one case in which the district court had held that capital gains were not income had a written district court opinion. What led these taxpayers in 1920 to bring suit, and then to appeal dismissals, when previous taxpayers had not done so? Perhaps some of the four were emboldened by the Supreme Court's *Eisner v. Macomber* holding in March of that year that stock dividends were not income. Three of the complaints had been filed after the *Macomber* decision. Perhaps the willingness to pay taxes had subsided with the war. Maybe the stakes were higher since inflation effectively increased the tax bill. For whatever reasons, the four cases appeared in 1920.

C. The Supreme Court Decisions

The four capital gains cases each dealt with the sale of a capital asset outside the ordinary course of business. Within that broad context, however, the gains arose in different factual settings. *Merchants' Loan & Trust Co. v. Smietanka* concerned the sale by a trustee of stocks held for four years under a testamentary trust that directed that "accretions of selling values shall be considered principal and not income." The taxpayer in *Eldorado Coal Co. v. Mager* was a mining corporation that had sold its mine and mining plant at a profit and distributed the proceeds to its shareholders. The plaintiffs in *Goodrich v. Edwards* and *Walsh v. Brewster* were individuals who had made a profit on the sales of investments in stocks and bonds, respectively. The Court informally grouped the cases together by issuing a gains drama including T.S. Adams, Advisor to the U.S. Treasury, and David Friday of the American Economic Association. The Bureau is still active.

33. See infra notes 36-39 and accompanying text.
34. The complaint in *Brewster v. Walsh* was filed in February 1919, although the decision did not appear until December 1920. The complaints in the other three cases arose in 1920 after the March 8, 1920, *Eisner v. Macomber* decision.
35. The National Bureau of Economic Research noted that during the war reporting of income increased compared to the years 1913 through 1916. The Board speculated that such increase may have been due not only to increased efforts of the Bureau of Internal Revenue to collect income, but also to individuals who "under the spur of patriotism, seem to have made less effort to evade." 2 *NATIONAL BUREAU OF ECONOMIC RESEARCH, INCOME IN THE UNITED STATES 403 (1922) (footnote omitted) [hereinafter cited as BUREAU REPORT 2].
36. 255 U.S. 509, 515 (1921).
37. 255 U.S. 522, 526 (1921). The corporation did not dissolve because of unsettled tax liabilities. Its affairs, however, were wound up.
38. 255 U.S. 527 (1921).
39. 255 U.S. 536 (1921) (reversing Brewster v. Walsh, 268 F. 207 (D. Conn. 1920)).
40. In taxing capital gains, the government had originally claimed that pre-1913 apprecia-
short opinion in Merchants' Loan and resting the other cases on that decision. Merchants' Loan thus became the most important of the capital gains cases.

The Court's brevity, coupled with its quick dismissal of taxpayer arguments as "interesting and ingenious" create the impression that the capital gains issue was long settled. Contemporary evidence suggests otherwise. After the publication of the district court opinion by Judge Thomas in Brewster v. Walsh, which held that taxation of profit from the sale of a bond was unconstitutional, the matter received a great deal of attention. The Yale Law Journal, for example, viewed the question as being of importance equal to that of the taxation of stock dividends decided in Eisner v. Macomber. In a published comment the journal stated:

That the federal government has been collecting such taxes is known to all; but the economists as well as lawyers have not been agreed as to the validity of them, and a judicial expression of opinion on the point has been eagerly awaited. Judge Thomas' decision that such profits are not taxable has consequently aroused much comment both in financial journals and in the daily press.

Opinions were divided as to whether such gains were constitutionally taxable under an income tax. The New York Times, which devoted many articles and editorials to the issue, was adamantly against the income taxation of capital gains. It stated, for example:

The economic distinction between capital and income is one of natural law, independent of either statutes or Constitutions. The Constitution controls the procedures of Congress, but the Constitution and Congress together would find difficulty in defeating natural law. A tax on capital gains is a direct tax, and if the Sixteenth Amendment means anything at all it confirms the principle that direct taxes must be apportioned to population.

61. See Merchants' Loan, supra note 41, at 514-22 (nine-page opinion); Eldorado Coal, supra note 41, at 526; Goodrich, supra note 41, at 534-35; Brewster, supra note 41, at 537-38.
62. 255 U.S. at 521.
63. 268 F. 207 (D.C. Conn. 1920).
64. Comment, Profit on Investments as Taxable Income, 30 Yale L.J. 396, 396 (1921).
65. Id.; see Income Taxpayers to Suffer Penalty, N.Y. Times, Mar. 17, 1921, at 17, col. 1, reporting that the Treasury was warning taxpayers that despite the district court decision in Brewster they must pay tax or be subject to fraud penalties.
66. Editorial, Taxation of Capital Gains, N.Y. Times, Feb. 15, 1921, at 8, col. 4; see also Editorial, Trading and Taxing, N.Y. Times, Mar. 4, 1921, at 10, col. 3. ("[i]t may be right to
Many, but not all, legal commentators favored taxing capital gains. Even those in favor of taxation, however, admitted that the issue was "not beyond dispute." Economists, too, were uncertain.

Even the Government, which had been taxing capital gains for seven years, admitted the unsettled nature of the issue. In his motion to advance the Merchants' Loan and Eldorado Coal cases, the Solicitor General, William L. Frierson, stated that the issues of capital gains taxation involved in the cases "are questions about which much controversy has arisen and which [enter] into the determination of many pending claims. Their early determination is of great importance to the department of the Government administering the tax law."

The Supreme Court itself had issued contradictory statements, not only in different cases but even within the same case. For example, in Eisner v. Macomber the Court at one point approved the definition of income it had put forth in earlier cases arising under the Corporation Tax Act of 1909. The Court stated: " 'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle Case (pp. 183, 185)." Yet several pages later the Court stated that "enrichment through increase in value of capital investment is not income in any proper meaning of the term."

The Supreme Court had been so inconsistent that one commentator concluded that "advocates of either view . . . can find aid and comfort in the language of the Supreme Court opinions . . . . [H]e would be a bold man who would predict with assurance, what the Supreme Court decision will be."
Despite the wealth of controversy over the capital gains issue, its unsettled legal state, and the recognized importance of the issue, the Court declared in *Merchants' Loan* that capital gains were taxable without seriously evaluating the merits of the taxpayers' arguments. Why did the Court skim so summarily over the diversity of contemporary opinion? What were those differing views? An examination of the spectrum of contemporary thought on the capital gains issue within the context of the *Merchants' Loan* opinion provides insight into the process that solidified a major pillar of our tax system—the taxability of capital gains as income.

The taxpayers in each of the four 1921 capital gains cases presented lengthy but basically similar arguments in their Supreme Court briefs. The Government presented a brief only in the *Merchants' Loan* case and adopted it for the other three cases. Both sides focused on the same issues: (1) Whether the Income Tax Act of 1916 taxed capital gains realized from sales that did not occur in the course of a trade or business; (2) whether taxation of such gains was constitutional; (3) whether prior case law included such gains in the definition of income; (4) whether the common meaning of income included these gains; (5) whether trust law, which attributed capital gain to corpus rather than to income, was relevant; and (6) whether British law, which did not tax capital gain from an occasional sale or sales not arising in a trade or business, was relevant.\(^5\)

The *Merchants' Loan* Court focused on the first four issues, quickly dismissing both British law and trust law. Trust law was of "little value" because of the variable terms of trust instruments and the variety of state statutes.\(^5\) British case law was also "quite without value" because it interpreted entirely different statutes.\(^5\)

As to the remaining issues, the Court determined first that previous Supreme Court cases had defined the term "income" for purposes of the Corporate Excise Tax Act of 1909 as including capital gains.\(^5\) Next, the

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Other commentators also noted the Court's confusion. For example, Note, *Is Appreciation in Value of Property Income?*, 34 Harv. L. Rev. 536, 538 (1921) (footnotes omitted) states, after examining prior cases:

From these authorities three conclusions seem justified. First, the Supreme Court has made a number of loose and inconsistent statements some of which must necessarily be repudiated. Second, the court has used the word "income" in a sense broad enough to include capital increment. Third, the constitutional question has not been decided.

The Note concludes that since the issue was undecided, the Court should hold capital gains taxable because Congress considered them taxable. *Id.* at 539.

53. The government further argued that under *Eisner v. Macomber* the gains accruing to a capital asset became taxable upon sale, the conversion into cash having separated the income from the capital. Brief for Defendant in Error at 33-34, *Merchants' Loan & Trust Co. v. Smietanka*, 255 U.S. 509 (1921) [hereinafter cited as U.S. Brief, *Merchants' Loan*]. The plaintiff in *Merchants' Loan* had contrary arguments, in addition to those of the plaintiffs in the other three cases, based on trust law and the trust instrument involved in the case, which allocated capital gain to the trust corpus. Brief and Argument on Behalf of Plaintiff in Error at 26-38, *Merchants' Loan & Trust Co. v. Smietanka*, 255 U.S. 509 (1921) [hereinafter cited as Plaintiff's Brief, *Merchants' Loan*].

54. 255 U.S. 509, 521 (1921).

55. *Id.* at 521-22.

56. *Id.* at 517-18.
Court stated that "income" had the same meaning under the various tax acts passed under the sixteenth amendment that it had under the Excise Tax Act. The Merchants' Loan Court, therefore, held that capital gains were included in the definition of income under all of the income tax acts passed pursuant to the sixteenth amendment. The Court noted that such a definition was the commonly understood meaning of income at the time of the adoption of the sixteenth amendment. Next, the Court observed that none of the prior tax acts, including the Civil War Income Tax Act and the Excise Tax Act of 1909, had differentiated between gains from sales in the course of a trade or business and gains from sales outside the course of business. The Court found unconvincing the taxpayers' "interesting and ingenious argument that this distinction is so fundamental and obvious that it must be assumed to be a part of the 'general understanding' of the meaning of the word 'income.'" Such a construction, the Court concluded, would undermine the purpose of the sixteenth amendment.

1. The Common Understanding of "Income"

A major premise of the Merchants' Loan decision is that income should be given its "common" meaning and not be defined by "the refinement of lexicographers or economists." In stating this, the Merchants' Loan Court merely followed the path provided in Eisner v. Macomber, from which it took the phrase. As one contemporary legal critic phrased it, Eisner v. Macomber had opened the "floodgates of juristic logomachy." The definitional debates, however, had started before Eisner v. Macomber; only the word being debated changed. Prior to the sixteenth amendment the arguments focused not on the definition of "income" but on the definition of the phrase "direct" tax. The delineation of the term was vital because the Constitution required that a tax be apportioned if it were a direct tax. In determining the meaning of "direct" the Court followed the general rule of construction that words are to be given their obvious, common meanings; economic views were specifically rejected.

57. Id. at 518-19.
58. Id. at 519.
59. Id.
60. Id. at 520.
61. Id. at 521.
62. The Court did not explain why an exclusion of capital gains would defeat the purpose of the amendment. Other exclusions, such as gifts, do not defeat the amendment. What the Court had in mind, most likely, was its stance with regard to the corporate excise tax, which was a tax on the privilege of doing business measured by income. See Revenue Act of 1909, ch. 6, § 38, 36 Stat. 11, 112. In formulating its stance in that area, the Court held that to exclude gain from the sale of assets was "inconsistent with the general purpose of the act. Selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form . . . ." Doyle v. Mitchell Bros. Co., 247 U.S. 179, 183 (1918). For a discussion of the excise tax cases in relation to Merchants' Loan, see infra notes 155-89 and accompanying text.
63. 255 U.S. at 519.
Although the sixteenth amendment removed any need to apportion an income tax, regardless of whether it was a direct tax, the first case arising under the sixteenth amendment, Brushaber v. Union Pacific Railroad, concerned the terms "direct" and "uniformity" and not the definition of income. Not until Towne v. Eisner did the Court consider the meaning of the word "income." At issue in that case was whether a stock dividend was income within the meaning of the Income Tax Act of 1913 and the Constitution. The Court held that the dividends were not income, but avoided a fixed definition of the word. Justice Holmes, speaking for the Court, said: "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 the time in which it is used."

Eisner v. Macomber opened the debate on the definition of income. Despite Holmes's pronouncements in Towne v. Eisner on the fluid qualities of the word "income," Justice Pitney, speaking for the Macomber Court, felt that a definition was possible. Although he noted that the relation between capital and income had been much discussed by economists, Justice Pitney stated: "we require only a clear definition of the term 'income,' as used in common speech, in order to determine its meaning in the Amendment."

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Chief Justice Fuller followed a line of precedent that "[t]he words of the Constitution are to be taken in their obvious sense." 158 U.S. at 618-19 (citing Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 188 (1824); Rhode Island v. Massachusetts, 37 U.S. (12 Pet.) 657, 721 (1838)). As to whether Pollock did use the "obvious" meaning, see infra notes 256-72 and accompanying text.

66. 240 U.S. 1 (1916). The case arose under the income tax provisions of the Tariff Act of 1913, ch. 16, § II, 38 Stat. 166. The Court held that the sixteenth amendment conferred no new taxing powers on Congress. 240 U.S. at 17-18. Nor did the amendment eliminate the difference as to direct or indirect taxes. Id. at 19. Rather, as to income taxes, it merely stated that the power to tax incomes, which power already inhered in Congress, could be exercised without apportionment even if the source of income made a portion of the tax direct. Id. at 18; accord Stanton v. Baltic Mining Co., 240 U.S. 103, 112-13 (1916); see infra notes 256-57 and 297 and accompanying text.

67. 245 U.S. 418 (1918).

68. Id. at 426-27.

69. Id. at 425.

70. 252 U.S. 189 (1920). Macomber, like Towne v. Eisner, dealt with whether a stock dividend was income, but in Macomber the 1916 Income Tax Act, rather than the 1913 Act, was at issue. The Court held that Towne v. Eisner controlled, because the conclusion of that case effectively established that stock dividends are not income within the meaning of the sixteenth amendment. Id. at 201, 205.

71. Id. at 206-07. The Court had initially resorted to common speech definitions in defining income for purposes of interpreting the 1909 Corporate Excise Tax Act. For example, in Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918), the Court defined income in its "natural and obvious sense." Similarly, in Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399, 414 (1913), the Court stated: "[W]e are little aided by a discussion of theoretical distinctions between capital and income. Such refinements can hardly be deemed to have entered into the legislative purpose." Of course, such refinements were not necessary since, as the Stratton's Independence Court noted, that tax was an excise tax, not an income tax. Id. at 416.

The Massachusetts case of Trefry v. Putnam, 227 Mass. 522, 116 N.E. 904 (1917), provides an interesting comparison with Macomber. At issue in Putnam, as in Macomber, was whether a stock dividend constituted income. 116 N.E. at 906. The Putnam Court looked to the everyday meaning of the word income. Id. at 907. The sources of this meaning included dictionary definitions, federal statutes, and cases. Id. at 908-09. After examining these sources, the court concluded that both stock dividends and gains from the sale of stock subscription rights were income. Id. at 910-11. The Macomber Court, of course, reached the opposite result. The
The Court considered dictionary definitions and concluded that the succinct definition found in two cases construing the Corporation Excise Tax of 1909 sufficiently reflected the common definition: "Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle Case." 

The Merchants' Loan Court was "entirely satisfied" with the Eisner v. Macomber "common man" definition of income. The Court made no attempt to locate sources of "common" knowledge, nor to explain more specifically the meaning of the somewhat cryptic and decidedly vague definition. The taxpayers' briefs in Merchants' Loan and the other capital gains cases, on the other hand, looked to three main sources for evidence of what they argued was the common understanding of the term "income": (1) judicial law concerning trusts; (2) court decisions under the British income tax laws; and (3) prior Supreme Court decisions on the definition of income. These sources, of course, are not common at all, but rather are specialized branches of knowledge. A circular logic thus develops whereby the "common" is defined by looking at the expert. These specialized sources of "common"

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Footnotes:

72. Macomber Court specifically rejected the broad interpretation of income in Putnam that included every item "which by any reasonable understanding can fairly be regarded as income." 252 U.S. at 216-17 (quoting Trefry v. Putnam, 227 Mass. 522, 526, 116 N.E. 904, 907 (1917)).

73. The Putnam case also held that the gain from the sale of intangible property was income partly because the Massachusetts Legislature, in passing the state's taxing amendment, must have approved of the federal income tax laws that taxed such gains. 116 N.E. at 908-09. The court recognized that authority existed that contradicted the right to tax such gains. Id. at 908. Nevertheless, the court stated that whether taxability would ultimately be sustained was not pertinent. What was relevant was that federal revenue officials asserted that such gains were taxable and that the public "generally acquiesced." Id.

74. In United States v. Oregon-Washington R.R. & Navigation Co., 251 F. 211, 212 (2d Cir. 1918), Judge Learned Hand had also applied a common usage approach to the definition of income under the Corporate Excise Tax. Judge Hand, however, attempted a more precise definition than did Justice Pitney in Macomber. The difference, he said, between capital and income "is between permanent sources of wealth and more or less periodic earnings." Id.

75. See, e.g., Plaintiff's Brief, Merchants' Loan, supra note 53, at 53-55. The taxpayer's brief in Walsh v. Brewster stated:

The expression "common speech" used by this court does not mean ignorant speech. Furthermore, the [Sixteenth] Amendment was adopted after the meaning of the word income had been well established by the decisions of this court and many state courts . . . and the decisions of the British courts, uniformly holding that the proceeds of the sale of a capital investment are wholly capital, though sold at an advance over capital cost.


76. See Irving Fisher's hypothetical interview with the "common man" in which the common man advises that experts should be consulted in order to define income properly. I. FISHER & H. FISHER, CONSTRUCTIVE INCOME TAXATION 192 (1942) [hereinafter cited as Fisher]. Fisher also reported that although courts, legislators, and economists all "profess to reverence the notions of the common man," no one has ever asked the common man what his
understanding will be examined later. The present discussion is limited to less legal, but more vague sources of “common understanding” alluded to by taxpayers and courts, or what may be termed “more common common understandings.”

The taxpayers’ briefs in the capital gains cases refer to the common man’s view of capital as a fund that produces income. The value of the fund, in this view, may fluctuate, as may its form. The conversion of the fund from one type of investment to another, however, never produces income—despite a rise in value—because an ordinary man “if commonly prudent and conservative . . . would regard and treat it [proceeds from the conversion or sale] as still an integral part of his permanent capital.”77 The man-on-the-street naturally derives his opinions from his own actions and beliefs, which, in turn, are influenced by thoughts and actions surrounding him; his thoughts reflect the world in which he lives. Thus, the “refinements of lexicographers or economists”78 do impact the common understanding, despite the contention of the Court in Merchants’ Loan. Not surprisingly, then, taxpayers and some courts often resorted to dictionary definitions. The taxpayer’s brief in Merchants’ Loan, for example, devoted two pages to dictionary definitions, all of which referred to the regular, recurrent, or periodic nature of income.79

77. Brief for Plaintiff in Error (Taxpayers) at 19, Goodrich v. Edwards, 255 U.S. 527 (1921) [hereinafter cited as Plaintiff’s Brief, Goodrich]. The taxpayer in Eldorado Coal took the same approach:

To speak, however, of an increase in a capital investment becoming a realized gain only when the capital has been converted into money or some other kind of property is a misuse of language. We refer in common speech to a man’s capital as having increased, regardless of whether he has recently converted it into money or not. Converting it into money does not increase or diminish capital. Keeping the capital in money, or investing it in some other property, does not “change the essence” as this court said in Doyle v. Mitchell Brothers, Co., supra. The careful investor considers income in the proper sense, as well as market values, in making investments. He is not in the business of making a money income from selling his investments for a profit, but if he is prudent he may change his investments from time to time. Does such a change involve a question of income? That has not been the popular understanding.

