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Baneful Effect Upon Taxation of Social Lag and Misapplied Star Decisis

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THE BANEFUL EFFECT UPON TAXATION OF THE SOCIAL LAG AND MISAPPLIED STARE DECISIS

Alexander Eulenberg

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Some Preliminary Definitions:

Social Lag—

The tendency for a society to continue—whether for physical or emotional reasons—practices, procedures or patterns of thought long after logic and experience have dictated that improved practices are easier, improved procedures are more productive or improved patterns of thought are more valid.

Stare Decisis—

The doctrine or principle that the decisions of a court should stand as precedents for future guidance. The general rule that, when a point has been settled by a decision, it becomes a precedent which should be followed in subsequent cases before the same court or inferior courts.

Some Preliminary Observations:

". . . We recognize that *stare decisis* embodies an important social policy. It represents an element of continuity in law, and is rooted in the psychologic need to satisfy reasonable expectations. But *stare decisis* is a principle of policy and not a mechanical formula. . . ."

Justice Frankfurter in *Helvering* v. *Hallock* 309 U. S. 106—1940

"When we move to constitutional questions, uncertainty necessarily increases. A judge who is asked to construe or interpret the constitution often rejects the gloss which his predecessors have put on it. For the gloss may, in his view, offend the spirit of the Constitution or do violence to it. That has been the experience of this generation and of all those that have preceded. It will likewise be the experience of those which follow. And so it should be. For it is the Constitution which we have sworn to defend, not some predecessor's interpretation of it. *Stare decisis* has small place in constitutional law. The Constitution was written for all time and all ages. It would lose its great character and become feeble, if it were allowed to become encrusted with narrow, legalistic notions that dominated the thinking of one generation."

Justice William O. Douglas: "The Dissent—A Safeguard of Democracy." Address before the Section of Judicial Administration of the American Bar Association, Seattle, Washington, September 8, 1948

"A foolish consistency is the hobgoblin of little minds."

Emerson—Essay on Self Reliance

"With consistency a great soul has simply nothing to do. He may as well concern himself with his shadow on the wall."

Ibid

"Inconsistency with past views or conduct may be but a mark of increasing knowledge and wisdom."

Tryon Edwards

"Those who honestly mean to be true contradict themselves more rarely than those who try to be consistent."

Oliver Wendell Holmes

"When I use a word," Humpty Dumpty said in rather a scornful tone, "it means just what I choose it to mean—neither more nor less."

"The question is," said Alice, "whether you can make words mean so many different things."

"The question is," said Humpty Dumpty, "which is to be master—that's all."

Lewis Carroll: "Through the Look-Glass."

"The cause of lightning," Alice said very decidedly, for she felt quite certain about this, "is the thunder—no, no!" she hastily corrected herself. "I mean the other way."

"It's too late to correct it," said the Red Queen. "When you've once said a thing, that fixes it, and you must take the consequences."

Ibid

The Problem is Universal—Not alone in the Law:

A profound example of how costly the social lag can be may be found in the modern typewriter—or what we consider to be the modern typewriter. The present typewriter keyboard was laid out about seventy-five years ago; and at that time, the arrangement of the keyboard was probably the most efficient that could be achieved.

In the early 1930's, a California professor named Dvorak designed an entirely new typewriter keyboard with a radically different arrangment of letters. Professor Dvorak, of course, had the advantage of the sciences of psychology and pedagogy which had not been available to his earlier predecessors who had pioneered the typewriter keyboard.

When, at the beginning of World War II, the United States Navy found itself in urgent need of qualified typists whom it could secure only from its pool of young men drawn from farms, factories and schools, it ordered the production of thousands of typewriters with Dvorak keyboards. And, we saw the miracle of unskilled and untrained young men with no particular aptitude for typing become fairly expert typists within the space of weeks, not months. What an opportunity to save hundreds of hours for the thousands of young women who will study typing in the years to come!

But that opportunity will never be realized because of the insurmountable obstacle of the social lag. Any young woman who would now train herself to the Dvorak keyboard would exclude herself from employment by the thousands of firms who own standard keyboard machines. Any employer who might equip his office with Dvorak keyboard typewriters would exclude himself from the opportunity to hire a typist from among the thousands who have been trained on the standard keyboard.

