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William D. Wallace

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Wallace: Income tax in the United States prior to the sixteenth amendment

THE INCOME TAX IN THE UNITED STATES PRIOR TO THE SIXTEENTH AMENDMENT

by *William D. Wallace*
University of Mississippi

The issue of taxation has been the subject of debate since the establishment of the thirteen colonies. Citizens have consistently disapproved of being taxed (once to the extent of going to war about taxation, among other issues). To be taxed was viewed as being forced to give up a portion of the taxpayer's wealth. However, the philosophy stated by Justice Oliver Wendell Holmes, Jr. ("Taxes are the price we pay for civilization.") prevailed with the enactment of the Sixteenth Amendment in 1913.

The Sixteenth Amendment culminated a ninety-eight-year effort to instigate a permanent income generator for the United States. This paper presents a description of the attempts at taxation of income prior to the adoption of the Sixteenth Amendment.

The Civil War and Before

After the American Revolution there was an adverse feeling concerning taxes of any kind. The states, however, did create taxes and systems of collection, concentrating on goods or property. Secretary Dallas suggested the first federal income tax in 1815 to help finance the War of 1812. At this time, there was already a direct tax imposed on land and slaves, so Dallas could see no conflict of the income tax with the direct tax problem imposed by the constitution. The coming of peace eliminated any need for the income tax, so no income tax provision was enacted.¹

In 1861, the outbreak of the Civil War put pressure on Congress to provide some means of raising revenue. On July 4, 1861, Secretary Chase suggested that a "small part-not to exceed twenty million-of the required revenue be raised by direct taxes or internal duties or excises or both."² The first proposed method of raising revenue was the

use of a tax on real estate. Western citizens opposed the real estate tax, claiming that they would suffer the most from such a tax. Congressman Colfax stated,

"I cannot go home and tell my constituents that I voted for a bill that would allow a man, a millionaire, who has put his entire property into stocks, to be exempted from taxation, while a farmer who lives by his side must pay a tax."³

The westerners had a valid argument. In order to achieve greater equality, Congress was forced to consider income taxation. A portion of Secretary Chase's proposal-direct taxes-was unconstitutional. However, Congressman Edwards stated that, "We can tax it [income] in some mode if we cannot impose on it what is technically called a 'direct tax' . . ."⁴

Deliberation and debate continued until July 29, when the Bill was finally voted and passed by a narrow margin-seventy-seven to sixty. Setting a trend that still continues, the House and Senate versions of the bill were different: the House version called for a levy of 3% on all income over \$600 per year, while the Senate version called for a 3% rate on all income over \$1,000. The two bodies compromised, and the floor was established at \$800.

The income tax law of 1861 was delayed, however; there had been no provision for the assessment and collection of the taxes. Finally, the Internal Revenue Bureau was established in July 1861, and the law of 1861 was revised. This resulting revision imposed a tax of 3% on income in excess of \$600 and up to \$10,000 and 5% on income above \$10,000. Deductions were allowed for all other national, state and local taxes levied on "property or source of income." The initial bill in 1862 also allowed for the exclusion of "all gains

¹Seligman, Edwin R. A., *The Income Tax* (New York: McMillan Company, 1914), p. 431.

²*The Congressional Globe, 37th Congress, First Session*, Washington, 1861, p. 248.

³*Ibid.*

⁴*Ibid.*, p. 432.

and profits derived from advertisements, or on any articles manufactured. . . ,” effectively excluding all business profits. Upon realization of the exemption of business profit, the clause was removed in 1863.

The law of 1864 revised the 1862 law. One provision of the 1862 act that met with violent opposition by some congressmen was the progressive tax rate structure. Congressman Morrill stated, “This inequality is in fact no less than a confiscation of property, because one man happens to have a little more money than another.”⁶ The opposition to the progressive rate structure lost its battle as the rates were increased and became more progressive. The 1864 Act imposed a rate of 5% on income of \$600 to \$5,000; 7½% of \$5,000 to \$10,000; and 10% over \$10,000. This law is the model upon which all subsequent tax laws were based.

The Post-Civil War Era

The Civil War ended in 1865, creating the question of whether the tax should be continued. The tax, at its inception, was defined as temporary, expiring in 1870. The revenue was still sorely needed, and it was generally agreed that it could not be dispensed with immediately. The tax had been a fiscal success: during the war, the tax yielded one-fourth of the required revenue. The tax reached its peak rate (10% over \$10,000) in 1865 and its peak revenue of \$73 million in 1866.⁷ Congressman Morrill made it clear that he was in favor of abolishing the income tax as soon as possible. However, the Commissioner of Internal Revenue declared that he was strongly in favor of the continuance of the tax.

Opponents to the tax attacked the constitutionality of the tax on the grounds that the tax was (1) a direct tax, and (2) if it is not a direct tax, it does not meet the criterion of uniformity specified by the Constitution.

Since the Supreme Court had held in 1796 that a carriage tax was not a direct tax,⁸ uniformity was first challenged. Opponents contended that the

⁵Act of July 1, 1862, Sec. 89-93.

⁶*Congressional Globe, 38th Congress, 1st Session*, Washington, 1864, p. 1876.

⁷Sharp, Ansel M., and Olson, Kent W., *Public Finance: The Economics of Government Revenues and Expenditures* (St. Paul: West Publishing Company, 1978), p. 182.