Brief for Plaintiff at 52, Eldorado Coal & Mining Co. v. Mager, 255 U.S. 522 (1921).

78. Merchants’ Loan, 255 U.S. at 519.

79. Plaintiff’s Brief, Merchants’ Loan, supra note 53, at 54-55 (emphasis in original) reads as follows:

In Webster’s New International Dictionary under the title “Income” 4, income is defined as

“that gain or recurrent benefit (usually measured in money) which proceeds from labor, business or property,” etc.

In Funk & Wagnalls’ New Standard Dictionary, under the title “Income” 1, the word is defined as

“The amount of money coming to a person or corporation within a specified time, or regularly (when unqualified, annually),” etc.

In the New English Dictionary, under the title “Income” 6, the definition given is

concept of income is. Id. at 110. Two of Fisher’s students, under his supervision, remedied this situation by “put[ting] twelve typical questions to one hundred typical laymen.” Id. at 110-14. The students received mixed responses. Nevertheless, according to Fisher’s interpretation of the responses, most laymen do not include capital increases in their conceptions of income.
These common dictionary definitions, as well as the man-on-the-street's definitions of funds, were based on economic concepts. Economists, in turn, agreed that their conception of income was similar to the common understanding. For example, R.M. Haig, one well-known economist, stated in 1921:

[T]he economist uses [the word income] in approximately the same sense as it is used in ordinary intercourse. It has merely been necessary for him to be more precise as to exact limits and distinctions. There has been no revolutionary contribution to economic thought on this topic since the passage of the Sixteenth Amendment. The economist and the man in the street both use the term now as they used it in 1913.80

Despite such similarities, however, the problem areas in the definition of income, such as whether capital gains were income, required the precision of exact limits and definitions. Since the common understanding was incapable of such distinctions, the Supreme Court's attempt to make these determinations based on the common understanding was, as one commentator stated, "a well-nigh impossible thing."81 The vagueness of common speech could not provide the required precision, but, according to Haig, economics could.

The appropriate solution to the puzzle of income thus might have been to graft the refinements of economists onto the core of common sense. Since this common understanding was, at bottom, based on economic concepts, the resulting definition could have been fairly coherent. Although the Court consciously rejected this solution, an overview of then prevailing economic views of income generally, and capital gains in particular, is still appropriate. As part of the intellectual context in which the decision was made, economic viewpoints inevitably influenced, albeit subtly, the Court's capital gains decision. Moreover, an exploration of the economic concepts shows that an economic definition was nearly as elusive as the common understanding.

"That which comes in as the periodical produce of one's work, business, lands or investments (considered in reference to its amount, and commonly expressed in terms of money); annual or periodical receipts accruing to a person or corporation; revenue.”

After quoting the above definition, the taxpayer concluded: “The human mind does not recognize, in a gain realized by a conversion, as an isolated event a gain of recurrent character, or a gain coming within a specified time, or regularly or periodically.” Id. at 55 (emphasis in original).

80. Haig, The Concept of Income—Economic and Legal Aspects, in The Federal Income Tax 1 (R. Haig ed. 1921), reprinted in Readings in the Economics of Taxation 54, 55 (R. Musgrave & C. Shoup eds. 1959) [hereinafter cited as Haig Reprint]. On the question of capital gains as income, however, the identity of the man-on-the-street's and the economists' ideas is suspect, since the "exact limits and distinctions" of the term "income" are the precise issue. See Fisher, supra note 76, at 191 (man-on-the-street interviews).

81. Comment, Profits from Sale of Capital Assets as Income: Taxable Under Sixteenth Amendment, 19 Mich. L. Rev. 854, 857 (1921). The Nation, for example, stated that the layman's idea of income "is something that a man receives currently, and which he may spend (or save if he can) without impairing his future." Taxing Stock Dividends, 110 Nation 356, 356 (1920). This definition is as helpful as the congressional definition of income as "gains, profits, and income," a definition that, in The Nation's view, was "as enlightening and descriptive as 'pigs is pigs.'" Id.
2. Economic Concepts of Income

Theoretically, the relevant time for determining the meaning of the word income was 1913, when the sixteenth amendment was enacted. Concepts current at the time of a court's interpretation of statutory language, however, may be intentionally or mistakenly attributed to the time of enactment. In the case of the word income, the potential for discrepancies between definitions at the time of enactment and the time of interpretation is slight due to the relatively short timespan between the proposal of the sixteenth amendment in 1909 and the Court's interpretation in the capital gains cases of 1921. As noted above, the economist, R.M. Haig, claimed that in fact no change in the understanding of the term had occurred during that period. Certainly, unanimity did not exist with respect to the proper definition of income. In fact, the subject had received little attention before 1913. By 1920 more economists were addressing the matter, possibly due to prevailing economic conditions.

By 1921, however, no clear definition of income had been reached. The capital gains as income issue was particularly troublesome. As Edwin Seligman, the noted economist and lawyer, said in his introduction to the printed collection of the December 1920 Columbia Lecture Series on income tax:

At the very outset we are confronted by the question of what income really is. To this many answers have been given. But no thoroughgoing fiscal analysis of the conception has yet been made, and as a conse-

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82. See the tax cases, such as Hylton v. United States, 3 U.S. (3 Dall.) 171, 173, 176 (1796), and Springer v. United States, 102 U.S. 586, 596-98 (1880), which look to the intent of the framers of the Constitution when determining the meaning of "direct." See also 33 C.J. Internal Revenue § 20, at 282 (1924) (words must be given ordinary meaning as of date statute took effect).

83. As late as 1925, William Hewett, a professor of economics, still proclaimed that few economists, except for Irving Fisher, had even discussed the issue. W. Hewett, supra note 14, Preface. This opinion was an overstatement. The definition of income was debated, if not decided, in 1920. See infra notes 89-124 and accompanying text. To a certain extent the issue was discussed even before 1913. See, e.g., Fisher, Are Savings Income?, 9 Am. Econ. A.Q. 21 (1908); E. Seligman, supra note 14. Generally, Seligman defined income as a flow that the consumer has at his disposal to consume without impairing capital. Id. at 19. He continued: "However, the problem of defining income with such precision as completely to avoid any net impairment of capital is one that almost baffles the student; and certainly no such precision can be attained for purposes of taxation." Id. (footnote omitted).

84. The American Economic Association discussed the issue at its annual meeting in 1920. Excerpts from a paper presented by Professor Fred Rogers Fairchild were included in taxpayer's brief to the Supreme Court in Walsh v. Brewer. Appendix to Brief for Defendant in Error at 8-11, Walsh v. Brewer, 255 U.S. 536 (1921) [hereinafter cited as Appendix to Defendant's Brief, Walsh v. Brewer]. The entire paper plus responses may be found in the American Economic Review. Fairchild, Federal Taxation of Income and Profits, 11 Am. Econ. Rev. 148 (1921). Fairchild claimed that the "weight of economic authority supports the theory that mere growth in value of capital is not income." Id. at 150. He acknowledged that the present tax law treated such increases as income upon sale of the asset, but stated that such a position "is clearly illogical, whatever otherwise may be said for it." Id. at 151. The 1924 meeting of the American Economic Association also addressed the issue. See Plehn, The Concept of Income as Recurrent, Consumable Receipts, 14 Am. Econ. Rev. 1 (1924). The Eisner v. Macomber case stirred legal and economic interest in the definition of income. See infra notes 317-25 and accompanying text.
quence no two countries agree in the law on the subject. Among the fundamental points at issue here are questions like the following:

Is income to be conceived of in terms of money, of money's worth, or of mere psychic benefit? If income is a flow and capital a fund of wealth, between what periods of time is the flow realized, and when does the flow congeal into a fund? Are both realization and separation necessary to the concept of income? Does income include the appreciation of capital? Are gifts to be considered income? The decision as to these and many other similar questions waits upon a far more thorough analysis than is found in the ordinary books. 85

The best definition of income, of course, varies with the purpose of the definition. Income may have one meaning when the purpose is to produce revenue and another meaning when the goal is to produce certain economic behavior. The definition also depends on one's view of equity, which, in turn, hinges on one's political and moral convictions. Different equities may compete with each other. At the time of the capital gains cases, economic definitions of income reflected a variety of needs and views.

Classically, income was defined as "that portion of the stock or wealth, which the possessor may annually consume without injury to his permanent resources." 86 Out of this definition came the concept that capital is a pond or stock of wealth and income is the flow from that stock. Stated differently, capital is the tree and income the fruit. 87 This basic concept was subscribed to by many American thinkers in the first quarter of the twentieth century, when the U.S. income tax originated. For example, in 1911 Edwin Seligman stated: "Strictly speaking income, as contrasted with capital, denotes that amount of wealth which flows in during a definite period and which is at the disposal of the owner for his purposes of consumption, so that in consuming it his capital remains unimpaired." 88

From the concepts of flow and unimpairment of capital came the idea that nonrecurrent receipts, such as gifts or inheritances, should be considered additions to capital rather than income. 89 Since these items are irregular, the prudent man would treat them as capital. The concept of regularity or recurrence, which often meant "merely periodicity," 90 was carried over to the common man's concept, as shown in the dictionary definitions cited by the taxpayers in the capital gains cases. 91 It was also subscribed to by some

85 Seligman, supra note 27, at vii-viii. The 1920 Columbia Lecture Series addressed legal and administrative problems created by the income tax as well as economic issues. See also, e.g., Comment, supra note 44, at 397 (distinguishing capital and income "is a task which baffles economists no less than lawyers"). R.M. Haig also treated appreciation in capital as one of the thorny income issues in his Columbia Lecture. Haig Reprint, supra note 80, at 63.
86 T. MALTHUS, DEFINITIONS IN POLITICAL ECONOMY 238, definition 18 (1827, 1963 reprints of Economic Classics ed.).
87 The Macomber Court noted these concepts, but in the end looked to income as used in "common speech." Eisner v. Macomber, 252 U.S. at 206-07. The fruit and tree metaphor reappeared in the assignment of income cases of the Thirties such as Lucas v. Earl, 281 U.S. 111, 115 (1930).
88 E. SELIGMAN, supra note 14, at 19.
89 Id. at 20.
90 Plehn, supra note 84, at 6; see R. MAGILL, supra note 14, at 219.
91 See supra note 79 and accompanying text.
The regularity requirement gave rise to another factor required by some economists: Income could arise only from economic activity. Regular gain, arising from economic activity, would be used for consumption. Irregular gain, from windfalls or casual sales outside the course of business, would not be spent by the prudent person, but rather would be added to capital. Irregular gain, therefore, was not income. This conception of income existed in Great Britain before and during the time period when debates over the classification of capital gains raged in the United States. Thus, in Great Britain: “Casual, non-recurring or occasional profits arising from transactions that do not form part of the ordinary business of the person who makes them are accordingly held not to be within the scope of the Income Tax . . . .”

According to some commentators the concept of regularity derives from an agricultural economy in which wealth was based on land. Land rarely changed hands; often, in fact, it was not freely transferable at all but was entailed, passing from heir to heir. The land was the capital, and the regular harvest from that land was the income. Out of this early concept arose the ubiquitous fruit-and-tree analogy in which the capital is the tree and the income the fruit. From this agrarian view also grew the concept of the principal or capital as a res itself. Increase in the value of the capital was not income because the res itself, rather than any particular value, was the capital. Income came only from what the land or the res produced. This concept meshed with trust law, which held that the land was the corpus to be preserved for the remaindermen. Any increase in value of the corpus did not

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92. United States v. Oregon-Washington R.R. & Navigation Co., 251 F. 211, 212 (2d Cir. 1918). In United States v. Supplee-Biddle Hardware Co., 265 U.S. 189, 195 (1924), the Court assumed the common understanding that periodicity was a requirement of income. Periodicity was noted well beyond the 1920s. For example, the Third Circuit in excluding punitive damages from income stated: “Periodicity seems to be considered a factor [in income].” Consequently a gift probably was not income even if the statute did not exclude it. Commissioner v. Glenshaw Glass Co., 211 F.2d 928, 931 (3d Cir. 1954), rev'd, 348 U.S. 426 (1955), reh'g denied, 349 U.S. 925 (1955).

93. H. SIMONS, PERSONAL INCOME TAXATION 68 (1938) (quoting several international economists). Simons, of course, is the Simons of the famed Haig-Simons definition of income: “Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.” Id. at 50.

94. R. MAGILL, supra note 14, at 85 (quoting the Report of the British Royal Commission on the Income Tax. Part I, § 8, 85 (1920)); see also Note, Some Techniques of Taxation in the United Kingdom, 52 YALE L.J. 400, 402-06 (1943) (discussing current and historical taxation of capital gains in the United Kingdom). W. HEWETT, supra note 14, at 110-53, speaks of the taxing statutes under the sixteenth amendment as taxing only income from productive activity. This, he claims, is the reason for excluding gifts and inheritances from income. Nevertheless, he includes capital gains in the definition of income. Id.

95. E.g., L. SELTZER, supra note 5, at 25-26; Seligman, Are Stock Dividends Income?, 9 AM. ECON. REV. 517, 524 (1919).

96. See, e.g., R. MAGILL, supra note 14, at 40-41; L. SELTZER, supra note 5, at 26.
benefit the life tenant, who was entitled only to the fruits or income.97

Opposed to the res concept of capital was the quantum theory of capital, in which the capital consisted of a money value equal to the original cost.98 The following example illustrates the difference between the two concepts: Adam Smith buys Blackacre for $150,000. Blackacre produces a ten percent return in the form of rents, which are income to Smith. When Blackacre appreciates to $200,000, Smith sells Blackacre and puts the proceeds in a bank account earning ten percent, or $20,000, per year. Under the res theory of capital Smith has no income on the sale of Blackacre. He has merely changed the form of his capital from land to cash. His income consists solely of the fruit of that capital, $20,000 per year. Under the quantum theory of capital, Smith’s capital consists only of the original cost of the property or $150,000; the $50,000 increase in value is income to Smith.99

Commentators generally agree that the United States subscribes to the quantum view of capital. Professor Lawrence Seltzer in his classic The Nature & Tax Treatment of Capital Gains and Losses attributes this to the cheap availability of land, which made the buying and selling of it a common occurrence early in American history.100 Wealth in America thus accumulated in a manner far different than in England. In America, wealth came from the frequent purchase and sale of land; in England, wealth derived from rents on stable, long-held land. Seltzer also cites the large and frequent increase in land values due to rapid business and population growth as causing Americans to view capital as a monetary amount.101 Businessmen as well as farmers began to meet some or all of their consumption needs from capital gains. Thus, the distinctions between ordinary and capital income blurred, and the quantum or pecuniary view gained ascendance.102

In 1921 the quantum theory and its consequent blurring of distinctions between income and capital gains may have been a widespread economic view. It was not, however, the only view, nor was it clearly the predominant view. Professor Fred Rogers Fairchild of Yale University, in his speech before the American Economic Association’s annual meeting in 1920, stated his belief that the “weight of economic authority” supported the theory that

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97. See L. SELTZER, supra note 5, at 27-29.
98. R. MAGILL, supra note 14, at 40.
99. The res theory assumes that gains from sales occurring in a nonbusiness context (such as Smith’s sale of Blackacre) will be plowed back into other investments and not consumed as income. Under the British tax system, gains from regular sales, as well as gains from casual or occasional sales if the transactions were entered into for profit, are income because the gains will most likely be consumed. The property itself was never held as capital but was intended for consumption.
100. L. SELTZER, supra note 5, at 29-30.
101. Id. at 30.
102. Writing in 1951, Seltzer said that American jurisprudence inherited the “tendency” to view capital as a res and not a quantum from the British common law. Nevertheless, “when Congress expressly included the gains from capital assets in taxable income, the Supreme Court did not find this unconstitutional.” Id. at 30. Seltzer may have put the cart before the horse: the Supreme Court may have first held that the quantum or pecuniary view of capital prevailed, and the Congress may have acquiesced.
capital increase was not income. He found "illogical" the notion that capital changed into income upon sale and conversion into cash. Although some economists agreed with Fairchild, others, perhaps the majority, believed that capital gains became income upon realization at a sale or other disposition.

The Eisner v. Macomber case of 1920 and the commentary upon it reflected in the legal field the economic division over whether capital gains were income. The decision that stock dividends were not income despite the rise in capital value reflected a res theory of income, whereas the dictum that the sale of the dividend converted the capital into income reflected a quantum theory. Many commentators recognized the implications of the case and used it as an opportunity to discuss whether capital gains were income. Although some noted commentators concluded that such gains were income, the mere fact that the discussion existed indicates that the issue was not settled.

The res theory was partially recognized by the Bureau of Income Tax itself. For example, regulations explaining § 202(b) of the Act of 1918, which dealt with gain on the exchange of property, acknowledged that no gain was recognized if the property received was not "essentially different from the property disposed of." In other words, the capital was, to some extent, the property (for example, the stock or bond) itself. Of course, to the extent that a different type of property was received on exchange, the regulations seemingly denied the res theory.

The taxpayers in the four capital gains cases followed the res or British theory, which maintained a distinction between sales within the course of business and casual or nonbusiness sales. For investors the property itself (for example, the stock or bond, or any res) was the capital, whatever its value. Capital was not limited to a pecuniary amount equalling its cost or its

103. Fairchild, supra note 84. Professor Fairchild's remarks were included in Appendix to Defendant's Brief, Walsh v. Brewster, supra note 84, at 2-3.  
104. Id.  
105. See Plehn, supra note 84, at 10. See also, for example, the responses to Fairchild's 1920 speech, by Professor H. Stein and the accountant George O. May. Federal Taxation of Income and Profits—Discussion, 11 AM. ECON. REV. 160-70 (1921) (realized capital gain should be taxed) [hereinafter cited as Discussion]. R.M. Haig went further; he believed that the increase was income as it accrued. Realization was not necessary since for him: "Income is the money-value of the net accretion to economic power between two points of time." Haig Reprint, supra note 80, at 75 (emphasis omitted).  
106. 252 U.S. 189 (1920).  
107. See id. at 210-12; see also R. Magill, supra note 14, at 41-42; Isaacs, Principal-Quantum or Res?, 46 Harv. L. Rev. 776, 789 (1933) (for discussions of Macomber as reflecting the res view of capital).  
108. See infra notes 317-25 and accompanying text.  
109. Treas. Reg. 45, § 1563. This regulation required a "change in substance and not merely in form." Id.  
110. If the section applies only to business property and not to investment property, the res theory is not disturbed. See supra note 99. Taxpayers in the capital gains cases argued that this distinction between business and nonbusiness sales was implicit. See infra note 111. Alternatively, the regulation can be interpreted as merely dealing with the realization requirement.
market value as of March 1, 1913.\textsuperscript{111} A trader, however, buys an asset "not . . . for his own use, but a house, or bond, to be sold at the market; his capital asset in each transaction is the amount of cash capital expended from the working capital of his business . . . ."\textsuperscript{112} The distinction between investor and businessman is critical here, as it was in Britain, because the former held his capital to produce income in the form of rents, dividends, or interest; the latter used his capital to buy and sell assets such that the act of buying and selling produced income in the form of the gains realized from the increased value. In other words, the quantum theory of capital applied to the trader, but the res theory applied to the investor.