And so we are inextricably bound to an archaic system and the loss of millions of hours of instructional time.

The Problem is Everywhere in the Law—Not Alone in Taxation:

The social lag manifests itself not only in matters of the mechanical and physical but also in patterns of thought.

Today, when a married woman is physically injured through the negligence of another not only does she have a cause of action for damages against the negligent party, but her husband also has a cause of action for what is known as "loss of consortium," which means loss of her services as a housekeeper and companion during the period of her disability.

On the other hand, if a married man is injured in a similar situation, he has a cause of action for his injuries but his wife has no compensable rights for *her* loss of consortium.

In further contrast, in the case of the injury of a minor, his parents are entitled to compensation for loss of his earning power.

This illogical discrimination against a wife stems from the archaic concept, from which we have not yet freed ourselves, of a married woman as the chattel of her husband.

Sometimes a great legal mind has the courage to break through such concepts. In 1915, a man named MacPherson, while driving a Buick automobile, was injured when a wheel collapsed and the car overturned. He sued the Buick Motor Company

which defended on the ground that it had sold the car to the dealer who in turn had sold it to MacPherson; so that there was no privity of contract between Buick and MacPherson and hence no obligation to him.

Buick's defence, which received the approval of the dissenting justices of the New York Court of Appeals was based on the ancient English case of *Winterbottom vs. Wright* (10 Meeson & Welsly 109-1842). This was an action by a driver of a stage coach against a contractor who had agreed with the postmaster to provide and keep the vehicle in repair for the purpose of conveying the royal mail over a prescribed route. The coach broke down and upset, injuring the driver who sought to recover against the contractor on account of the defective construction of the coach. The Court of Exchequer denied him any right to recover on the ground that there was no privity on contract between the parties, the agreement having been made with the postmaster agent alone. Lord Abinger, Chief Baron, said:

"If the plaintiff can sue, every passenger or even any person passing along the road, who was injured by the upsetting of a coach, might bring a similar action. Unless we confine the operation of such contracts as this to the parties who enter into them, the most absurd and outrageous consequences, to which I can see no limit, would ensue."

The majority of the court, however, held for MacPherson in an opinion written by Benjamin Cardozo who was later to become a Supreme Court Justice and one of the most lucid and eloquent, the Court said:

"The presence of a known danger, attendant upon a known use, makes vigilance a duty. We have put aside the notion that the duty to safeguard life and limb, when the consequences of negligence may be foreseen, grows out of contract and nothing else. We have put the source of obligation where it ought to be. We have put its source in the law . . . *Precedents drawn from the days of travel by stage coach do not fit the conditions of travel today.* The principle that the danger is imminent does not change, but the things subject to the principle do change. *They are whatever the needs of life in a developing civilization require them to be . . .*" (Italics supplied.) *MacPherson vs. Buick Motor Co.*, 217 *N.Y.* 382—1916.)

Incidentally, the boldness of the majority opinion is highlighted by the fact that at the time the wheel broke and MacPherson was injured he was driving the Buick at a speed of eight miles per hour.

The Problem is in Every Phase of Taxation:

The quest for certainty and assurance in taxation as well as in other fields, although it appears to be a quite popular cause at the moment, is nothing new. It did not germinate in the administration of Franklin Delano Roosevelt nor did it reach fructification in the administration of Harry S. Truman. One of the earliest modern attempts to find a tax whose application and administration could be fixed and crystalized once for all, was made in the latter part of the 19th century by Henry George, the author of that famous work on the concept of the "Single Tax" entitled "Progress and Poverty."

For a somewhat more recent illustration of the yearning for certainty and unchangeability we may turn to the Congressional discussion at the time of the establishment of the Board of Tax Appeals, now the Tax Court of the United States. The Board was originally set up in 1924 as a temporary experiment and was made permanent by the Revenue Act of 1926. There was a strong sentiment at the time to continue the Board on a temporary basis for a period not to exceed ten years.

In view of what has transpired since 1926, the following questions by Congressman McKeown can cause us only to smile:

"Why extend the term beyond ten years? Would not the fact that they do render judicial opinions and settle questions—will not that settle those questions in ten years so that there will no longer be any confusion? May not the matter settle down to the point where they will have no work?" (67 Congressional Record, Pg. 1129-1925.)