⁸*Hylton vs. United States*, 3 Dall 171.

progressive rate structure and discriminating treatment of corporations (rates established by business form) made the income tax fail the uniformity test. The Supreme Court, however, ruled that the Constitution referred to geographic uniformity, and the income tax thus satisfied the test of uniformity.

Several taxpayers attempted to claim the income tax was a direct tax, but to no avail. The income tax finally died in 1872 when it was abolished.

In 1893, after a twenty-one-year lapse, President Grover Cleveland supported Congress in its attempt to pass a personal income tax to offset the revenue loss that would result if a proposed tariff reduction was approved. The Bill provided for a 2% tax on income over \$4,000. Though this bill was mild relative to its Civil War predecessor, it was still not a welcome addition to the economy. It was quickly contested.

In 1895, Charles Pollock, a stockholder in Farmers' Loan and Trust Company of New York, filed suit against the Company alleging a “breach of trust in misapplication or diversion of the funds of a corporation by illegal payments out of its capital or profits.”⁹ Pollock claimed that the income tax was unconstitutional and that the Company's willingness to pay the tax constituted the illegal act. The justices that heard the case were equally divided, and no opinion was expressed. The decrees of the lower courts were reversed concerning only the tax on rents or real estate and income derived from municipal bonds. In effect, the Supreme Court declared a portion of the Act unconstitutional. Pollock asked for a rehearing,¹⁰ stating that the Court failed to state: (1) whether some void provisions invalidate the whole Act, (2) whether. . . the act is unconstitutional as laying direct taxes, and (3) whether any part of its tax, if not considered as a direct tax, is invalid for want of uniformity.

The Supreme Court's opinion was as follows:

First. We adhere to the opinion already announced, that taxes on real estate being indisputably direct taxes, taxes on rents or income of real estate are equally direct taxes.

Second. We are of the opinion that taxes on personal property or on the income of personal property are likewise direct taxes.

⁹*Pollock vs Farmers' Loan and Trust Company*, 157 U.S.

¹⁰*Pollock vs Farmers' Loan and Trust Company*, 158 U.S.

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Summary

Third. The tax imposed by Sections twenty-seven to thirty-seven, inclusive, of the Act of 1894, so far as it falls on the income of real estate and personal property, being a direct tax within the meaning of the Constitution, and therefore, unconstitutional and void because not apportioned according to representation, all these sections, constitutes one entire scheme of taxation, are necessarily invalid.

Four justices dissented, but the Supreme Court reversed its earlier stand concerning the income tax as a direct tax.

The Spanish-American War forced the passage of the War Revenue Act of 1898. The constitutionality of this Act was challenged in 1900, the Supreme Court rendered judgment for the plaintiff, and the Act was repealed in 1901.

The result of the court cases made it quite clear that constitutional change was in order if a valid personal income tax was to be levied. It is important to note that the income tax per se has never been ruled unconstitutional. The issue in 1894 was not the right of the federal government to levy a personal income tax, but the way in which the tax was levied.

The financial needs of the United States were growing, and, in 1909, another income tax act was passed. This income tax was imposed only on corporations and was at a rate of 1% on net income above \$5,000. Even while this act was being considered, Congress sent a resolution to the states to enable a constitutional amendment to allow Congress to enact a federal income tax on individuals as well as corporations. The states ratified the resolution so that in 1913 the three-fourths requirement was met.

Finally, effective February 25, 1913, the Sixteenth Amendment to the Constitution was enacted. This amendment provided Congress the power to collect taxes on incomes from any source without apportioning among the states and without regard to the census. On October 3, 1913, Congress imposed a personal income tax effective from March 1, 1913. This Act allowed a \$3,000 exemption. The rates were low-1% on income in excess of \$3,000 up to \$23,000, a surtax of 1% to 6% of income over \$23,000, and 7% on income over \$500,000. The personal income tax had become a permanent part of the American economy.

Earlier taxes were levied on property; these taxes met with hostile opposition. Governments tended to shy away from income taxes, relying upon import duties for raising revenue. Income taxes were usually only levied in the event of an outbreak of war. After the Civil War and the Spanish-American War, the income tax was challenged on the grounds of constitutionality. The challenges finally led to a necessary amendment to the Constitution and alleviated any grounds for contesting the legality of the tax established as of March 1, 1913.

RECENTLY RELEASED WORKING PAPERS

Three new working papers have recently been released as a part of The Academy of Accounting Historians Working Paper Series. The new papers are: No. 43, "A Synthesis of and Inquiry Into the Contribution of Double-Entry Bookkeeping to Capitalism" by James L. Strachan of Case Western Reserve University; No. 44, "Philosophies of History—Their Basic Tenets" by Owen B. Mosely of Murray State University and Milton F. Usry of Oklahoma State University; and No. 45, "The Development of the Audit Report in the United States" by Tonya K. Flesher and Dale L. Flesher, both from the University of Mississippi.

Members of the Academy may obtain copies of the above papers, free of charge, by writing Ashton C. Bishop, School of Business, Virginia Commonwealth University, Richmond, Virginia, 23284.

THESIS ON CARMAN BLOUGH

Richard Scott informs us that one of his graduate students at the University of Virginia, Elizabeth G. Ward, has written a 139 page thesis entitled "Intertwining Movements: Carman Blough and the Progress of the Accounting Profession." Scott also has a transcription of twelve hours of interviews with Blough. The transcript is 254 pages in length. Copies of either the thesis or the transcript may be obtained, at cost, from Richard A. Scott, McIntire School of Commerce, University of Virginia, Charlottesville, VA 22903.