Even if a quantum or pecuniary theory of capital did predominate in America in the period 1909 to 1921, profit from the sale of a capital asset was not necessarily income. If the sale were only a casual, occasional one, the attribute of periodicity or recurrence would be missing. Income must be a recurrent flow, and profit from "a sale is not a flow. It cannot be repeated, the transaction being final. An income tax is a recurring tax and ought to be confined to the tax period."\textsuperscript{113} Thus, the question whether capital gains constituted income was controversial even under the pecuniary theory.\textsuperscript{114}

The flow/fund and regularity concepts led to another factor considered by some economists to be a requirement of income: expendability. According to this theory, income is what a person can spend without impairing his capital. If an item is recurrent, a person will see it as consumable; if the item is not recurrent, it will be saved. Carl Plehn, for example, focused on "spendability" as a key characteristic of income in his 1923 presidential address to the annual meeting of the American Economics Association.\textsuperscript{115}

Connected with the concept of expendability was the view of income as a "flow of satisfactions of intangible psychological experiences."\textsuperscript{116} Although contemporary economic analysis recognized that income consisted of the satisfaction of these wants, it also acknowledged that a "more definite and

\begin{enumerate}
\item \textsuperscript{111} Defendant's Brief, \textit{Walsh v. Brewster}, supra note 75, at 7. The "regular recurrent interest payments [on the bonds in Brewster], not the fluctuations of market values, are income." \textit{Id.} at 8. The income tax law set March 1, 1913, as the date on which increased value might be viewed as income. Even this point, however, was confused. \textit{See supra} note 40 and accompanying text.
\item \textsuperscript{112} Defendant's Brief, \textit{Walsh v. Brewster}, supra note 75, at 8.
\item \textsuperscript{113} N.Y. Times, Feb. 15, 1921, at 8, col. 4.
\item \textsuperscript{114} Carl Plehn, for example, stated in his Presidential Address to the American Economic Association on December 27, 1923, 3 years after the capital gains cases, that the gains of a merchant or a dealer in capital assets are income because they are expected to reoccur, even if irregularly. On the other hand, gains from "transactions outside of one's regular vocation or line of business . . . are of doubtful income character." Plehn, \textit{supra} note 84, at 10. \textit{See supra} note 94.
\item \textsuperscript{115} By "spendable" Plehn means that the receipts "may be used to live on without direct impairment of one's anticipated or expected income." Plehn, \textit{supra} note 84, at 9. Plehn then confusingly says that although gifts are spendable because they don't impair anticipated future income, it is not wise to spend them. Rather, gifts should be used as capital. \textit{Id.}
\item \textsuperscript{116} \textit{HAIG REPRINT}, \textit{supra} note 80, at 55-56 (citing statements made by Professor Taussig, of Harvard, in 1916; Professor Irving Fisher, of Yale, in 1911; Professor Ely, of Wisconsin, in 1908; and Professor Seligman, of Columbia University, in 1914).
\end{enumerate}
more homogenous" measure than psychic satisfaction was needed.\textsuperscript{117} Money and money's worth thus were commonly used by economists to measure income.\textsuperscript{118} Income consisted of the money's value of goods and services received. Following this reasoning, the economist R.M. Haig concluded that capital gains were income because they increase "the economic power of the recipient to command satisfaction-yielding goods or services."\textsuperscript{119}

Not everyone agreed with the money or money's worth theory of income measurement. Professor Irving Fisher of Yale University held a contrary view of income. If income consisted of the satisfaction of wants, then only final satisfactions should be taxed. Money received for services rendered was not properly income per se. Whether receipt of the money eventually created income depended on what one did with the money. If the recipient saved or invested the money, then no income resulted; wants had been postponed rather than satisfied. Only when the recipient actually spent money would income result because consumption, not saving, satisfied wants.\textsuperscript{120}

The expendability theory of income partially meshes with the theory that capital gains are not income. The latter theory presumes that nonbusiness capital gains should and would be reinvested because to spend them would impair capital. To the extent that this presumption is true, the gains are also not income under the expenditure theory. To the extent that the presumption is false, the conclusions reached under the two theories differ. The expenditure theory may be viewed as more accurate in that it is based on what actually happens rather than on a presumption that may not always prove true.

Another view of income involved the concept of social or national income. National income measures the increase in goods and services on a national level as opposed to the individual level. Under this view items such as gifts and capital gains are not income because they do not increase the income of society as a whole. Such items are merely a transfer of existing wealth from one member of society to another rather than a creation of new wealth. Sometimes this view was applied to the concept of personal income: even though a person increased his net worth, by receiving a gift for example, he received no income because no new wealth on a national level was created. In the 1920s the exact relationship between national and individual income was unclear. Although some commentators recognized that individual income measured a person's increased wealth without distinguishing between

\textsuperscript{117} Id. at 56.

\textsuperscript{118} Id.

\textsuperscript{119} Id. at 62. Haig argued, however, that the prevailing method of taxing gains only at the time of realization was unfair since gain had accrued over several years. Id. at 62, 73. Professor Haig's article was written before the opinion in Brewster v. Walsh, 268 F. 207 (D. Conn. 1920), holding that capital gains were not income, was published.

\textsuperscript{120} Fisher, Communication: Comment on President Plehn's Address, 14 AM. ECON. REV. 64, 65 (1924). Professor Fisher is the official father of the expenditure, or consumption-based, tax now the subject of much discussion. See, e.g., Fisher, supra note 76; N. Kaldor, An EXPENDITURE TAX (1955); Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 HARV. L. REV. 1113 (1974); Warren, Fairness and a Consumption-Type or Cash Flow Personal Income Tax, 88 HARV. L. REV. 931 (1975).
new wealth or transferred wealth and without regard to whether it increased national income, the issue was not completely settled. This issue only added to the confusion as to whether capital gains were income at the individual level.\footnote{See generally H. Simons, supra note 93, at 45-49. Simons, speaking seventeen years after the Supreme Court's capital gains decision, perceived the income tax as focusing on the individual's increased command of wealth regardless of source. More contemporaneously with the Court's decision, the National Bureau of Economic Research, in its 1921 volume on national income, remarked: One of the most serious difficulties in working with these data is the difficulty of definition. Precisely what is the national income? Is it money, or commodities and services, or satisfactions? Is the National Income the sum of the incomes of individuals, or may an individual have personal income which is not income to the nation? BUREAU REPORT, supra note 32, at 3. The Bureau then stated that increased selling prices of real property did not represent increases in national income, but did represent increases to individuals. Id. at 48; BUREAU REPORT 2, supra note 35, at 249-50. Professor Hewett, writing in 1925, stated that social income was merely the sum of individual income. W. Hewett, supra note 14, at 48-51. He understood the 1913 Income Tax Act to tax only the individual's share of the national income derived from business or commercial activities, not mere transfers of already existent wealth, such as gifts. Id. at 48. Although Hewett did not directly state that later acts also measured an individual's share of the national or social income, he implied that this was the case when he said that those acts did not differ significantly from the 1913 Act. Id. at 49-51. Nevertheless, he included capital gains in his definition of individual income. Id. at 48.}

By 1921, the principle that the burdens of taxation should be distributed according to a taxpayer's ability to pay had long been established.\footnote{This article will not re-examine the various theories of justice in taxation since, as Henry Simons stated, a body of "extensive and exceedingly dull literature" has already been written on the subject. H. Simons, supra note 93, at 2. Simons himself did, however, address the issue in the introductory chapter of his book. Id. at 2-40. Such notables as Adam Smith and John Stuart Mill discussed the problem of justice in taxation. The first of Adam Smith's four maxims of taxation is that individuals ought to pay tax "in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state." A. Smith, An Inquiry Into the Nature and Causes of the Wealth of Nations, Book V, ch. 2, at 777 (Random House, Modern Library ed. 1938) [hereinafter cited as THE WEALTH OF NATIONS]. John Stuart Mill asserted that taxes should be distributed so that each individual bears an equal burden. J. Mill, Principles, Political Economy, Book V, ch. 2, § 2, at 306-26 (Colonial Press ed. 1899). What these statements mean, of course, is unclear. Should everyone pay the same proportion of tax (e.g., 10% of income), or should those with more money pay a progressively higher rate of tax on the theory that the marginal utility of money decreases as the amount of money increases. If one accepts the theory that the marginal utility of money decreases and believes that everyone should bear an equal burden, then those with more money will have to pay a progressively higher rate of tax. See generally W. Klein, Policy Analysis of the Federal Income Tax 5-36 (1976) (policy discussion of progressivity and taxation based on ability to pay). In the first quarter of the twentieth century, a progressive income tax was generally accepted (by those who accepted the income tax) as the proper measure of ability to pay. See, e.g., Brushaber v. Union Pac. R.R., 240 U.S. 1, 25-26 (1916) (progressive tax not unconstitutional); Note, Progressive Income Taxes, 12 COLUM. L. REV. 443, 443 (1912) (progressive income tax in Wisconsin not violative of federal Constitution in State v. Frear, 134 N.W. 673 (Wis. 1912)); infra note 323. A progressive tax was not, however, accepted by all. See Hackett, The Constitutionality of the Graduated Income Tax Law, 25 YALE L.J. 427, 441 (1916).} Although exact concepts of how to measure the ability to pay differed, capital gains represented a definite increase in wealth and a correspondingly increased capacity to bear tax burdens. Consequently, some people believed...
that in accordance with the principle of ability to pay, capital gains should be taxed under an income tax even if they were not income in a technical or economic sense.\textsuperscript{123}

As the above survey of economic thought demonstrates, at the time of the capital gains cases economists held widely divergent views on whether a capital increase realized from a casual, nonbusiness sale was income. Opinions ran the gamut from not taxable to probably not taxable to taxable. In differing degrees various theories of income, such as the res theory, the expendability theory, and the periodic nature of income, supported the nontaxable view. On the other hand, those in favor of taxing capital gains adhered to a quantum or pecuniary theory of capital. They believed that income measured one's increased wealth over a period of time, and capital gains increased wealth. Moreover, even if capital gains were not technically income in an economic sense, some believed that equity required taxation of this source of ability to pay.

If economic concepts in fact underlay the common understanding of the word income, the vagueness of that understanding in 1921 is not surprising. Given the diversity of economic definitions, the resulting lay definition could hardly be more precise. The Court's failure to apply an economic solution to the definition of income problem was, therefore, not a missed golden opportunity. Economic solutions were not even necessarily appropriate since the Court was not engaged in a theoretical quest for economic truth, but was interpreting a statute and a Constitution.\textsuperscript{124} An examination of legal concepts of income might be more appropriate. Thus, the next two sections of the Article explore the Court's examination of relevant legal issues.

3. \textit{Trust Law and British Law}

The \textit{Merchants' Loan} Court dismissed both trust law and British law as irrelevant.\textsuperscript{125} Both bodies of law, however, were long-established and probably more generally known than the more recent, technically complex income

\textsuperscript{123. Discussion, supra note 105, at 160. T.R. Powell took this view a step further. In commenting on the "realization" requirement of \textit{Eisner v. Macomber}, he stated that separation of income from capital is not a strict prerequisite for taxation: "From a practical commonsense point of view, there is something strange in the idea that a man may indefinitely grow richer without ever being subject to an income tax." Powell, \textit{Income From Corporate Dividends}, 35 Harv. L. Rev. 363, 376 (1922).

\textsuperscript{124. See, e.g., Powell, \textit{Constitutional Aspects of Federal Income Taxation}, in \textit{The Federal Income Tax} 51 (R. Haig ed. 1921). Powell stated that economists were not so unanimous in their theories that they could advise the Court as to "the one and only right definition of economic income." Id. at 52. Furthermore, he stated that courts were not bound by economic concepts. Legal and economic concepts of income could differ as they did in \textit{Lynch v. Hornby}, 247 U.S. 339, 344 (1918), and \textit{Peabody v. Eisner}, 247 U.S. 347, 349-50 (1918), in which dividends out of pre-1913 earnings were taxed. See Powell, supra, at 65 (taxpayer is not richer than before dividend; only form changed).

Although economic and legal conceptions may vary, R.M. Haig warned that if the legal definition "departs in any very fundamental fashion from the economic concept, injustices may arise of such magnitude as to necessitate either the abandonment of the income tax or the adoption of a constitutional amendment which will give a positive and comprehensive definition of income." Haig \textit{Reprint, supra} note 80, at 66.

\textsuperscript{125. Merchants' Loan, 255 U.S. at 521-22.}
tax laws and the confusing cases concerning them. The conception of income embodied in trust law and British law, therefore, should have influenced the common understanding of “income.”

The Merchants' Loan Court dismissed trust law as irrelevant for two reasons. First, trust law varied from state to state. Second, the powers of trustees varied greatly since they depended on the terms of the trust instrument. Although trust law did vary with the locality, most states allocated gains from sales of capital assets to principal rather than to income. The taxpayers in the capital gains cases argued that this common practice reflected the common meaning of income. The government admitted that under trust law capital gains were corpus. It argued, however, that trust law was irrelevant because the Court had disregarded trust law in its Eisner v. Macomber decision.

Whether the Macomber Court disregarded trust law is not clear. The issue in that case was whether stock dividends were income for income tax purposes. Under what was known as the Massachusetts’ Rule, dividends were allocated to corpus. Most states, however, held the contrary Pennsylvania or American view that dividends were income. Despite the so-called American view, the Macomber Court held that stock dividends were capital rather than income. In Merchants' Loan the government argued that the Court should ignore trust law as irrelevant to the capital gains issue just as the Court had ignored trust law previously on the stock dividend issue. The Merchants' Loan Court obliged. The Macomber opinion, however, does not show that the Court disregarded trust law in that case. Rather, the opinion offers proof that the Court followed trust law, or at least the Court's view of it. The Macomber Court quoted approvingly from its previous stock dividend opinion of Towne v. Eisner: “we cannot doubt that the dividend was capital as well for the purposes of the Income Tax Law as for distribution between tenant for life and remainderman.”

British law also supported the exclusion of certain capital gains from income. Based on a res theory of capital, British law distinguished between sales made in the course of business and those occasional sales made in the ordinary course of changing investments. Gains in the former situation

126. Id. at 521.
127. Id.
128. See U.S. Brief, Merchants' Loan, supra note 53, at 31-32. This practice reflected the res theory of capital.
129. Plaintiff's Brief, Merchants' Loan, supra note 53, at 53-55.
130. U.S. Brief, Merchants' Loan, supra note 53, at 31-32.
132. U.S. Brief, Merchants' Loan, supra note 53, at 31-32; Plaintiff's Brief, Merchants' Loan, supra note 53, at 36.
133. The taxpayer-plaintiff in Merchants' Loan also believed that the Macomber Court had disregarded state trust law. See Plaintiff's Brief, Merchants' Loan, supra note 53 (state law allocated dividend to life tenant despite the fact that it really was capital).
135. See discussion supra notes 94-99 and accompanying text.
were income; those in the latter were not. British law also taxed only those types of income described in five schedules. Income not listed in any schedule was not taxed. The law taxed only annual income, and the word “annual” was interpreted to exclude the occasional sale.

The Merchants’ Loan Court dismissed this British body of law as being “quite without value” because it was based on statutes “wholly different in their wording.” Presumably, the Court was contrasting the British schedular system with the American system of taxing income “from whatever source derived.” Interestingly, however, the Encyclopaedia Britannica in 1910 (one year after the sixteenth amendment was proposed) described the British income tax as “a general tax on income derived from every source.” The British viewed their system as comprehensive and described it in words strikingly similar to the phrasing of the sixteenth amendment.

The similarity may not be coincidental. Since the American income tax was relatively new, the United States naturally looked to the experience of countries such as England and Germany, which had longer histories of income taxation. Given American ties to Britain, the logical course would be for the United States to look to British law. Consequently, in drafting the sixteenth amendment Congress may have deliberately used a phrase similar to the British term and used it in the same sense. Thus, the absence of schedules in the statutes drafted under the amendment may indicate no important difference in the intended scope of American versus British tax law.

Even if the Court correctly stated that the two tax systems were totally different, the Court should not necessarily have disregarded English procedure. In fact, the Court often looked to British law. That commentators

136. L. SELTZER, supra note 5, at 29.
137. Prior to World War I the British excluded from income all gains arising from isolated or infrequent transactions. World War I, however, drastically changed the economy by creating numerous opportunities for nonrecurrent sales. Although the assets involved in such sales were bought for speculation rather than traditional investment purposes, the sales did not occur in the ordinary course of business. Since applicable British law taxed only recurrent transactions, the treasury lost large sums of revenue. The Royal Commission on the Income Tax attempted to remedy this by recommending the taxation of gains from any business transaction entered into for profit regardless of whether the transaction was a recurring one. Profits resulting from ordinary investment changes would continue to be exempt from tax. Although the Commission’s recommendations were not enacted into law, the Board of Inland Revenue began a successful administrative policy of taxing profits from transactions of a trading nature even though such transactions were technically not a business. British practice continued to exclude gains arising from a mere change in investment. L. SELTZER, supra note 5, at 28-29.
138. 255 U.S. at 521-22.
139. U.S. CONST. amend. XVI.
140. 14 THE ENCYCLOPAEDIA BRITANNICA 356 (11th ed. 1910). The Encyclopaedia also gives a concise, but good history of the American income tax from 1862 to the joint resolution proposing the sixteenth amendment in 1909. Id. at 358.
141. See Grossfeld & Bryce, supra note 14, at 238. Even Professor Seltzer admits that American jurisprudence “inherited” the British view. L. SELTZER, supra note 5, at 30. Britain’s experimentation with income tax began in the Napoleonic Wars in 1798. A regular income tax was inaugurated in 1842. Germany, taking a lesson from England, began using a tax in 1806. See supra notes 14 and 140 for some histories of income taxation.
142. In 1900, for example, the Court upheld a succession tax with copious references to English precedent. Knowlton v. Moore, 178 U.S. 41, 47-49 (1900). The Court based its 1921
would attach significance to the fact that England distinguished between gains from sales in business and gains from sales of investments was, therefore, not surprising. Robert H. Montgomery stated that some people, basing their belief on English and German precedent, predicted that:

[The United States Supreme Court, when it comes face to face with this question [of capital gains], will draw a distinction between property purchased to be resold at a profit and property purchased primarily as an investment and will decline to include in the definition of income the appreciation in the value of property of the latter class.143]

4. The Federal Tax Statutes and Decisional Law

The taxpayers asserted in the four capital gains cases that the word “income” as used in the sixteenth amendment and income tax acts enacted thereunder did not include gain from the occasional sale of a capital asset, but did include profits realized from sales in the course of business. Prior Supreme Court decisions, they claimed, supported this contention. The Merchants’ Loan Court quickly dismissed what it termed an “elaborate” argument that a distinction existed, or ever had existed, between isolated or casual gains and gains in a trade or business.144 The Court first determined that section 2(a) of the Income Tax Act of 1916145 taxed gains from the sale of stock.146 Section 2 defined income to include gains from “sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property . . . or gains or profits and income derived from any source whatever.”147 The Court concluded that the gain at issue arose from the sale of personal property within the meaning of the section and that the comprehensive last clause of the statute certainly included such gain in the definition of income as well.148

On the issue of whether the investment gain was income within the six-

decision upholding the estate tax in New York Trust Co. v. Eisner, 256 U.S. 345, 348-49 (1921), largely on British Law as interpreted in Knowlton. Finally, in United States v. Field, 255 U.S. 257 (1921), another estate tax case, the government’s “chief reliance” was on English law “generally, but not universally” followed in this country. Id. at 262. The Court gave credence to the English precedent, but distinguished it from the issue presented at bar. Id. at 263.