In some situations, unfortunately, there is little if any possibility that either Congress or the Tax Court may extricate us from the involvement of the social lag. A prime example is found in the seemingly endless complexity of the double rate structure of the Federal Estate Tax consisting of a Basic Tax, an Additional Tax, and various proportional deductions and credits for gift taxes and state inheritance taxes.

This confusion stems from the Revenue Act of 1926 at which time certain states, Florida in particular, imposed no inheritance tax upon their residents. As a matter of fact, Florida had a constitutional prohibition against death taxes. In contrast such states as New York and Wisconsin imposed comparatively heavy succession taxes. As a result, Florida was able to offer legal

residence on an attractive basis, tax wise, to wealthy persons who sought to escape such taxes.

The Revenue Act of 1926 granted a credit against the Federal Estate Tax (with certain limitations) for such inheritance taxes imposed upon estates subject to the Federal tax. Shortly, thereafter, Florida enacted a tax equal to the credit allowed under the Federal Estate Tax Act. There was a further provision that the Florida tax would lapse at any time that the Federal Tax credit was repealed.

When, in 1932, Congress decided to raise substantially the Federal Estate Tax rates, it became necessary to super-impose upon the Basic Tax a so-called Additional Tax. Otherwise, a repeal of the 1926 tax with a complete and clean-cut revision of rates, would have effected the repeal of the Florida tax until such time as the Florida Legislature might again meet to enact a State Inheritance Tax to match whatever exemption a new Federal Estate Tax might have established. It was conceivable that in the intervening period, one or more wealthy Floridians might die, and the State lose whatever succession tax it might otherwise have collected.

A layman might think that this difficulty could be resolved if state legislatures would provide that the state inheritance tax should be such an amount as would be equal to whatever credit might be allowed under subsequently enacted Federal legislation; but here we would run into two Constitutional barriers. The first is the principle that no legislative body may pass laws binding a succeeding assembly. The second is that the Congress of the United States and the State Legislatures are mutually exclusive and independent bodies; so that Congress can not legislate for the States. (In 1938, Commerce Clearing House, Inc., published "The Theory and Practice of Modern Taxation," by William Raymond Green, who was Chairman of the Ways and Means Committee of the House of Representatives at the time of early estate tax legislation and the father of the state inheritance tax credit against the Federal estate tax. Chapter XIV of his book sets out in great—and interesting detail—the factors which led to the provision for this credit, the problems that the credit sought to eliminate or alleviate, and the problems that it created.)

So here too, analogous to the case of the Typewriter keyboard, it appears that we may be permanently chained to a cumbersome and illogical taxing procedure.

Of the hundreds of instances of social lag and the misapplication of *stare decisis*, available space permits my developing but one further example. In the situation I am about to describe to you, however, there is no barrier to a salutory correction other than the unwillingness of our courts to change an out-moded and distorted pattern of thought.

The case of *South Tacoma Motor Car Co. vs. Commissioner*, decided by the Tax Court March 6, 1944, is reported in 3 TC 411. The taxpayer was a Chevrolet automobile agency. It sold coupon books for lubrication, inspection and service to its customers. An automobile owner would pay $10 for a book of 12 coupons or $5 for a book of 6 coupons. Each time the owner had his car serviced, the South Tacoma Motor Car Co. would tear a coupon from his book. When the books were sold to customers, the proceeds were credited to a liability account. As the coupons were used, an aliquot portion of the sales price of the book was transferred to income. Quite frequently, purchasers of books would turn in unused portions for cash refunds which were made without question. In the face of these facts, the Tax Court sustained the Commissioner in taxing as income, in the year the books were sold, the entire proceeds from their sale. As a result, the proceeds from books sold in 1940, an excess profits tax year, were taxed to the extent of more than half of their value; and the taxpayer was permitted to deduct as expense the cost of services rendered in subsequent years when, as you know, there were no sales of civilian automobiles, and no income against which such expense could be applied.

The Tax Court based its judgement upon *Astor Holding Company v. Commissioner* (135 F (2d) 47—1943, CCA-5th) which held that:

"Where a lease referred to an advance payment made in the first year of the lease as "part payment of the tenth year's rent" and where the parties intended that the payment be so applied, the full amount of the payment was taxable to the lessor in the year of its receipt."