143. R. MONTGOMERY, INCOME TAX PROCEDURE 336-37 (1920). Montgomery ultimately disagreed with this conclusion, stating that the “average person” considered nonrecurrent capital gain to be income. Id. at 337. Many other scholars also referred to British practice in discussing American tax law. See, e.g., Note, Income Tax-Profit on Conversion of Capital Assets Is Taxable Income, 16 ILL. L. REV. 68, 71 (1921); 33 C.J. Internal Revenue § 30, at 286 n.87 (1924). Even Magill in 1945 devoted twenty pages to British taxation of capital gains. R. MAGILL, supra note 14, at 82-102.

144. Merchants’ Loan, 255 U.S. at 520-21. The district court in Connecticut, however, had upheld the distinction just a few months earlier in Brewster v. Walsh, 268 F. 207, 214 (D. Conn. 1920). See also Montgomery’s earlier observation, supra note 143 and accompanying text.


146. 255 U.S. at 516-17.


148. 255 U.S. at 516. The Court then determined that a trustee was a taxable person within the Act so that income to the trust at issue in Merchants’ Loan was taxable. Id. at 516-17.
teenth amendment, the Court said: "The question is one of definition, and the answer to it may be found in recent decisions of this court." The Court then proceeded to pick and choose from among what one contemporary commentator termed its many prior "loose and inconsistent statements." The Court's choice of precedent presented the appearance that the Court had long before settled the issue of whether income included gains realized on occasional sales of capital assets. This appearance simply was not true. Prior to the Court's capital gains decision, contemporary commentators had recognized that "[a]dvocates of either view . . . can find aid and comfort in the language of Supreme Court opinions." Moreover, after the decision they recognized that the Merchants' Loan Court had dealt summarily with the issue.

A closer examination of the Merchants' Loan opinion illuminates the actual state of the law at the time of the decision. Although two prior Supreme Court cases, Gray v. Darlington and Lynch v. Turrish, had held that capital gains were not income under earlier income tax statutes, the Merchants' Loan Court first looked to cases decided not under an income tax statute but under an excise tax statute, the Corporate Excise Tax Act of 1909 (the Excise Act). The Excise Act levied a tax on the corporate privilege of doing business. The tax was calculated annually based on the "net income . . . received by [the corporation] from all sources during such year." Consequently, the Court had found it necessary to define the term "income" at a fairly early stage. In Stratton's Independence Ltd. v. Howbert the Court had defined income for purposes of the Excise Act as "the gain derived from capital, from labor, or from both combined." The Merchants' Loan Court approved that definition as supplemented by Eisner v. Macomber, which had required that the definition "be understood to include profit gained through a sale or conversion of capital assets." The Court then cited three other excise tax cases: Hays v. Gauley Mountain Coal Co., United States v. Cleveland, Cincinnati, Chicago, & St. Louis Rail-

149. Id. at 517.
150. Note, supra note 52, at 538.
151. Comment, supra note 44, at 398; see also Note, supra note 52, at 538 (noting the Supreme Court's inconsistent statements).
152. "The opinions . . . contain no analysis of the objections thus summarily disposed of." Powell, The Supreme Court's Construction of the Federal Constitution (pt. 2), 20 Mich. L. Rev. 135, 150-51 (1921). "Troublesome statements in earlier opinions that such a profit is capital and not income were rejected [by the Merchants' Loan Court] as obiter dicta or as confined to the interpretation of particular statutes." Id. at 150.
154. 247 U.S. 221, 231 (1918).
155. Ch. 6, 36 Stat. 11, 112, § 38 (1909). The Act was held constitutional as an excise tax rather than as a direct tax in Flint v. Stone Tracy Co., 220 U.S. 107, 165 (1911). For a list of excise tax cases cited by the Court, see infra notes 158, 160-63 and accompanying text.
156. Ch. 6, 36 Stat. 11, 112, § 38 (1909).
157. Id.
158. 231 U.S. 399, 415 (1913) (cited in Merchants' Loan, 255 U.S. at 517).
159. 252 U.S. 189, 207 (1920) (cited in Merchants' Loan, 255 U.S. at 518).
way, and one case arising under the Income Tax Act of 1913, Southern Pacific Co. v. Lowe. The Court used the first three cases to support its contention that income included capital gain; it cited the fourth case as authority for the proposition that the term “income” had the same meaning under the sixteenth amendment and the Income Tax Acts of 1913, 1916, and 1917 as it had under the Excise Act.

The Court then stated that its 1872 decision in Gray v. Darlington, which had held that a mere increase in value realized on a sale was not income, had been “sufficiently distinguished” by the Excise Act case, Gauley Mountain. Darlington was held inapplicable to Merchants’ Loan because of differences in the two statutes involved. Finally, the Court disregarded its 1918 case of Lynch v. Turrish, which had held that appreciation was not income under the 1913 Act. The Merchants’ Loan Court distinguished Turrish on the grounds that the case dealt with pre-1913 appreciation, which could not be subjected to the tax imposed by the 1913 Act. In short, the Court proclaimed that except for the irrelevant case of Darlington, the Court and Congress had always included capital gains in income.

The first curiosity in the Merchants’ Loan opinion is its quotation of the Eisner v. Macomber definition of income. The complete definition as stated in Macomber read: “‘Income may be defined as the gain derived from capital, from labor, or from both combined,’ [the Stratton’s Independence definition] provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle Case.”

The emphasized phrase, which was omitted by the Merchants’ Loan Court but much cited by the taxpayers, is a critical phrase if it means that gains are taxed only if they arise from sales such as that in Doyle v. Mitchell Brothers Co. In that case a lumber company sold land from which timber had been removed. Such a sale would be taxed even under an income tax system that taxed only those gains connected with a business. The gains in

162. 247 U.S. 179 (1918) (cited in Merchants’ Loan), 255 U.S. at 519, 520.
164. Merchants’ Loan, 255 U.S. at 519.
166. Merchants’ Loan, 255 U.S. at 521.
167. Id. The Court, in one sentence, also unceremoniously dumped all British precedent because it was based on statutes that the Court characterized as “wholly different.” Id. at 521-22.
169. 255 U.S. at 521.
170. Macomber, 252 U.S. at 207 (emphasis added; footnote omitted).
171. Plaintiff’s Brief, Merchants’ Loan, supra note 53, at 73.
172. 247 U.S. at 181.
173. Determining whether assets used in a business should get capital gains treatment creates problems under current law. Is the sale of the asset so connected with the ordinary course of business that the gain from its sale is ordinary, or is the sale extraordinary, a liquidation, and therefore deserving of capital gains treatment? See, e.g., Corn Prod. Ref. Co. v. Commissioner, 350 U.S. 46 (1955), and its progeny. Corn Products held that corn futures were capital assets in the hands of a company that refined corn. Although the futures were not held for everyday sale to customers, they were an integral part of the taxpayer’s business. The assets, consequently, were not capital.
Gauley Mountain and Cleveland, Cincinnati Railway also might have been taxed under such a system. In both of those cases the taxpayer corporation sold stock of a company engaged in the same business as the taxpayer. Consequently, the gain arguably was in the course of or connected with business.

This view is supported by the fact that the tax involved in those cases was a tax on the corporate privilege of doing business. To omit taxing even casual gains of a corporation would be inconsistent with the purpose of such a tax: “Selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of the income received ‘from all sources.’” In contrast, the omission of casual gains from taxation under an income tax would not contradict the general purpose of the income tax. Finally, one should remember that the Excise Act did not tax income, but merely based excise tax calculations on income. Consequently, fine distinctions of what was and was not income were not necessary because the Excise Act could tax nonincome, too.

Also of interest is the Merchants’ Loan Court’s use of Gauley Mountain to demolish the precedent of Gray v. Darlington. Gauley Mountain had stated that Darlington was not controlling because it was based on the 1867 Act, which taxed income for the year, whereas the 1909 Excise Act based its tax on income received during the year. Two weeks later, however, in Lynch v. Turrish, the Court rejected the government’s attempt to distinguish Darlington. The government argued that Darlington hinged on the 1867 Act’s taxation of income “derived” in the preceding year whereas the 1913 Act at issue in Turrish taxed income “arising or accruing” in the preceding year. The Court stated: “Granting that there is a shade of difference between the words, it cannot be granted that Congress made that shade a criterion of intention and committed the construction of its legislation to the

174. Gauley Mountain, 247 U.S. at 190; Cleveland, Cincinnati Ry., 247 U.S. at 195.
175. Although Justice Pitney stated that the stock in these cases was held for investment, Gauley Mountain, 247 U.S. at 193; Cleveland, Cincinnati Ry., 247 U.S. at 196, the government had argued in its brief that investments completely unconnected with business were different from assets tangentially connected to a company’s general business. Powell, supra note 124, at 77. Thomas Reed Powell, Professor of Constitutional Law at Columbia University, commented in 1920 that although this argument was not mentioned in the Court’s opinions in the Excise Act cases, the argument “furnishes a leverage” for those who distinguish between sales by persons in business and those not in business. Id. at 78.
177. The Merchants’ Loan Court stated that upholding the distinction “would, in a large measure, defeat the purpose of the Amendment.” 255 U.S. at 521. The Court, however, did not explain what the purpose of the sixteenth amendment was. Presumably, the purpose was to allow the taxation of income without apportionment, regardless of the source. The amendment thus eliminated the problem of determining whether the tax on an item of income was a direct tax. See, e.g., Macomber, 252 U.S. at 205-06. The amendment did not, however, eliminate the issue of whether the item was income. An income tax could only tax income. If appreciation was characterized as capital, it could be taxed, but only under a direct tax and not under an income tax. 252 U.S. at 217.
disputes of purists." The great difference between Gauley Mountain and Lynch v. Turrish is difficult to explain. Possibly the Court's different treatment rests on the fact that Gauley Mountain dealt with the Excise Act whereas both Turrish and Darlington dealt with an income tax. Nevertheless, the possibility that the two opinions merely reflect a divided and confused Court cannot be discounted.

The third point of interest is the Merchants' Loan Court's treatment of Turrish. The Court distinguished that case on its facts. Specifically, because all of the appreciation in Turrish occurred prior to the effective date of the Act it was not taxable. The Turrish Court, however, had not confined itself to these facts. Rather, it stated broadly that the mere increase in value of capital was not income. As precedent the Court cited Darlington, a case that in the Court's opinion had "not been since questioned or modified," despite the fact that Gauley Mountain had been decided two weeks previously. Turrish thus provided strong support for the belief that Darlington was valid precedent and that capital gains occurring outside the business context were not income.

The case law, in short, was a morass of contradictory statements. The income tax cases of Darlington and Turrish clearly did not tax capital gains. The Excise Act cases distinguished Darlington and taxed capital gains, although arguably not in a context outside the course of business. Macomber contained statements that could be used to support either side of the issue.

If judicial statements were confusing, perhaps clarity and certainty lay in the statutory language itself. As the Merchants' Loan Court noted, the statutes clearly taxed gains from dealings in property or from any source whatever; but could a statute make an item income simply by labelling it such? In Macomber the Court had said no. The Court declared that the sixteenth amendment did not permit capital to be taxed as income; it merely permitted income to be taxed without apportionment. Some commentators applied this reasoning to the capital gains issue, too: "It may be right to tax profits as profits, but it cannot be right to tax capital as income, nor can capital be made income by statute."

Did either the statute or the amendment really include gains from casual

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181. Id.
182. See Merchants' Loan, 255 U.S. at 521.
184. Id. at 230.
185. Even Professor Powell, who was in favor of taxing such gains, recognized the force of Turrish. Powell, supra note 124, at 79-81. Powell, however, noted that the gain in Turrish had accrued prior to 1913. The government conceded in its Merchants' Loan brief that Darlington governed Turrish because the statutes in both cases taxed income "arising or accruing" in the year. It claimed that Darlington did not govern cases under the 1916 Act because that Act, like the Excise Act, taxed income "received" during the year. Thus, according to the government, Mitchell Bros. should govern. U.S. Brief, Merchants' Loan, supra note 53, at 28.
186. Merchants' Loan, 255 U.S. at 516.
188. Editorial, Trading and Taxing, N.Y. Times, Mar. 13, 1921, at 10, col. 13; see also Kates, Profit Taxed as Income, N.Y. Times, Jan. 23, 1921, § 7, at 2, col. 4 (questioning Con-
sales of capital assets or were such gains excluded from income despite the broad wording of the enactments? The Merchants' Loan Court said that the statute taxed all gains from dealings in property, noting Congress's failure to distinguish between business and occasional, nonbusiness related sales.\textsuperscript{189} Thus, the Court reasoned that no distinction was intended. This reasoning, however, is too facile.

British statutes also did not distinguish between business and occasional sales. Nevertheless, British courts had interpreted the statutes to exclude occasional sales.\textsuperscript{190} Although the British statutes differed from the American ones,\textsuperscript{191} the British approach of distinguishing between business and nonbusiness sales in practice despite the lack of such distinction in the statutes was surely known to Congress when it framed the income tax laws. That Congress had intended to follow a similar scheme is a real possibility. Thus, Congress might have intended that occasional gains from nonbusiness sales would be excluded from taxation, although no explicit statutory exclusion existed because the common understanding of the word "income" contained such an exception. The exclusion would be understood without verbalization. This type of congressional reasoning is not an uncommon phenomenon. Words truly are not "crystals."\textsuperscript{192} Language that is clear to one generation may be unclear to another and need a gloss to make it understandable. For example, the Constitution sets forth the age and nationality requirements that a "person" must meet to hold office.\textsuperscript{193} Nowhere in the Constitution is a distinction made between white persons and nonwhite persons or between male and female persons. The distinction, however, so clearly existed in the common understanding of who was qualified to hold office that it did not have to be put in writing.\textsuperscript{194}

\textsuperscript{189} 255 U.S. at 516, 520.
\textsuperscript{190} L. Seltzer, \textit{supra} note 5, at 29.
\textsuperscript{191} See \textit{supra} notes 135-43 and accompanying text.
\textsuperscript{192} See the statement of Justice Holmes, \textit{supra} text accompanying note 69.
\textsuperscript{193} U.S. CONST. art. I, § 2, cl. 2 (for Representatives); U.S. CONST. art. I, § 3, cl. 3 (for Senators); and U.S. CONST. art. II, § 1, cl. 3 (for the President).
\textsuperscript{194} The taxpayers in Merchants' Loan similarly argued that the wording of the sixteenth amendment achieves its meaning only within the context of the times. Plaintiff's Brief, Merchants' Loan, supra note 53, at 62. The taxpayers argued that the sixteenth amendment uses, not the words of the Act of 1867, "gains, profits and income from whatever source derived," but merely the one word "incomes," and added "from whatever source derived." The omission is significant. Those who voted for the Sixteenth Amendment excluded "gains and profits" as such and granted to Congress a power to tax only "income."... It is difficult to close one's eyes to the fact that the language of the Amendment was selected in the light of the decision of this Court in Gray v. Darlington. In order that there might be no basis for enlarging the scope of the Amendment, the words "gains and profits" were particularly omitted. The decision in Gray v. Darlington became, therefore, as much a part of the Amendment as did the language used in it. 

\textit{Id.} In United States v. American Trucking Ass'ns, Inc., 310 U.S. 534, 543-44 (1940), the Court declared that extrinsic evidence may be necessary to explain seemingly clear statutory language. A discussion of various types of extrinsic evidence that may be used, as well as the problem of weighing the evidence, appears in 1 B. Bittker, \textit{supra} note 5, ¶ 4.2.2. Although
As shown previously, the common understanding of the term "income" at the time of the sixteenth amendment was unclear. 195 Prior income tax acts, however, would naturally form a basis for any such understanding. Pre-sixteenth amendment income tax acts had severely limited the tax on profits from the sale of property. The 1867 Act involved in Darlington as well as the ill-fated 1894 Act, for example, did not overtly distinguish between casual sales and business related sales. Rather, the Acts limited gains from sales of real property to property bought and sold within two years. 196 The two-year cut-off, however, implies a distinction between casual and business sales. The fact that real property was bought and sold within two years would indicate that the property was held for trade rather than investment purposes, and the gain would, therefore, be taxable. Some legislative history of the period indicates that Congress did not intend to change this rule concerning occasional capital gain after the passage of the sixteenth amendment. For example, in congressional debates on the 1913 Act Representative Hull, while explaining the bill to the House, stated that although he could not possibly explain every transaction, the task would be aided by "[t]he rulings of the Treasury Department and the decision of the courts of this country with respect to similar provisions of the old income-tax laws, and also the English rules of construction, all essential portions of which will be embraced in the Treasury regulations." 197 Since case law, trust law, British law, and prior U.S. income tax laws all held that gains from occasional sales were not income, Hull likely intended the 1913 Act also to exclude such gains.

Shortly after this first statement, Mr. Hull engaged in a conversation on the floor of the House with Representatives Mann and Rogers concerning the gain from sale of property. Much of that exchange is confusing. Mention is made of taxable gain on sales, but that discussion often, if not always, seems connected with a sale in business. 198 The exchange concluded with Mr. Hull saying: "as to an occasional purchase of real estate not by a dealer or one making the buying and selling a business this bill would only apply to profits on sales where the land was purchased and sold during the same year." 199

Such statements thus support the proposition that in 1913 Congress intended to exclude casual capital gains from taxation. Was this intended ex-

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195. See supra notes 63-81 and accompanying text.
196. See, e.g., Plaintiff's Brief, Goodrich, supra note 77, at 82; R. MAGILL, supra note 14, at 103. The Commissioner of Internal Revenue apparently treated gains from casual sales as income in the same manner under the early Civil War Acts. See CONG. GLOBE, 38th Cong., 1st Sess. 2515 (1864) (remarks of Senator Fessenden). The 1864 amendment offered by Senator Fessenden would apparently have taxed as income only the profit attributable to the year of sale.
197. 50 CONG. REC. 506 (1913) (discussion on H.R. 3321). Hull was an "author and committee chairperson" of the Act. 50 CONG. REC. 89 (1913) (statement of Hon. J. Hampton Moore).
198. Plaintiff's Brief, Goodrich, supra note 77, at 78.
199. 50 CONG. REC. 513 (1913).
clusion still present in 1916 when, according to the government and the
Court, Congress changed the meaning of income by replacing “accrued”
with “received”? If the constitutional parameters of income are to be
determined from the meaning of the word in 1913, the year in which the
sixteenth amendment was adopted, then congressional intent in 1916 is
constitutionally relevant only to the extent that the meaning of income remained
constant. Even if constancy is assumed, the 1916 legislative history is
inconclusive. The history only makes clear that some confusion existed on
the issue of capital gains taxation.

The fact that the provision of the 1916 bill governing gain from the sale of
property was repeatedly amended, sometimes in a manner differentiating be-
tween business and nonbusiness property and sometimes not, reflects the
confusion that surrounded the issue. The intent behind the numerous
changes is unclear to the modern reader and perhaps was unclear to the
legislators themselves. For example, on August 30, 1916, Senator Clarke of
Arkansas offered yet another amendment that stated:

[T]he profits realized within the year from the sale or other disposition
of any real estate purchased within two years previous to the close of
the year for which such income is estimated, shall be the basis for deter-
mining the amount of such gain so derived from such sale or other
disposition.202

In explaining his amendment, Senator Clarke stated that its purpose "was
to fix a date when the profits of an investment should cease to be income and
become capital. . . . This has been one of the troublesome questions in tax
legislation." According to Clarke, the 1913 Act did not have such a pro-
vision and thus had not taxed gain on any sale of investment property other
than gain for the current year.204 The original provision of the 1916 bill
purported to correct the situation by fixing March 1, 1913, as the permanent
date for fixing capital.205 Any gain after that date would be income. Ac-
cording to Clarke, however, this provision violated the rule established in
Gray v. Darlington that if real estate were held for longer than two years,
then the gain "merged in capital and it was not proper to fix it as in-
come." Clarke's amendment aligned the statute with what he perceived
to be the Supreme Court's rule. When Senator Hitchcock asked how per-
sonal and mixed property would be treated under Clarke's amendment,
Clarke responded: "Profit not made on [personal or mixed] property during
the year or rather realized by the sale, would not be treated as income. That

200. For a discussion of the import of the different wordings, see supra notes 179-81 and
accompanying text.
201. The Merchants' Loan Court assumes it, as do some contemporaries such as R.M.
Haig. 255 U.S. at 519.
202. 53 CONG. REC. 13,407 (1916). This amendment, those amendments alluded to earlier in
the text, and the text of the original bill are all collected in the appendix to the plaintiff's
brief in Goodrich v. Edwards. Plaintiff's Brief, Goodrich, supra note 77, at 80-86.
203. 53 CONG. REC. 13,407 (1916).
204. Id.
205. See supra note 202.
is the universal rule."\(^{207}\) In other words, Clarke's interpretation of *Darlington* was that gains from dispositions of capital assets could never be income unless the assets were bought and sold within the year; however, gains on real property could be income if the property was bought and sold within two years. When asked why the law treated real estate differently from other property, Clarke responded: "That is the law. The Supreme Court of the United States answered that question . . . ."\(^{208}\) He then proffered the explanation that personal and mixed property change hands frequently, whereas real estate does not.\(^{209}\) This response suggests that real estate that is bought and sold quickly is not a casual sale, but one in connection with a business. In short, the response suggests the very distinction that the taxpayers argued in the capital gains cases. At any rate, Senators Hitchcock and Chamberlin expressed some confusion.\(^{210}\) The issue was postponed until the next day, but apparently never reopened.\(^{211}\)

Legislative history of the 1913 and 1916 Acts, as demonstrated above, is inconclusive. Some statements indicate that nonbusiness capital gains were not meant to be taxed, but such statements are few. Perhaps the most accurate description of congressional intent is that Congress was confused and its intent was ambiguous. If so, Congress was in good company; almost everyone else, including the Supreme Court, was confused.

II. EXPLANATION OF THE COURT'S DECISION

The Supreme Court's decision on the capital gains issue could have gone either way. Legal precedent would have supported a decision either for or against taxation. Legal and economic experts disagreed whether taxation was proper. Although the majority probably thought taxation of capital gains was wise, they admitted that the issue was legally unsettled.\(^{212}\) The contradictory judicial statements added to the confusion caused by constant change in tax legislation. Stability in the tax system was needed. The unsettled state was seen as detrimental to the economy. Business was afraid to take risks because the law changed too fast for comprehension.\(^{213}\) Confusion endangered the revenue system, which relied on self-enforcement.

\(^{207}\) Id. at 13,408.

\(^{208}\) Id.

\(^{209}\) Id.

\(^{210}\) Id.

\(^{211}\) This conclusion is based on a statement that subsequent debates "do not appear to throw any light upon the intention of Congress." Plaintiff's Brief, *Goodrich*, supra note 77, at 86. I have not personally read the thousands of pages of debates, but I feel confident that a plaintiff with a pocketbook at stake would have perused the debates fairly thoroughly.

\(^{212}\) Robert Montgomery's standard manual stated in its 1920 edition, prior to the *Eisner v. Macomber* decision, that the 1918 Act rightly taxed capital gains, but whether the sixteenth amendment was broad enough to cover such gains was not yet clear: "what is needed is an authoritative definition of 'income.' It cannot be found in the Supreme Court decisions because there are too many differentiations and limitations to make it at all clear what a decision will be in any future case." R. MONTGOMERY, *supra* note 143, at 253.

\(^{213}\) See, e.g., 61 CONG. REC. 5355 (1921) (statements of Rep. Mondell); N.Y. Times, May 30, 1920, § 7, at 1, col. 5 (the author of this article, Otto H. Kahn, was a noted banker); Editorial, *supra* note 12, at 12, col. 2.
If people did not know or understand the law, they could not self-police payment of the tax. As professor Seligman said: "Inasmuch as certainty is one of the prime requisites of a good tax system, the attempt of our courts to achieve certainty and to make it harmonize with constitutionality is one of supreme interest."214

That the Court needed to state clearly a position on the taxability of capital gains was apparent. The position that the Court would take, however, was not apparent.215 Precedent did not point clearly in either direction. Ultimately, precedent proved indeterminative since the Court, as previously discussed, did not make its decision based on careful analysis of legal argument. What tipped the balance toward taxability of capital gains was not legal doctrine, but the political, economic, administrative, and constitutional concerns of 1921.

A. Economic and Political Concerns

The economic state of the union in 1921 was dismal. The post-World War I boom, which slowed in the last quarter of 1920, had become a depression by 1921.216 Tax revenues were decreasing despite high rates. Governmental expenses, on the other hand, remained high.217 The costs of World War I, especially the need to retire war debts, were already enormous, but pressures existed to increase governmental expenditures further in the form of a soldier's bonus.218 In addition, troubled agriculture and transportation industries required governmental assistance.219 Both D.F. Houston, the outgoing Secretary of the Treasury under the Wilson Administration, and Secretary Mellon, beginning under the Republican Harding Administration, recognized in varying degrees that the government needed to contain expenditures and readjust tax rates.220 The public believed that high taxes crippled industry and business because they caused the rich to invest their money in tax-

214. Seligman, supra note 27, at ix. The need for certainty in a tax system was one of Adam Smith's maxims. See THE WEALTH OF NATIONS, supra note 122, at 778.
215. Thomas Reed Powell, Professor of Constitutional Law at Columbia University, was convinced, based on Eisner v. Macomber, that the majority of the Court believed gain from sale of capital assets was income. Powell, supra note 124, at 82. Other commentators were not so sure. See supra notes 47-52 and accompanying text.
217. See supra note 19 and accompanying text.
218. E.g., Brown, Why Our Budget System Will Not Reduce Taxes, 112 NATION 789 (1921); Editorial, The Treasury's Dilemma, N.Y. Times, Dec. 25, 1920, at 6, col. 2 (Treasury's situation "so serious" that it was trying to collect "slow assets" from foreign governments); Treasury to Urge Revision of Taxes But Sees No Cut, N.Y. Times, Nov. 8, 1920, at 1, col. 1; Excess Profits Tax or Sales Tax, N.Y. Times, May 3, 1920, at 1, col. 5.
219. The Transportation Act of 1920 provided some governmental relief to railroads and imposed a corresponding burden on the government. In 1921 President Harding proposed additional relief for railways. See, e.g., Harding Proposes War Finance Board & Fund Railroad Debt, N.Y. Times, July 27, 1921, at 1, col. 1.
220. See, e.g., ANNUAL REPORT, supra note 9, at 34, 47. The Nation editorialized that the only way to reduce taxes was to reduce the arms build-up. It claimed that in 1921 68% of the budget went for expenses of past wars (pensions, war debt, etc.), 20% went for future wars, and only 12% for nonmilitary purposes. Since Congress already had trimmed nonmilitary
exempt securities instead of in private industry.\textsuperscript{221} In addition, the high rates prevented transactions in capital assets because people did not want to pay the tax on the realized capital gains, which the Treasury required even though the law was arguably unclear on the issue.\textsuperscript{222} Consequently, property was not being used in the most efficient and profitable manner. Newspapers, businessmen, and Congress recognized and complained of this “lock-in” factor, or freezing of capital.\textsuperscript{223}

The flow of capital to tax-exempt securities, and the lock-in effect both decreased revenue receipts and depressed an already stagnating economy. A Supreme Court decision holding that capital gains were not taxable had the potential to encourage business activity. Without a threat of a tax upon sale, property would change hands more readily. Theoretically, property would ultimately rest in the hands of those who could use it most productively. Increased productivity would then create taxable income, which would lead to revenue for government.

The exemption of capital gains, however, would not necessarily have been a panacea either for the cash-hungry Treasury or for business; in reality it might have been disastrous. A holding that capital gains did not constitute income would have decreased a tax base that already had been precipitously reduced by the huge flow of money into tax-exempt securities. The British experience in World War I had shown that an exemption for capital gains could reduce the tax base dramatically. The war had created vast opportunities for sporadic gains from sales of speculative property. Since these spo-

\begin{footnotesize}
\begin{enumerate}
\item The cry for reduced armaments was not unique to \textit{The Nation}. \textit{The New York Times}, in an editorial urging the United States to lend money to Germany, proclaimed:

\begin{quote}
Millions lack food while billions are spent for powder and bullets. . . . It is little to say that “defense” expenditures are unproductive. They are destructive. Men must live before they can use weapons, and the hungriest nations must be fed first. . . . Lloyd George last week set the example of heroic reduction of armament expenses. Others must imitate that example if the world is to be saved from famine and if civilization is to be preserved.
\end{quote}


221. \textit{See ANNUAL REPORT, supra note 9, at 137; supra notes 11-12 and accompanying text; and innumerable references in congressional hearings and debates on 1921 Revenue Act.}

222. \textit{See supra notes 29-33 and accompanying text.}

223. \textit{See Editorial, supra note 12, at 12, col. 1; supra note 26 and accompanying text.} The lock-in or freezing effect may have been exaggerated. The National Bureau of Economic Research (the Bureau) stated that many property owners “doubtless” failed to report profits from the sale of property. \textit{BUREAU REPORT, supra note 32, at 44-45.} If the Bureau’s report was accurate, then fewer assets were frozen than were being reported. Perhaps the complaints about the tax rates indicated merely a fear that the Bureau of Internal Revenue would discover and tax the sale. \textit{See BUREAU REPORT 2, supra note 35, at 254.} The Bureau, however, further stated that taxes “were an effective deterrent from making realizing sales.” \textit{Id.} On the same page the Bureau second-guessed itself once again by noting that tax on capital gains was often avoided via gift and subsequent sale. For example, if a taxpayer gave securities to a son who then sold the stock, the son did not realize taxable income on the sale since his basis in the stock was the fair market value of the stock at the time of the gift. \textit{Id.} at 254-55. Section 202(2) of the 1921 Revenue Act closed this loophole by providing that the donee’s basis for a gift was the donor’s basis. \textit{Taft v. Bowers, 278 U.S. 470 (1929),} upheld the provision, which is embodied in § 1015 of the current Internal Revenue Code. Section 1015(d) provides for an increase in basis to reflect gift tax paid on net appreciation. \textit{I.R.C. § 1015(d) (West 1982).}
\end{enumerate}
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radic sales were excluded from tax, the British Treasury lost large amounts of revenue. Consequently, in 1920 the Royal Commission on the Income Tax recommended that gain from any profit-seeking transaction be taxed, regardless of whether the transaction was isolated.224 In essence, the Commission broadened the scope of business income while maintaining the exemption for gain on a mere change of investment. Although such a view of exempt capital gains could have been adopted by the Supreme Court, it would have created much ambiguity and litigation. Moreover, it would have narrowed the tax base.

The government could not afford a further narrowing of the tax base, particularly in light of the Court’s decision in Eisner v. Macomber, which had held that stock dividends were not income. The Macomber decision cost the Treasury between twenty-five and 105 million dollars that the government had to pay in refunds for the years 1918 and 1919.225 If the ultimate sale of the stock dividends were not taxable, the Treasury would fail to recoup the refunded $105 million.226 More importantly, the tax base would be forever narrowed as more and more corporations would give stock, instead of cash, dividends.227

The Evans v. Gore decision had also narrowed the tax base. Although the issue in Gore was limited to whether the salaries of federal judges were taxable, the opinion stated broadly that the sixteenth amendment had not enlarged Congress’s taxing power.229 Consequently, salaries paid by state and municipal governments were not taxable.230 The Court’s statement in Gore effectively resolved a question that had been debated since the amendment was first proposed.231 As one commentator noted, this broad holding would further encourage the flow of capital into tax-exempt securities, thus seriously impairing the tax-base.232

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224. See supra note 137; ROYAL COMM’N ON THE INCOME TAX ¶ 90-91 (1920) (cited in L. SELTZER, supra note 5, at 29). The recommendations were never enacted into law, but were effected administratively by the Board of Inland Revenue. L. SELTZER, supra note 5, at 29.

225. ANNUAL REPORT, supra note 9, at 36 (Treasury paid $35 million in refunds for 1918 and tax income would probably be reduced by $70 million for the year 1919).

226. The Treasury’s report further stated that despite the refunds most Treasury experts expected the net loss to be less than $25 million dollars. Id. These estimates, however, were based on the assumption that taxable income would result when the stock dividends were eventually sold. See Secretary Houston’s Tax Proposals, N.Y. Times, Mar. 19, 1920, at 12, col. 3; see also 23 NEW REPUBLIC, June 9, 1920, at 60 (letter of Charles Clark in which he expressed hopes that Macomber’s dictum settled the issue of taxing the gain upon sale of the dividend). The exact amount of the revenue loss caused by Macomber was debated. Small Government Loss From Stock-Dividend Decision, LITERARY DIG., Apr. 17, 1920, at 159 (reports exaggerated amount of loss).


228. 253 U.S. 245 (1920).

229. Id. at 260-62.


231. Evans v. Gore, 253 U.S. at 255 (Court stated in dictum that income from state and municipal bonds not taxable); see Comment, supra note 230, at 76.

232. Id. at 80; see supra note 227.
Theoretically, the reduction in a tax base caused by a capital gains exclusion could be offset by taxing larger numbers of people. In 1920 Congress easily could have expanded coverage since most people were not taxed. A lowering of the exemption amount would have subjected a vast portion of the population to income tax for the first time. Taxing a larger number of people on a narrower tax base could net the same amount of revenue as taxing fewer people on a more comprehensive tax base. Politically, however, this solution was dangerous. Although the majority of people did not pay income tax, they paid a variety of miscellaneous taxes. Both parties had run the 1920 presidential campaign on platforms that promised tax relief for the protesting populace. The general public probably would not have thought that subjecting people to the income tax for the first time constituted tax relief. Moreover, such a move would have done little or nothing to provide relief in the form of reduced rates to those people who were already paying income taxes at rates they considered burdensome.

The group clamoring for lowered rates was small, but it consisted of many wealthy and politically powerful individuals, including the Secretary of the Treasury, Mr. Mellon. Furthermore, contemporary opinion was that tax rates needed to be reduced in order to lift the country out of the depression. Lowered rates would reverse the flow of capital from tax-exempt securities back into profitable business investments, stimulate the economy, and eventually produce equal or greater revenues despite lower tax rates. In the meantime, however, Congress would need another source of revenue to replace the revenues lost by the lowered rates. The miscellaneous taxes mentioned above provided a possible source, but subjecting more of the public to the income tax while raising other taxes might have been unacceptable politically.

233. See supra note 18.
234. See supra notes 18-20 and accompanying text.
235. See supra note 20. Representative Bacharach stated that Harding won the election in part because people wanted efficient economic management of government "with a consequent rearrangement and reduction of Federal taxation which would permit an early return of business prosperity and a more equitable distribution of the burden of Federal taxes." 61 CONG. REC. 5135 (1921). Representative Joseph Fordney of Michigan, Chairman of the House Ways and Means Committee, reiterated the mood of the public when he introduced the 1921 revenue bill: "The sentiment of the country is that the people should be relieved, so far as possible, from the heavy burdens of taxation." 61 CONG. REC. 5125 (1921). Both parties had pledged lower taxes. See, e.g., Editorial, Congress on Trial, N.Y. Times, Aug. 12, 1921, at 12, col. 1. The question was simply which group would bear the brunt of the taxes. The battle concerning the 1921 tax legislation was whether the bill helped the rich or the poor. See, e.g., Democrats Prepare to Fight Bill, N.Y. Times, Aug. 17, 1921, at 3, col. 3, stating that the bill was a rich man's bill because individuals with incomes ranging from $5,000 to $66,000 a year would pay the same taxes as under existing tax laws, whereas persons with incomes exceeding $66,000 would receive reductions ranging from 1% to 50%. The commonly perceived difference between the parties was that Republicans shifted tax so as not to hurt big business, whereas Democrats believed in allocating the tax burden according to ability to pay. 61 CONG. REC. 5131 (1921) (remarks of Mr. Garner).
236. See supra note 12 and accompanying text.
237. Part of the political struggle during the debates on the Revenue Act of 1921 related to relief from the miscellaneous taxes. Senator Smoot's proposed amendment to the revenue bill would have repealed the following miscellaneous war taxes: the excise taxes; luxury taxes; stamp taxes; capital stock tax; transportation, telegraph, and insurance taxes; the taxes on soft
The Supreme Court Justices must have been aware of the public demands for lower income and miscellaneous taxes and the congressional need for more revenue. The connection between the government's need and the capital gains cases was obvious. Many contemporary accounts linked the two, and some observers implied that the need for revenue was a factor in the Court's decision to tax capital gains.\textsuperscript{238} \textit{The New York Times} noted, for example, that if the Court had not held capital gains taxable, the Treasury "could scarcely have met" the large demands upon it without legislative relief.\textsuperscript{239}

Furthermore, an exemption for capital gains would narrow the tax base. Recent British experience had shown how difficult it was to include gain in taxable income when distinctions existed between occasional and business capital gains. The more gain that was excluded, the more the tax base was eroded. So long as the tax base was narrow, it would be difficult, if not impossible to lower rates on taxable income without increasing other taxes or subjecting more citizens to the income tax. Thus, an exemption for capital gains would neither satisfy the political clamor for tax relief nor provide the spur to general economic growth that a general rate reduction would.

Finally, a holding that the taxation of capital gains was unconstitutional would permanently limit Congress's ability to meet revenue needs. The economic and industrial changes wrought by World War I and its aftermath demonstrated that Congress needed flexibility. A decision upholding the taxability of capital gains would provide Congress with the requisite power to meet changing economic conditions. It would maintain a theoretically broad tax base and allow Congress to exclude or prefer capital gains as economic conditions required. The Revenue Act of 1921, in fact, used this flexibility by including capital gains in taxable income, but taxing them at lower than normal rates in order to mitigate the "lock-in" effect on capital asset transactions.\textsuperscript{240}

Thus, the Supreme Court had strong political and economic motives to tax capital gains. The tax ostensibly would help meet immediate revenue demands. Although a tax on these gains might have an adverse effect on the

\textsuperscript{238} See, e.g., Note, supra note 143, at 72 (a decision that capital gains were not income "would have destroyed a very large source of revenue" greatly needed by the government).