Of the many misapplications of *stare decisis*, the South Tacoma Motor Car Company was certainly a prime example. But you should know that *Astor Holding Company*, itself, was a misapplication of *stare decisis* because it was bottomed on three earlier cases which had nothing to do with the issue then before the Court of Appeals.

In the *Astor* case, the Court said:

"Both the taxpayer and the Commis-

sioner recognizes this to be settled law: An amount paid to a lessor as rent in advance is taxable income in the year of its receipt." Citing—

U. S. vs. Boston & Providence Railroad Corp. 37 F (2d) 670—1930
Renwick v. U.S. 87 F (2d) 123—1937
Com. v. Lyon 97 F (2d) 70—1938

In the *Boston and Providence Railroad* case, the issue was whether the lessee's obligation to pay the lessor's debt was income when undertaken in 1888, so as to be a credit to invested capital under the Revenue Acts of 1917 and 1918 (Excess Profits Tax). The Court held that the items in question were income when paid saying:

"An amount paid in advance as rental . . . as to the lessor in computing his tax . . . is treated as income in the year in which received." Citing—

O'Day Investment Co. 13 BTA 1230—1928
Miller v. Gearin 258 F (2d) 225—1919

The *Renwick, Lyon* and *O'Day* cases related to taxpayer on the *cash basis.*

In *Miller v. Gearin,* it was held that:

"The value of a building constructed on the lessor's premises in 1907 by a lessee pursuant to the terms of a lease was not income to the lessor in 1917 when the lessee defaulted and the lessor repossessed the premises. By the terms of the lease, title to the building rested in the lessor upon its construction."

But note that in 1907, there was no income tax law. In fact from 1913 through 1915, only the cash basis of accounting was recognized in income taxation. The 1916 Act *permitted,* but did not *require* taxpayers to use the accrual basis even when it more accurately reflected true income.

The facts in *Cyran v. Wardwell* were similar to those in *Miller v. Gearin* and the conclusion was the same:

"Plaintiff was the owner of a lot of land in the city of San Francisco upon which under the terms of a lease made by plaintiff in 1908 for a term of 26 years, there was erected by her tenant a class A steel and concrete building, the lease providing that 'in no event shall the lessee hereunder have any right to remove any building from said premises.' The building was completed in 1910. In 1916, the tenant defaulting in accrued rent, the lease was by mutual arrangement cancelled and terminated, and possession of the leased premise surrendered to plaintiff."

The Court held that income was realized in 1910.

In view of the specific language in the Revenue Acts since 1918, the decision in *South Tacoma Motor Car Company* and a host of similar cases is difficult if not impossible to reconcile or justify.

Section 212 (b) of the Revenue Act of 1918 stated:

"net income *shall* (italics supplied) be computed upon the basis of the taxpayer's annual accounting period . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer."

The same provision has appeared in every subsequent Revenue Act and is now embodied in the Internal Revenue Code. And yet, a misconception of *stare decisis* continues to compel our Courts to ignore basic accounting principles.

In the ancient kingdom of Phrygia in Asia Minor there was an ox cart to which a bow was secured by a knot so complex that no man had been able to untie it.

Legend had it that a certain peasant, Gordius by name, used this vehicle, with oxen, for the labors of his day. Gordius became king of Phrygia, whereupon he dedicated his ox cart and yoke to the pagan god Zeus. According to this legend, also, there would some day come to Phrygia a man who would untie this complex knot. This man would later rule the world. About three hundreds years before Christ, there came to Phrygia a young prince, Alexander, son of King Phillip of Macedon—later to become king himself, to be known as Alexander the Great.

When he learned of the ox cart and yoke —and the legend concerning them—he went to the place where the cart and yoke were enshrined, studied the knot and, lifting his sword, he smote the knot, cutting it asunder.

To this day, we describe the "direct approach" which eschews the barriers of tradition, convention and inertia, as "cutting the Gordian knot."

I am not one who believes that all change is necessarily progress or that all apparent progress is necessarily conducive to happiness.

But I do feel impelled in these days of uncertainty and the resultant nostalgia for "things as they used to be," to sound a note of warning against complacency and to urge you not to be afraid to cut the Gordian knot.