\textsuperscript{239} Editorial, supra note 12, at 12, col. 2. "Naturally it [the Court] prefers the decisions in which it has found income taxable." \textit{Id.} col. 3. The article also noted, however, that the Treasury lost 100 million dollars because the Court had held that the basis for computing gain would be the higher of cost or 1913 value. \textit{Id.} col. 2.

\textsuperscript{240} 1921 Revenue Act, ch. 136, § 206(b), 42 Stat. 227, 233.
B. Balance of Power and Administrative Concerns

The balance of power among the three branches of the federal government is a cornerstone of our Constitution. Normally the balance is a delicate one. Since "the power to tax involves the power to destroy,"242 one would expect the system of checks and balances to be especially strong in the tax area. Somewhat paradoxically, however, this area is one in which the judiciary has ceded much of its power of judicial review. The Court has so far abdicated its power that in a constitutional sense there is practically no check on either executive or congressional power other than a general sense that the taxing power must be exercised for the general welfare.243 The capital gains cases of 1921 were a pivotal point in the cession of this judicial power.

The power to tax is Janus-faced. It is a destructive power, but it is also constructive, for without the power to tax a government cannot long survive. From its inception the United States has grappled with these two aspects of the taxing power in an attempt to strike a viable and democratic balance. In the Articles of Confederation, the states reserved to themselves all taxing powers. Since the War of Independence had been caused in part by oppressive taxation, the reservation of the taxing power by the states was not surprising. The failure to grant any taxing powers to the federal government, however, proved fatal. The Constitution remedied this weakness. Article I provided Congress with the "power to lay and collect taxes, duties, imposts and excises."244 The only limitations upon this power were that "direct" taxes had to be apportioned among the states according to population245 and that "all duties, imposts and excises [had to] be uniform throughout the United States."246 The Constitution did not define "direct" or "uniform." Debates at the Constitutional Convention and the ratifying state conventions were vague as to those terms and did little to clarify them.247

In Hylton v. United States the Court considered whether a tax on carriages was a direct tax and, therefore, had to be apportioned.248 Alexander Hamilton argued the case for the government,249 and three of the four judges deciding the case were members of the Constitutional Convention.250 The

241. See Note, supra note 143, at 72; Comment, supra note 44, at 400. Congress also recognized this tension and provided some relief in the 1921 Revenue Act. See supra note 240 and accompanying text.
243. See, e.g., cases listed in 1 B. BITTNER, supra note 5, ¶ 1.2.
244. U.S. CONST. art. I, § 8, cl. 1.
245. Id. art. I, § 2, cl. 3 & § 9, cl. 4.
246. Id. art. I, § 8, cl. 1.
248. 3 U.S. 171, 172, 3 Dall. 171, 172 (1796).
249. Id.
250. Justices Wilson, Paterson, and Chase were members of the Constitutional Convention.
Court held that the tax was not a direct tax and stated in dictum that perhaps only poll taxes and land taxes were "direct" taxes. The Court approached the task of defining "direct" from a practical standpoint, rather than from a technical or economic one. If a tax could not be practicably apportioned, then it was an indirect tax. To hold otherwise would result in some items being completely untaxable, and the Court reasoned that it was "obvious the intention of the framers of the Constitution, that Congress should possess full power over every species of taxable property, except exports." By using a practical rather than a technical or economic approach to the meaning of the term "direct," the Court interpreted Congress's taxing power expansively. Well-aware of the inherent flaw of the Articles of Confederation, the Justices viewed the Constitution as "vest[ing] in Congress plenary authority in all cases of taxation." Justice Chase went so far in deferring to Congress as to state that even if the Supreme Court were found to have the power to declare a congressional act invalid on constitutional grounds, he would "never exercise it, but in a very clear case."

During the period between the Hylton case in 1796 and the Pollock v. Farmers' Loan & Trust Co. case in 1895, the Supreme Court had several opportunities to consider whether a particular tax was a direct tax and, therefore, required apportionment. In each case the Court took a position consistent with Hylton. Congressional power to tax was viewed expansively, and none of the taxes, including the income tax of 1864 at issue in Springer v. United States, was held to be direct.

The Fourth Justice, Iredell, had been a member of the North Carolina Convention that ratified the Constitution. Springer v. United States, 102 U.S. 586, 600 (1881).

251. 3 U.S. at 174, 3 Dall. at 175 (Chase, J.). Justice Iredell stated: "[P]erhaps, a direct tax ... can mean nothing but a tax on something inseparably annexed to the soil." Id. at 182, 3 Dall. at 183 (Iredell, J.). Justice Paterson agreed. See id. at 177 (Paterson, J.).

252. Id. at 175, 3 Dall. at 176 (Paterson, J.). Paterson intended this comment to provide a guide to interpreting the meaning of "direct," "excise," and "duty" since "the natural and common, or technical and appropriate, meaning of the words ... is not easy to ascertain." Id.

253. Id. at 178, 3 Dall. at 176.

254. Id. at 175, 3 Dall. at 176.

255. Id. at 175 (Chase, J.) (emphasis in original).


257. "The taxing power is given in the most comprehensive terms." Pacific Ins. Co. v. Soule, 74 U.S. (7 Wall.) 433, 446 (1869) (tax on income of insurance companies was indirect).

Veazie Bank v. Fenno, 75 U.S. (8 Wall.) 533, 547, 549 (1869), held that a tax on state bank notes was both constitutional and indirect. The Court said that in light of the weakness of the Articles of Confederation, the framers of the Constitution intended to give to Congress the power to tax in "its fullest extent." Id. at 540. The Court continued:

The comprehensiveness of the power, thus given to Congress, may serve to explain, at least, the absence of any attempt by members of the Convention to define, even in debate, the terms of the grant. The words used certainly describe the whole power, and it was the intention of the Convention that the whole power should be conferred. The definition of particular words, therefore, became unimportant.

Id. at 541. Scholey v. Rew, 90 U.S. (23 Wall.) 331, 346 (1875), held that the succession tax was an excise or duty tax. Finally, Springer v. United States, 102 U.S. 586, 602 (1881), held that an income tax was an excise or duty tax and that only capitulation taxes and taxes on real estate were direct taxes. The issue, of whether a tax is direct, it stated, was not an economic issue but "one exclusively in American jurisprudence." Id. The meaning of a "direct tax" was
In accordance with this expansionist view of congressional power, the Court's powers of judicial review were downplayed. In *Hylton* Justice Chase had expressed uncertainty whether the Court could invalidate a congressional act. In *Marbury v. Madison* the Court clearly announced its powers of judicial review. Nevertheless, the Court did not exercise this power in a tax case until 1895. Instead, the Court practically ignored its power in the tax area. In 1868 in *Pacific Insurance Co. v. Soule* the Court stated:

> Where the power of taxation, exercised by Congress, is warranted by the Constitution, as to mode and subject, it is, necessarily, unlimited in its nature. . . . Within the limits of the constitution [Congress] is supreme in its action. No power of supervision or control is lodged in either of the other departments of the government.

Although the Constitution limited the taxing power and the Court reviewed statutes for constitutional violations, in actuality the Court never found such a violation. The Court construed the contract and due process provisions of the Constitution to have little or no limiting effect on the taxing power. The explicit constitutional limitations on the taxing power contained in the rules of uniformity and apportionment were interpreted so expansively that they provided no real limitations. Underlying these decisions was the Court's understanding that a broad congressional power to tax was fundamental to the nation's survival. All the taxes involved could not be apportioned practically; therefore, if the taxes were direct, Congress's real and necessary power to tax would be emasculated.

In 1895, in the original decision and the rehearing of *Pollock v. Farmers' Loan & Trust Co.* the Supreme Court dramatically reversed its interpretation of the taxing power and thereby challenged the accepted roles of Court and Congress in the tax field. In the first *Pollock* case the Court invalidated much discussed in connection with the ratification of the sixteenth amendment. See, e.g., Morrow, *The Income Tax Amendment*, 10 COLUM. L. REV. 379 (1910) (discussing origins of term “direct” and the term’s implications in interpreting the sixteenth amendment); Whitney, *The Income Tax and the Constitution*, 20 HARV. L. REV. 280 (1907) (discussing meaning and origins of term “direct” and the advisability of a constitutional amendment). E. SELIGMAN, supra note 14, at 535-55 also discusses the meaning of “direct” taxes in depth.

> Moreover, in *Veazie Bank v. Fenno* the taxpayer had argued that the tax on state bank notes was so excessive that it indicated a congressional intent to destroy the bank's franchise. 75 U.S. (8 Wall.) 533, 548 (1869). Thus, Congress had exceeded its constitutional powers. *Id.* The Court responded:

> [T]he judicial cannot prescribe to the legislative departments of the government limitations upon the exercise of its acknowledged powers. The power to tax may be exercised oppressively upon persons, but the responsibility of the legislature is not to the courts, but to the people by whom its members are elected. *Id.* at 548.

> In *Veazie Bank v. Fenno*, for example, the bank had contended that the tax impaired the franchise granted by the state. The Court, however, did not invoke either the contract or the due process clause to invalidate the tax. See 75 U.S. (8 Wall.) 533, 547 (1869). In *Stockdale v. Insurance Cos.*, 87 U.S. (20 Wall.) 323, 332-33 (1874), the Court reaffirmed that a retroactive tax was constitutional.

> See *supra* notes 252-53 and accompanying text.

only two portions of the Income Tax Act of 1894: (1) the tax on income from municipal securities;265 and (2) the tax on rents and income from real property.266 The validity of the latter tax hinged on whether the tax was a direct tax.267 Previous Supreme Court decisions had made this determination on practical grounds. The Pollock Court, though it couched its decision in practical language, used an economic approach and defined a direct tax as one whose burden could not be shifted to another taxpayer.268 Using this definition, the Court found that the tax on rents was a tax on the real estate itself and thus constituted a direct tax that had to be apportioned.269

The original Pollock Court was evenly divided on the other issues: (1) whether the tax on rents from personalty was a direct tax; and (2) whether the invalidity of the tax on land rents invalidated the entire act.270 On rehearing, one Justice changed his mind.271 The Court then held by a one-vote majority that the tax was a direct tax on personalty and that the entire Act was unconstitutional.272

The Pollock decision abandoned the Court's prior expansionist view of the taxing power and contradicted apparently clear precedent holding that an income tax was not a direct tax.273 The decision was consistent, however, with a general trend then present in the Court actively to protect private
property rights. Pollock, in fact, represents merely one of three cases decided in 1895 that epitomized for the public the Court's extreme pro-business bias. The three cases, Pollock, United States v. E.C. Knight Co.,274 and In re Debs,275 created much public furor concerning both the pro-business bias of the decisions and the role of the Court in usurping congressional power.276

Knight, the “Sugar Trust Case,” held that corporations involved in the refinement of sugar had not committed federal antitrust violations because manufacturing was not interstate commerce.277 In re Debs, decided a week after Pollock, upheld an injunction against obstructing railroads engaged in interstate commerce.278 All three cases were laissez-faire, pro-business decisions. Pollock and Knight, through narrow interpretations of constitutional provisions, left the propertied class alone so that it could pursue business and the accumulation of private wealth without governmental restriction. Debs allowed the executive branch to use its powers to protect private property.

Paradoxically, a pro-business, laissez-faire judicial policy required an activist Court. To protect business from both union activists and legislative regulation the Court expanded its powers in two ways. First, as in In re Debs, the Court increasingly exercised its equity jurisdiction and the use of injunctions to protect business. Second, as in Pollock, it exercised its power

274. 156 U.S. 1 (1895).
275. 158 U.S. 564 (1895).
276. 3 C. WARREN, THE SUPREME COURT IN UNITED STATES HISTORY 421-26 (1922); see also Edwards, The Federal Judiciary and Its Attitude Towards the People, 5 MICH. L.J. 183, 192-93 (1896) (reporting some press comments on the pro-business bias of the decisions). For contemporary views of the judicial usurpation issue, see, e.g., Aggressions of the Federal Courts, 32 AM. L. REV. 669 (1898); Edwards, supra, at 183-84; Winchester, The Judiciary—Its Growing Power and Influence, 32 AM. L. REV. 801 (1898). The Justices who dissented in Pollock also raised this issue, as well as the issue of the extreme pro-business bias of the Pollock decision. E.g., 158 U.S. at 695 (Justice Brown stated that “the decision involves nothing less than the surrender of the taxing power to the moneved class”); Id. at 672, 674, 679, 685 (statements of Justice Harlan); Id. at 712 (statements of Justice White); see also infra note 281 (discussing contemporary popular response).
277. Knight, 156 U.S. at 17.
278. Debs, 158 U.S. at 599. The Debs case arose out of the Pullman strike. See, e.g., A. PAUL, supra note 276, at 131-58 (discussing the Debs case and its contribution to the legal conservatism of the era).
of judicial review and thereby limited congressional power. Many commentators saw both types of activity as usurpations of power.\textsuperscript{279} For many people \textit{Pollock} epitomized the laissez-faire Court's blatant pro-business stance and its usurpation of power through judicial review. The plaintiff in \textit{Pollock} had directly raised the class issue by referring to the specter of socialism lurking behind the income tax.\textsuperscript{280} The dissenting judges as well as the public recognized that the decision favored the propertied class.\textsuperscript{281} Furthermore, the case raised the issue of judicial review and the balance of power in a particularly dramatic way. \textit{Marbury v. Madison}, as the first \textit{Pollock} decision noted, had established the Supreme Court’s right of judicial review.\textsuperscript{282} Nevertheless, the Court had never invalidated a statute in the tax area before the \textit{Pollock} case.\textsuperscript{283} The \textit{Pollock} decision thereby automatically provided an opportunity to object for those who still protested the right of judicial review.

Two other facts unique to the \textit{Pollock} case caused others to join the furor. First, the very nature of the taxing power highlighted the gravity of the judicial review issue. The power to tax is fundamental to a government. By restricting that power the \textit{Pollock} Court potentially crippled the federal government or endangered its survival.\textsuperscript{284} Thus, even those who generally fa-

\begin{footnotesize}
\textsuperscript{279} For a listing of contemporary articles on the subject, see 3 C. Warren, supra note 276, at 424-27. See also, e.g., authorities cited supra note 276; Edwards, supra note 276, at 194 (Court has assumed power that Congress ought to have and has displayed this authority in "a more pronounced attitude . . . than ever before"); Patteson, \textit{The Judicial Usurpation of Power}, 10 V.A. L. REG. 855, 855 (1905) ("[T]he greatest danger which threatens the American republic is the judicial usurpation of power . . . The fatal extension of the power of the process of injunction . . . [was] the greatest step of all.").

\textsuperscript{280} \textit{Pollock}, 157 U.S. at 532 (appellant's argument before the Court).

\textsuperscript{281} See supra note 276; see also Riddle, supra note 247. Riddle characterized the \textit{Pollock} case as "a unique product of judicial solicitude for the salvation of society against itself, the bugaboo of socialism set forth by the attorneys for the complainant caused the court to declare a tax on income from property, real or personal, to be a direct tax." \textit{Id.} at 577. Justice Harlan, in a letter to his sons shortly after the \textit{Pollock} case, expressed his opinion that the case will become as hateful with the American people as the \textit{Dred Scott} case was when it was decided. That was the attempt of the owners of slave property to dominate the freemen of America and compel them against their wishes to sustain the institution of slavery. The recent decision will have the effect . . . to make the freemen of America the slaves of accumulated wealth.

Farrelly, supra note 271, at 180 (quoting Justice Harlan’s letter of May 24, 1895). Arnold Paul provides a good discussion of \textit{Pollock} in connection with the \textit{Debs} and \textit{E.C. Knight} cases. A. Paul, supra note 276, at 159-220 (including many citations to contemporary sources). E. Seligman, supra note 14, at 576-89, is useful, as always.

Not everyone was critical of the \textit{Pollock} decision. Writing prior to the decision, Robert Sewell stated that the 1894 Act should be invalidated because it had been passed by Democrats who wished to "curry favor of the Populists and throw a sop to the Socialists. It is a measure of purely socialistic tendency." Sewell, supra note 276, at 808.

\textsuperscript{282} \textit{Pollock}, 157 U.S. at 554 (citing 5 U.S. (1 Cranch) 137, 177 (1803)).

\textsuperscript{283} See supra notes 260-64 and accompanying text.

\textsuperscript{284} See, e.g., 158 U.S. at 671 (Harlan, J., dissenting). Justice Harlan said that the decision "strikes at the very foundations of national authority, in that it denies to the general government a power which is, or may become, vital to the very existence and preservation of the Union . . . . It tends to reestablish that condition of helplessness [under the Articles of Confederation] . . . ." \textit{Id.}; see also \textit{id.} at 695 (Brown, J., dissenting) (decision may imperil country); \textit{Id.} at 705 (Jackson, J., dissenting) (decision endangers Congress's ability to tax); W. Leuchtenburg, supra note 216, at 36.
\end{footnotesize}
vored judicial review might limit its exercise in the tax area. Second, the fact that the Court—by the change of one Justice's vote—had not only invalidated a federal statute but also overruled its own apparent precedent created concern about the legitimacy of the Court's power of judicial review and the integrity of its decision-making process.\textsuperscript{285}

The Court soon retreated from its extremely active pro-business position. The Court checked its aggressive stance vis-à-vis Congress, and from \textit{Pollock} until the adoption of the sixteenth amendment the Court upheld every tax statute that came before it. The Court accomplished this retreat primarily by abandoning an economic definition of direct tax and returning to the pre-\textit{Pollock} practical definition: if the tax could not be apportioned practically, it was not a direct tax.\textsuperscript{286} The Court thus moderated its fervid protection of the propertied class and upheld a variety of taxes, including a progressive inheritance tax\textsuperscript{287} and a corporate excise tax based on net income.\textsuperscript{288}

\textsuperscript{285} Justice Harlan stated in his dissent that, in light of the contrary precedent, the \textit{Pollock} decision holding that the income tax must be apportioned “may, not improperly, be regarded as a judicial revolution, that may sow the seeds of hate and distrust among the people of different sections of our common country.” 158 U.S. at 665. Sylvester Pennoyer, former Governor of Oregon, stated that the Court had no power to invalidate a congressional law and that Congress should “impeach the nullifying judges for the usurpation of legislative power.” Pennoyer, \textit{The Income Tax Decision, and the Power of the Supreme Court to Nullify Acts of Congress}, 29 AM. L. REV. 550, 558 (1895). Another commentator, however, characterized Pennoyer's article as “a course of childishly vicious reasoning.” Allen, \textit{The Income Tax Decision: An Answer to Gov. Pennoyer}, 29 AM. L. REV. 847, 853 (1895). See supra notes 279-81 and accompanying text (discussing other contemporary views).

\textsuperscript{286} For example, in \textit{Knowlton v. Moore}, 178 U.S. 41, 83 (1900), a succession tax was held not to be a direct tax. The \textit{Knowlton} Court (quoting Nicol v. Ames, 173 U.S. 509, 515-16 (1899)) stated:

\begin{quote}
In deciding upon the validity of a tax with reference to these requirements, no microscopic examination as to the purely economic or theoretical nature of the tax should be indulged in for the purpose of placing it in a category which would invalidate the tax. As a mere abstract, scientific or economical problem, a particular tax might possibly be regarded as a direct tax, when as a practical matter pertaining to the actual operation of the tax it might quite plainly appear to be indirect. Under such circumstances, and while varying and disputable theories might be indulged as to the real nature of the tax, a court would not be justified, for the purpose of invalidating the tax, in placing it in a class different from that to which its practical results would consign it. Taxation is eminently practical, and is, in fact, brought to every man’s door, and for the purpose of deciding upon its validity a tax should be regarded in its actual, practical results, rather than with reference to those theoretical or abstract ideas whose correctness is the subject of dispute and contradiction among those who are experts in the science of political economy.
\end{quote}

178 U.S. at 83. \textit{Pollock} had turned over the “uncommonly practical question” of what is a direct tax to economists. Morrow, supra note 257, at 407. To the extent \textit{Pollock} was based on economic definitions, \textit{Knowlton} was seen as overruling \textit{Pollock}. E.g., Whitney, supra note 257, at 186.

\textsuperscript{287} Knowlton v. Moore, 178 U.S. 41, 110 (1900). The Court did restrict Congress, however, by interpreting the statute so as to apply progressive rates only to each inherited share, not to the inheritance as a whole. \textit{Id}. at 77.

\textsuperscript{288} Flint v. Stone Tracy Co., 220 U.S. 107, 177 (1911). In \textit{Stone Tracy} the Court was not obliged to rule directly on an income tax since the act was technically an excise tax. By upholding the tax as a tax on doing business the Court escaped a difficult situation. The Court avoided overruling its own precedent in \textit{Pollock} without offending Congress. Overruling the Excise Act would have been a slap in Congress’s face since Congress had gone to great technical lengths to avoid the constitutional problems of \textit{Pollock}. See, e.g., 92 \textit{NATION} 258 (1911).
Through these decisions the Court allowed Congress to chip away at the fringes of accumulated wealth.

The Court's retreat from the attitudes evidenced in *Pollock* was a practical and tactical necessity in light of the furor that the case had caused. The shift was merely a retreat, however, and not a capitulation. *Pollock* was not overruled. The constitutional ban on income tax protected the wealthy. The income tax, more than any excise or sales tax, can focus on individual wealth and both limit its accumulation and partially redistribute it. The corporate excise tax, although based on income, was not as direct an attack on individual wealth since it was levied on corporations. The succession tax also limited wealth accumulation by taxing transfers from one generation to another, but the Court's approval of that tax may have been partly based on the fact that the tax was passed to support the war effort during the Spanish-American War. 289 Traditionally, the Court tended to view Congress's taxing power more broadly during times of war. 290 Thus, from 1895 until 1913 the Court moderated its protection of property in the tax area. The Court, however, did not change its position on the income tax, which because of its flexibility and focus on the individual possessed the most potential to damage the propertied class's accumulation of wealth.

Similarly, in terms of the relationship between Court and Congress, during the period between *Pollock* and the sixteenth amendment, the Court had avoided a confrontation, but had not yielded. To yield would have meant overruling *Pollock*. Such a move might have weakened the Court's authority relative to the other branches of government and caused the public to lose confidence in the Court as an institution. 291

By 1909 the factors outlined above indicated that the Court probably would not overrule *Pollock*. Pressure to enact an income tax, however, was growing. Income tax legislation would place Congress and the Court in direct conflict. To forestall passage of the tax, President Taft proposed a compromise: Congress would pass only a corporate excise tax based on net income, and a constitutional amendment would then be proposed to deal

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On the other hand, if the Court overruled *Pollock*, Congress might think that its attempts to avoid a direct confrontation with the Court were not appreciated. See Bickel, *The Judiciary and Responsible Government 1910-21*, Part One, in 9 HISTORY OF THE SUPREME COURT OF THE UNITED STATES 242-43 (1984). Professor Bickel viewed the *Stone Tracy* decision merely as a procedural finesse out of the difficult situation of not overruling its own decision in *Pollock* and yet properly rewarding Congress for its deference to the Court demonstrated by Congress's decision not to pass a pure income tax. Substantively, he appeared to see no difference between overruling *Pollock*, which in his view the sixteenth amendment soon made obsolete, and holding that the tax was an excise tax. In this respect, Professor Bickel is in accord with many contemporary writers who saw no difference between the corporate tax upheld in *Stone Tracy* and the income tax act held unconstitutional in *Pollock*. *Id.* at 247 (citing contemporary writers on both sides of the question of whether a difference existed). A subtle but important difference, however, does exist. By leaving the *Pollock* case intact, the Court left itself free to interpret the sixteenth amendment narrowly. See infra notes 293-326 and accompanying text. 289. War Revenue Act, ch. 448, §§ 29-30, 30 Stat. 448, 464-66 (1898).

290. E.g., The Civil War Revenue Acts had been upheld in Springer v. United States, 102 U.S. 586 (1880).

291. 44 CONG. REC. 4022 (1909) (statement of Sen. Root); *Id.* at 3446 (statement of Sen. Sutherland).
with the income tax. In July of 1909 Congress passed a joint resolution proposing the sixteenth amendment.292

Congress scarcely debated the joint resolution despite the fact that the exact meaning of the amendment was unclear.293 Contemporary discussion focused on two major issues: (1) whether the income tax was still a direct tax and, therefore, not subject to the rule of uniformity;294 and (2) whether the amendment added new powers or simply overruled Pollock by eliminating the need to apportion a direct tax.295 The core issue of defining income was simply ignored.

The ratification of the sixteenth amendment in 1913 did not stop the Court's activist role in the income tax area. The vagueness of the amendment left a void for the Court to fill. From the first case interpreting a statute passed under the amendment until the capital gains cases in 1921 the Court narrowly interpreted the amendment. In the process, the Court twice invalidated statutes passed by Congress pursuant to the amendment.296

*Brushaber v. Union Pacific Railroad*, decided in 1916, upheld the constitutionality of the Revenue Act of 1913, the first statute passed under the sixteenth amendment.297 In holding the statute constitutional, the Court reaffirmed Congress's broad power to tax with minimal constitutional limitations. Thus, for example, the Court held that the retroactivity of the statute was not unconstitutional.298 More importantly, the Court held that the due process clause of the fifth amendment did not constrain the taxing power unless the tax was so arbitrary as to be confiscatory.299 The Court stated

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292. Taft sent his message to Congress on June 16, 1909. By July Congress had passed Joint Resolution 40 proposing the amendment. For histories of the introduction of the amendment and the excise tax, see, e.g., E. SELIGMAN, supra note 14, at 591-96; Sherman, The Recent Constitutional Amendments, 23 YALE L.J. 129 (1913). The amendment was finally ratified in 1913. U.S. CONST. amend. XVI.

293. The lack of congressional debate was noted contemporaneously by E. SELIGMAN, supra note 14, at 593-96, as well as by later commentators, such as A. MASON & W. BEANEY, THE SUPREME COURT IN A FREE SOCIETY 136 (1959).

294. For discussions of the issue of a direct tax, see, e.g., Morrow, supra note 257; Sherman, supra note 227; Whitney, supra note 257. Whitney, for example, agreed with those who had supported an abolition of the apportionment rule rather than making an exception to it for income taxes. Id. at 296. Brushaber v. Union Pacific R.R., 240 U.S. 1 (1916), held that the rule of uniformity contained in U.S. CONST. art. I, § 8, cl. 1 applied to the income tax. Id. at 12-13. Moreover, the Court stated that the graduated rate structure of the tax did not violate the uniformity clause: "it is settled that that clause exacts only a geographical uniformity." Id. at 24. E. SELIGMAN, supra note 14, at 621-26, had predicted this result. Uniformity, according to Seligman, permitted different treatment of different classes of property, but required equal treatment within a class. Id. at 622-25.

295. The debate on whether the amendment gave Congress new powers focused in particular on whether Congress could tax income from state and local securities. Justice Hughes had raised this argument when he was Governor of New York in his objection to ratification of the amendment. See, e.g., E. SELIGMAN, supra note 14, at 596; Hubbard, The Sixteenth Amendment, 33 HARV. L. REV. 794, 798 (1920) (sixteenth amendment gives power to tax income from state and local salaries and bonds); Morrow, supra note 257, at 407.

296. See infra notes 305-14.

297. 240 U.S. 1 (1916).

298. Id. at 20 (citing Stockdale v. Insurance Cos., 87 U.S. (20 Wall.) 323, 331 (1873), as authority for position on retroactivity).

299. 240 U.S. at 24-25.
that the plaintiff's contention that the progressive tax was sufficiently arbitrary disregarded the fact "that its absolute want of foundation in reason was plainly pointed out in Knowlton v. Moore, . . . and the right to urge it was necessarily foreclosed by the ruling in that case made."\textsuperscript{300}

A progressive income tax redistributes wealth and thus represents the type of social and economic legislation that a pro-business, laissez-faire court would want to invalidate. Whatever the Court may have desired, however, it had little choice. To invalidate the progressive feature of the Act would have been a direct assault on congressional powers. It would recreate the furor of \textit{Pollock} without producing much benefit. Because even a non-progressive income tax redistributes wealth, the primary infringement of private economic rights was protected by the sixteenth amendment. Given the history of \textit{Pollock} and the relatively small positive result that could be obtained from invalidating the progressive structure, the Court undoubtedly felt compelled to uphold that portion of the Act.\textsuperscript{301}

Although the \textit{Brushaber} Court generally interpreted congressional taxing powers broadly, it viewed the scope of the sixteenth amendment narrowly. As previously discussed, one of the major contemporary concerns about the amendment was whether it removed all constitutional limitations from the income tax. Direct taxes were subject to the rule of apportionment, but not to the rule of uniformity. Since the sixteenth amendment relieved the income tax from apportionment, people were concerned that the income tax, as a direct tax, would be free from all constitutional restraints and thus would upset the delicate balance between state and national powers.\textsuperscript{302} The \textit{Brushaber} Court restricted the scope of the amendment and abated the danger. The rule of uniformity applied, it said, because income taxes were basically excise taxes; according to the Court, \textit{Pollock} had not held that the

\textsuperscript{300} Id. at 25 (citation omitted); accord Tyee Realty Co. v. Anderson, 240 U.S. 115, 117-18 (1916).

\textsuperscript{301} The \textit{Brushaber} Court's approval of the progressivity feature is similar to the approach it later took in \textit{Merchants' Loan} with respect to capital gains. The similarity lies in the Court's disdainful dismissal of arguments as being without "foundation in reason," \textit{Brushaber}, 240 U.S. at 25, or "ingenious," \textit{Merchants' Loan}, 255 U.S. at 221. Both opinions rely on questionable precedent. Indeed, the use of such summary language seems to occur whenever the Court relies on questionable authority. The dubiousness of the authority that the Court relied on in \textit{Merchants' Loan} is discussed supra in notes 144-211 and accompanying text. As to the questionable authority relied on in \textit{Brushaber}, see, e.g., Comment, \textit{Constitutional Law: Income Tax: Sixteenth Amendment}, 4 \textit{Cal. L. Rev.} 333, 336 (1916); Note, supra note 122, at 445. These articles state that Knowlton v. Moore, 178 U.S. 41 (1900), and Magoun v. Illinois Trust & Sav. Bank, 170 U.S. 283 (1898), on which \textit{Knowlton} relied, were limited to progressive taxes on the right to inherit and did not apply to taxes on property. In fact, the government conceded in its brief in \textit{Magoun} that if the tax in that case was a property tax it would have been invalid. Hackett, supra note 122, at 433 n.4.

The progressive feature of the 1913 Act was one of the most discussed features. See, e.g., various editorials in \textit{The Nation} 117, 224, 432, 490 (1913).

\textsuperscript{302} See, e.g., Morrow, supra note 257, at 411-12; Riddle, supra note 247, at 574; Note, \textit{The Bearing of the Sixteenth Amendment on the Power of Congress to Tax Any Income Regardless of Its Source, 7 Va. L. Rev.} 136 (1920). The last article stated that the amendment "was so sweeping in its terms and all-inclusive in the construction that might possibly be given it, that its ratification gave rise to grave apprehension—the fear that it would undermine some of the vital safeguards placed about our system of government." \textit{Id.} at 137.
income tax was a direct tax.\textsuperscript{303}

The Court's restrictive view of the amendment appeared in another series of cases holding that the amendment conferred no new powers of taxation. The Court first made this statement in dictum in 1916.\textsuperscript{304} In 1920, however, the Court decided two cases that directly and dramatically limited the scope of the amendment. The first case, \textit{Eisner v. Macomber},\textsuperscript{305} raised the question of whether a stock dividend was income within the meaning of the sixteenth amendment. In concluding that it was not income, the Court reasserted both its narrow view of the amendment and its activist role in the income tax field. The provision of the Revenue Act of 1916 under which \textit{Macomber} arose was similar to the 1913 provision invalidated by the Court in \textit{Towne v. Eisner}.\textsuperscript{306} The \textit{Macomber} majority held that \textit{Towne} controlled because "Congress intended in that act [of 1913] to exert its power to the extent permitted by the Amendment."\textsuperscript{307} Although the 1913 Act exerted congressional taxing powers to their constitutional limits, the attempt to tax stock dividends exceeded those limits. Since stock dividends were not income under the 1913 Act they could not be income under the 1916 Act.\textsuperscript{308} Only income was taxable, and stock dividends were not income. In reaching this conclusion, the Court restated its position, first announced in \textit{Brushaber} and \textit{Baltic Mining}, that the sixteenth amendment created no new powers to tax. The amendment simply eliminated any necessity to apportion an income tax.\textsuperscript{309} Moreover, the Court specifically rejected a broad interpretation of income.\textsuperscript{310}

\textsuperscript{303.} \textit{Brushaber}, 240 U.S. at 16-17, 19. Many early commentators expounded on this restrictive view of the Court. See, e.g., A. Mason & W. Beaney, supra note 293, at 136-37; S. Ratner, supra note 14, at 337-38; Brown, \textit{The Sixteenth Amendment to the United States Constitution}, 54 AM. L. REV. 843, 845 (1920); Riddle, supra note 247, at 576. The Court's statement that \textit{Pollock} did not hold that the income tax was a direct tax involved a high degree of verbal legerdemain since \textit{Pollock} had held the tax unconstitutional because it was a direct tax. 157 U.S. at 580-83.

For a more recent examination of the rule of uniformity and the income tax, see Amidon v. Kane, 444 Pa. 38, 279 A.2d 53, 58-60 (1971). The consolidated cases decided in Amidon all involved the Pennsylvania income tax, which was a flat percentage of taxable income as defined under federal tax laws. The court held that the tax base had so many inequalities due to deductions and exclusions that it violated the Pennsylvania Constitution's requirement of uniformity. 279 A.2d at 60-63.

\textsuperscript{304.} Stanton v. Baltic Mining Co., 240 U.S. 103, 112 (1916) (tax on mining company's gross income held constitutional); see also William E. Peck & Co. v. Lowe, 247 U.S. 165, 172-73 (1918) (tax on net income of corporation which exports goods is valid). In Peck the Court's statement also was not necessary to the decision. \textit{Id.} at 172-73.

\textsuperscript{305.} 252 U.S. 189 (1920).

\textsuperscript{306.} 245 U.S. 418 (1918). \textit{But cf.} Lynch v. Hornby, 247 U.S. 333, 333-34 (1918) (extraordinary cash dividend was income although based on earning accrued prior to the adoption of the sixteenth amendment); Peabody v. Eisner, 247 U.S. 347, 348-49 (1918) (dividend payable in stock of another corporation was income despite being based on pre-1916 earnings).

\textsuperscript{307.} 252 U.S. at 203.

\textsuperscript{308.} \textit{Id.} at 207; see supra note 70.

\textsuperscript{309.} 252 U.S. at 206.

\textsuperscript{310.} \textit{Id.} at 214-17. The Court cited Trefry v. Putnam, 227 Mass. 522, 116 N.E. 904 (1917). See supra note 71 for a discussion of how the \textit{Macomber} Court handled the \textit{Trefry} case. The \textit{Macomber} Court stated that it could not accept the reasoning of \textit{Trefry} because the interpretation of the sixteenth amendment was constrained by "other constitutional provisions that stand in the way of extending it by construction." 252 U.S. at 217.
Three months later in *Evans v. Gore* the Court reiterated that the sixteenth amendment conferred no new powers.311 The issue in *Gore* was whether a tax on federal judges' income violated article I, section 1, clause 6 of the Constitution, which prohibited any diminution in the salary of judges.312 Although recognizing that congressional power to tax was broad, the Court emphasized it was not unlimited.313 Certain exceptions to the power existed. Congress, for example, had no right to tax state and municipal securities or, as here, federal judges' salaries.314

The practical effect of the narrow interpretation of the sixteenth amendment contained in both *Macomber* and *Gore* was to expand the role of the Court in the income tax area. The Court would be constantly asked to decide whether a particular provision was within the narrow scope of the taxing power. The Court would be the arbiter of whether a particular item was income. Such constant intervention would upset the delicate balance of power between the Court and Congress. The dissent in both cases, therefore, favored a broad interpretation of the taxing power.315 A natural concomitant of a broad interpretation would have been a withdrawal from the tax field. The Court, as Justice Brandeis stated in his *Macomber* dissent, should invalidate an act of Congress only in a "clear case."316 If the Court broadly construed the sixteenth amendment, fewer clear cases would require Court intervention.

Although the *Gore* case went generally unnoticed, Congress and the public perceived the *Macomber* case as severely disturbing the balance of power.317 For example, Professor Thomas Reed Powell acknowledged that

311. 253 U.S. 245, 261 (1920).
312. Congress had passed this portion of the income tax without being sure as to whether it was constitutional. See 253 U.S. at 248 (citing 56 Cong. Rec. 10,370 (1918)).
313. 253 U.S. at 255.
314. *Id.*
315. In *Evans v. Gore* Justice Holmes in a dissenting opinion joined by Justice Brandeis stated his conclusion that the original Constitution permitted the taxation of judges' salaries. Even if the original Constitution did not, the sixteenth amendment permitted such taxation because it allowed an income tax to be imposed on income from whatever source. 253 U.S. at 267. Justice Holmes, who had written the opinion in *Towne v. Eisner* that invalidated an income tax on stock dividends, also dissented in *Macomber*. He believed that the *Towne* decision "was right in its reasoning and result." *Macomber*, 252 U.S. at 219. Nevertheless, in his view the *Towne* decision had been based on statutory language rather than constitutional principles. In a constitutional sense, Holmes believed that the sixteenth amendment permitted such taxation since the "known purpose" of the amendment was "to get rid of nice questions as to what might be direct taxes." *Id.* at 220.
316. 252 U.S. at 238. Justice Clarke, author of the *Merchants' Loan* decision, joined in Justice Brandeis's opinion. In a footnote, Justice Brandeis quoted the *Sinking Fund Cases*: "One branch of the government cannot encroach on the domain of another without danger. The safety of our institutions depends in no small degree on a strict observance of this salutary rule." *Id.* n.1 (quoting *Sinking Fund Cases*, 99 U.S. 700, 718 (1878)).
317. Charles Clark believed that "two possible reasons" existed for the lack of public interest in *Gore*. First, the case involved an ostensibly narrow issue; "the larger question [the constitutionality of a tax on the incomes of federal judges] was only perceived upon a study of the opinion." Second, many felt that the question of such nontaxability of state securities was "well settled." Comment, *supra* note 230, at 76. Harry Hubbard, one of the few observers to comment on the case, thought that the sixteenth amendment amended the entire Constitution. The amendment, therefore, overrode any prior constitutional limitations on the taxation of federal judges' salaries. Hubbard, *From Whatever Source Derived*, 6 A.B.A. J., Dec. 1920, at
the majority in *Macomber* was correct from an economic standpoint. Nevertheless, he stated that the true issue in *Macomber* was "the Supreme Court's conception of its function":318 what was the Court's role in interpreting the sixteenth amendment and the income tax statutes? On this issue Powell disagreed with the majority; in his opinion, the Court should overrule Congress only when it had a "clear mandate" to do so.319 The *Macomber* majority, he wrote, interpreted the sixteenth amendment literally. It did not abolish *Pollock*, but merely eliminated the need to determine whether the tax was direct. This holding contradicted the purpose of the amendment, which was "passed to unshackle Congress from the chains riveted" by *Pollock*.320 Others reacted more emotionally to the *Macomber* decision. One commentator characterized the decision as "riding-rough shod" over Congress and stated that the Court should defer to Congress because to declare an act of Congress unconstitutional "strike[s] a blow at the foundation of our institutions."321 The decision caused an outpouring of protest in Congress, which

202, 206; see also Hubbard, supra note 295 (sixteenth amendment gives new power to tax income from government salaries and bonds). In 1925 the Court again dealt with the issue. The Court held that a tax on the salary of a Court of Claims judge was invalid as it was within the "plain rule" of *Evans v. Gore*. Miles v. Graham, 268 U.S. 501, 509 (1925). In 1939 the Court finally reversed itself. O'Malley v. Woodrough, 307 U.S. 277, 283 (1939) (the Court specifically overruled *Graham*, but not *Gore*).

Although contemporary commentators recognized that the true issue in *Macomber* was a struggle between the Court and Congress, modern commentators generally do not focus on this issue. To the best of this author's knowledge only Bickel, supra note 288, at 506-13, explores this aspect of *Macomber* in any depth. Even Professor Bickel's analysis, however, is too limited. *Macomber* was not the only income tax case of its era involved in the Court-Congress struggle. Bickel fails to relate *Macomber* properly to these cases and thus does not completely explain the issue. *Macomber*, for example, is not adequately identified with cases such as *Brushaber*. *Macomber* merely continued the narrow activist role of the Court that *Brushaber* began. See supra notes 297-303 and accompanying text. More importantly, Bickel entirely fails to connect *Macomber* with the capital gains cases of 1921. As this Article shows, the results in these cases were in part a response to the furor that *Macomber* created. See infra notes 326-33 and accompanying text. As such, the capital gains cases represent a turning point in the Court's conception of its function in the tax area. See also S. Ratner, supra note 14, at 336-37.

319. Id. at 538.
320. Id. at 549.
321. Note, supra note 52, at 539. Another interesting contemporary opinion was expressed as an editorial in the *New Republic*. The anonymous writer stated that the "deeper implications" of the *Macomber* decision "have hardly caused a ripple, and yet they challenge the wisdom of leaving the ultimate law-making power of the nation to nine men. At least they call for a consideration of the safeguards to be imposed upon the extraordinary judicial power of the Supreme Court." *The Supreme Court vs. The Supreme Court*, 22 *New Republic* 235, 235 (1920) (Bickel, supra note 288, at 511, asserts that this editorial was written by Felix Frankfurter).

The editorial occasioned some correspondence. Professor Edward Corwin responded: [T]he practical nub of your article is difficult to discover. Is it merely that the Court should not be regarded as "a sacred priesthood free from criticism?"

Of course it shouldn't. But perhaps it would be fair to exact of the critic something approaching the same measurement of intelligence and good faith that he demands of the Court. The fact is, that the Court has always been subject to criticism, and the further fact is that no part of the national government has, first and last, proved more responsive to the best thought of the country.
did not abate for years and which included proposals for constitutional amendments to permit the taxation of stock dividends and state and local income.\textsuperscript{322}

Both decisions raised practical concerns as well as constitutional ones. A narrow construction of the sixteen amendment, such as in \textit{Macomber} and \textit{Gore}, meant that numerous questions would be raised about the constitutionality of particular statutory provisions. Such uncertainty in a tax system was highly undesirable, especially in a system that relied on self-assessment.\textsuperscript{323} To expect the Court to decide every minor issue was impracticable,\textsuperscript{324} yet the desire and need for constitutional certainty would demand that the Court make minor decisions. The \textit{Macomber} Court had attempted to provide certainty by defining income. The Court's narrow interpretation of income resulted in a "regrettable tying of the hands of the legislator and an undue curtailment of legislative discretion, with the result of raising many new problems in the place of the single problem which the courts endeavor to settle."\textsuperscript{325}

The concern over the balance of power was still high when the 1921 capi-

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23 New Republic 60, 60 (1920).

The editor rebutted:

\textquote{The question before the Court [in \textit{Macomber}] was not whether a stock dividend is "income." That is a question as to which opinion is bound to differ ... But that, we insist, was not the question before the Supreme Court. ... The question before the Supreme Court was the very much narrower issue whether Congress in declaring that a stock dividend is "income," within the purport of the eighteenth [sic] amendment, went outside its constitutional boundaries. Such an issue is not to be decided by technical niceties.} \textit{Id.} at 61. The editor further stated that criticism of the Court is proper when, as in \textit{Macomber}, the Court took too narrow a view of the Constitution. Such petty views, he said, posed a serious danger, and "the work of the Court, as at present constituted, does not make the danger seem any less serious." \textit{Id.} The editor's solution was to have as judges "able men, men of the caliber of Marshall and Moody, Hughes and Holmes." \textit{Id.} (Perhaps a Frankfurter as well.)

322. Senator Knute Nelsen of Minnesota immediately proposed an amendment to override \textit{Macomber}. N.Y. Times, Mar. 27, 1920, at 20, col. 6; Editorial, A Grotesque Amendment, N.Y. Times, Mar. 29, 1920, at 20, col. 2. As is evidenced by the many \textit{New York Times} editorials cited in this Article, \textit{The Times} would be expected to characterize the proposed amendment as grotesque since the paper was adamantly against the taxation of anything that appeared to be capital. As to the issue of taxing federal judicial salaries raised in \textit{Evans v. Gore}, Charles Clark stated that the chances that an amendment overriding \textit{Gore} would be passed were "slight" due to state opposition. Comment, \textit{supra} note 230, at 80.

In the congressional debates concerning the 1921 Revenue Act, Senator Watson of Georgia stated that Congress ought to annul the \textit{Macomber} decision and tax stock dividends. Senator McCumber had remarked that the 1916 Tax Act had "annulled" the Supreme Court decision in \textit{Towne v. Eisner} (stock dividends not taxable under the 1913 Act), but that the Supreme Court had annulled that act in \textit{Macomber}. Watson responded that the Court did not have the "right" to annul a congressional act. 61 Cong. Rec. 6474 (1921).

323. Adam Smith listed certainty as one of four prerequisites of any income tax system. \textit{See Wealth of Nations, supra} note 122, at 778. Certainty was so desirable that some degree of equality (another prerequisite) could be sacrificed to achieve it. \textit{Id.} This requirement was well-known and often cited in the 1920s. \textit{See Hord, The Sales Tax, 95 Annals 193, 198 (1921).}

324. Clark, \textit{supra} note 47, at 736.

325. Seligman, \textit{supra} note 27, at ix. Clark, \textit{supra} note 47, at 737, said that "while the decision in Eisner v. Macomber seems quite simply correct, if it is to be pressed to the extent of unduly hampering Congress its results will be unfortunate."
tal gains cases arose. The Court knew of the furor and was, in fact, divided on the issue of the Court's role in the tax area. The narrow construction of the sixteenth amendment created tension and administrative difficulties. The construction resulted in frequent Court action, friction with Congress, and appeals to the cumbersome constitutional amendment process. The tax system needed flexibility to work effectively, especially in economically strained times such as 1921. The capital gains decisions signalled a retreat from the Court's narrow construction of the sixteenth amendment and a consequent abandonment of its activist role in the income tax area. In all of the other areas in which Congress had imposed a tax on the basis of a power enumerated in the Constitution, the Court had deferred to Congress's broad power to tax. The sixteenth amendment gave Congress the specific power to levy income taxes, yet the Court had resisted congressional exercise of that power. The capital gains cases signalled the Court's acceptance of this power in the income tax area also.

The Court had several choices in the capital gains cases: the Court could have held capital gains either taxable or nontaxable, and it could have based its decision either on statutory or constitutional grounds. A decision upholding capital gains taxation on statutory grounds would have necessitated a constitutional holding also since the taxpayers had raised the issue. On the other hand, a holding that the statute did not tax capital gains would have avoided the constitutional issue altogether. As the stock dividend issue had shown, however, a statutory decision merely delayed temporarily a constitutional decision since Congress would pass another statute explicitly taxing capital gains and thus force the constitutional issue. Given both the intensity of the power struggle between the Court and Congress in the tax area and the administrative need for certainty, an immediate resolution of the inevitable constitutional issue was best. The Court's decision that capital gains were income within the meaning of the sixteenth amendment upheld what it perceived to be congressional intent. The capital gains decisions thereby maintained the precarious balance of power and provided much needed certainty.

After the capital gains cases, the Supreme Court decided several other tax cases in 1921. These decisions supported Congress's constitutional power to tax in a variety of areas. Both the estate tax and the excess profits tax were upheld. The scope of Macomber was restricted so as not to apply in two
corporate reorganization cases. Thus, by the end of 1921 the Court had withdrawn from an activist role in the income tax area. In recognizing Congress’s comprehensive power to tax, the Court limited its actions to interpreting statutes. The halcyon days of substantive constitutional restrictions on the taxing power were over.

tax under the 1916 Act was an indirect tax and, therefore, constitutional. Justice Holmes, speaking for the Court, relied on Knowlton v. Moore, 178 U.S. 41, 46-56 (1900), which had upheld a legacy tax as an indirect tax.

The Court upheld the definition of invested capital under the Excess Profits Tax in LaBelle Iron Works v. United States, 256 U.S. 377, 386 (1921). Speaking for the Court, Justice Pitney stated that in the tax area Congress has great discretion, which the courts have no authority to question. The fifth amendment due process clause was not a limitation on this power. Id. at 392-93. Arthur Ballantine had predicted the result in LaBelle and its consequent loosening of constitutional restrictions on congressional taxing power: “[T]he latitude permitted to Congress is likely to be extended under the pressure of new conditions at the further expense of equality of treatment of individual taxpayers.” Ballantine, Some Constitutional Aspects of the Excess Profits Tax, 29 YALE L.J. 625, 637 (1920). Thus, not only did the Court read the sixteenth amendment more expansively than previously, but it continued the post-Pollock trend in the non-income-tax area to remove other constitutional limits to the taxing power.

The capital gains decision was also reaffirmed in Darlington v. Mager, 256 U.S. 682 (1921) (per curiam), and Miles v. Safe Deposit & Trust Co., 259 U.S. 247, 252-53 (1921). Although the only question in Safe Deposit was how much gain was taxable, the defendant taxpayer reargued the capital gains issue. See id. at 249-53.

332. See United States v. Phellis, 257 U.S. 156, 168-69 (1921); Rockefeller v. United States, 257 U.S. 176, 183-84 (1921) (both cases decided after capital gains cases).

333. The Court did not immediately and completely defer to congressional tax agendas in cases in which no enumerated power was involved. The Court’s record in that area continued to be spotty. Some regulatory taxes had been upheld prior to the capital gains cases. E.g., McCray v. United States, 195 U.S. 27, 64 (1904) (tax on butter-colored margarine); United States v. Doremus, 249 U.S. 86, 95 (1919) (tax on narcotics). In 1922, however, the Court struck down an excise tax on the net income of an employer who used child labor. Bailey v. Drexel Furniture Co., 259 U.S. 20, 44 (1922). In 1936 the Court struck down a processing tax on commodities passed as part of the Agricultural Adjustment Act. United States v. Butler, 297 U.S. 1, 74-78 (1936). See A. MASON & W. BEANEY, supra note 293, at 140-50.

Professor Tribe sees the Court’s inconsistent treatment of tax legislation as an example of the “internal disarray” of the Lochner model. See L. TRIBE, supra note 276, at 442-43. Although Tribe asserts that “it would be difficult (perhaps impossible)” to show that the Court’s action in the cases was not “related to the degree of redistribution or interference” with property rights, he states that a consistent Lochner model would have always used the degree of interference as a measuring rod. The tax cases, he states, indicate “at least some ambiguity.” Id. at 443.

This Article has shown that the capital gains cases ended that ambiguity in the income tax area by recognizing that Congress has broad discretion. This concession gutted the Court’s Lochner analysis in the tax area. The income tax, together with the inheritance tax previously upheld in Knowlton v. Moore, 178 U.S. 41, 110 (1900), was the most potent tool available to Congress with which to redistribute wealth. Once the Court recognized Congress’s comprehensive power to levy income tax, it acknowledged that Congress could interfere significantly with private property rights.

The cases cited above concerning social and economic regulation were the Court’s last stand. The battle over congressional ability to interfere with property rights via taxation had been lost with the capital gains cases of 1921.

The real future battle would not concern the extent of Congress’s power to tax, but would involve the Treasury’s power to interpret Congress. In two cases decided close to the time of the capital gains cases, the Court ruled against the Treasury’s interpretation of a statute. See Smietanka v. First Trust & Sav. Bank, 257 U.S. 602, 605 (1922) (1913 Act did not tax income accumulated in trust for the benefit of unborn and unascertained persons); United States v. Field, 255 U.S. 257, 265 (1921) (property passing under a general power of appointment held not includable in estate). In both cases, the Court admitted without question that Congress could tax the item involved. At issue was merely whether the Treasury had exceeded its power
III. Conclusion

The capital gains decisions of 1921 are best understood in an historical context. The cases are more a product of their times than a necessary result of legal precedent. In particular, contemporary economic and political conditions, as well as the practical effects of some recent Supreme Court cases, were the decisive factors in the Court's holding that capital gains were income within the sixteenth amendment.

Legal precedent on the capital gains issue could not have been controlling since prior Supreme Court decisions not only conflicted with each other, but also conflicted within a single opinion. Only two prior cases had considered whether realized gains from a casual or infrequent sale of property were income under an income tax statute. Both cases had held that the gains were not income. Each case, however, was distinguishable on its facts, even though the opinions had been neither based on nor limited to such facts. The corporate excise tax cases had taxed such gains, but technically the tax at issue in those cases was not an income tax. As recently as 1920 the Supreme Court had issued contradictory dicta in the income tax case of Eisner v. Macomber as to whether such capital gains were income. Thus, precedent did not dictate any particular conclusion in the capital gains cases. Even those commentators who favored taxability realized that the precedents were a muddle. No matter which outcome the Court chose, it would have to repudiate some prior statement.

If legal precedents provided little or no guidance, neither did the economists or commentators. Economists could not agree on a definition of income. One of the most troubling issues in their search for agreement was the very issue of whether income included casual capital gains. The legal commentators also divided over the issue, although the majority perhaps favored taxability.

Politics, on the other hand, provided strong reasons to uphold the taxability of capital gains. Since the Pollock decision in 1895 the Court and Congress had been at odds over the extent of congressional power in the taxing area. Pollock, which created a furor in Congress, had reversed the Court's broad construction of congressional power. Although the Court retreated from its viewpoint expressed in Pollock, Congress still found it necessary to pass the sixteenth amendment. In interpreting the amendment, however, the Court once again narrowly construed the scope. By acting in this manner, the Court assumed an activist role in the income tax area. This role created concerns over the balance of power between the Court and Congress. The

by interpreting the relevant statute so as to include the item. The Court held in both cases that the Treasury had exceeded its power, First Trust, 257 U.S. at 606; Field, 255 U.S. at 262, and in both instances Congress included the omitted item in a later statute.

1920 *Macomber* decision, in particular, antagonized Congress and raised the concern over the balance of power to a new pitch. If the Court had overruled Congress again in the capital gains cases, the uproar would have been tremendous. A decision upholding what the Court perceived to be congressional intent, however, would stabilize the teetering balance.

A pro-tax decision would also preserve the tax base for the Treasury. The 1920 cases of *Evans v. Gore* and *Eisner v. Macomber* had diminished the tax base by holding certain items not taxable under the sixteenth amendment. In 1921 the government was faced with falling revenues and large, steady demands for expenditures. The Treasury could not easily withstand a further contraction of the tax base. The exclusion of capital gains would have produced a large gap in revenues. Moreover, as the English experience had shown, to control this particular exclusion in a fluid post-war economy in which people exchanged property frequently would have been difficult.334

In the midst of a depression, the Court surely was sensitive to the government's need to tax. As the Court must have known, a decision favoring the taxability of capital gains would preserve the government's tax base at a time when revenues were sorely needed.

A decision favoring taxability also made sense from a practical, administrative sense. As several commentators had noted, the Court's activist approach, epitomized by *Macomber*, was unworkable. A tax system, especially a self-enforced one, needed certainty to work. The Court could not decide every issue concerning what was or was not income. The *Macomber* Court's definitional approach to income, however, continually required such decisions from the Court. A decision upholding congressional intent would indicate the Court's withdrawal from the tax area and provide certainty because taxable income would be whatever Congress said it was.335 The Court would intervene only when a provision was ambiguous.

The capital gains decisions thus provided satisfactory results for a variety of needs. From a purely judicial standpoint, they resolved an issue that was unsettled. From an economic standpoint, the decisions preserved a potential source of revenue for the government. Moreover, the decisions satisfied the administrative need for certainty in the tax system. Most importantly, however, in a political and constitutional sense they restored an historic balance of power in the tax field between the judicial and legislative branches of government. With these decisions the Court basically ceased its activist role in substantive tax matters.

The Court's recognition of Congress's broad power to tax gave the tax

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334. See Clark, supra note 47, at 739 (citing a Manchester Guardian article of April 2, 1920, in which the Royal Commission urged the taxing of speculative gains).

335. In 1931 the Court explicitly recognized the abdication of its activist role, which had been maintained in large part by judicial definitions of "income." In United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931), the Court held that the discharge of indebtedness was income. In so doing the Court accepted the Treasury Regulations as a "correct statement of the law." *Id.* The Court's own interpretation was not necessary since "[w]e see nothing to be gained by the discussion of judicial definitions." *Id.* The Court had come a long way from *Macomber*.
system the flexibility it needed; the existence of a broad power to tax, however, did not mean that the power had to be exercised. Congress retained legislative discretion to fashion complex revenue-producing statutes to meet changing needs and conditions. If, for example, the taxation of capital gains created economic problems, then Congress was free to change the law. The capital gains cases ensured that the changes would withstand constitutional challenges. The decision was in congressional hands.\footnote{336}

\footnote{336. Some commentators thought that the taxation of capital gains hindered the economy by preventing sales. \textit{The New York Times} thought that business could not survive under the restraint of such taxation. Editorial, \textit{Trading and Taxing}, N.Y. Times, Mar. 13, 1921, at 10. However, as one commentator said: "If the law as it stands works unjustly, it is up to Congress to change it." Comment, supra note 81, at 858. That is exactly what Congress did. The Revenue Act of 1921 was the first to provide for the preferential treatment of capital gains (a maximum rate of 12½%) and to expand greatly the nonrecognition provisions. Congress, of course, did not stop with its 1921 provisions. Congress has changed the capital gains provisions again and again and again—but that is another story.}