Gains, Profits, and Income — The Deceptive Camel

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I said there was a society of men among us, bred up from their youth in the art of proving by words multiplied for the purpose, that white is black, and black is white, according as they are paid. To this society all the rest of the people are slaves.

Mr. Lemuel Gulliver, explaining to the Houyhnhnms the concept of lawyers, from Gulliver's Travels, by Jonathan Swift, 1735

The well accepted principle with respect to taxation that the term income meant profits and gain was embedded directly into the tax statutes. With each revenue act, authors consistently wrote "gains, profits, and income" throughout their legislation. The three words were always used in a redundant sense and this practice continued for several decades. The revenue act of 1894 stated in part:

. . . there shall be assessed, levied, collected, and paid annually upon the gains, profits, and income received in the preceding calendar year . . . ." [emphasis added.]

The revenue act of 1913 stated in part:

That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from . . . ." [emphasis added.]

The revenue act of 1916 stated in part:

That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from . . . .

Legislators repeated this practice in the 1917, 1919, 1921, 1924, 1926, 1928, 1932, 1934, 1936, and 1938 revenue acts. In section 22(a) of the first external codified version of the tax laws of 1939,[1] legislators continued the practice, which reads in part:

"Gross income includes gains, profits, and income derived from . . . ." [emphasis added.]

This common practice changed with the revised 1954 Code.[2] Section 22 of the 1939 Code became section 61 in the 1954 Code. Legislators strangely decided that redundancy no longer was necessary. Section 61(a) reads in part:

"Gross income means all income from whatever source derived . . . ."

The 1954 Code contained footnotes to help cross-reference back to the 1939 Code. The footnotes for section 61 refer to House Report No. 1337 from the Ways and Means Committee, dated March 9, 1954. At page A18 that report references the defined term "gross income" and states in part:

> Section 61. Gross income defined
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> This section corresponds to section 22(a) of the 1939 Code. While the language in existing section 22(a) has been simplified, the all-inclusive nature of the statutory gross income has not been affected thereby. Section 61(a) is as broad in scope as section 22(a).
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> Section 61(a) provides that gross income includes "all income from whatever source derived." This definition is based upon the 16th Amendment and the word "income" is used in its constitutional sense. [emphasis original.]

Reading that report established that within section 61(a), the term "income" remained synonymous with the words profits and gains — net income. The Supreme Court justices even provided an explicit connection between the 1939 and 1954 Code and the legislative footnotes in Commissioner v. Glenshaw Glass Company.[3]

With the 1986 revised Code, legislators dispensed with the footnotes. People would read section 61 and not know the limited meaning of the term income with respect to taxation — including lazy court judges and attorneys. There can be little debate about the confusion this omission has caused since 1954, which is only a few years after the World War II period when significantly more people began to file tax returns and pay an income tax on all their wages and salaries. As that generation lost sense of history, so too would offspring. With this simple change income was interpreted as "everything that comes in" rather than profits and gains. Was this omission deliberate or just another example of ignorance toying with the camel's nose?

An inherent challenge with trying to tax incomes is that income is a concept. Income is not something tangible that can be immediately touched or seen. Income must be calculated. With respect to taxation, income is net profit or gain. At best, calculating income can only provide a one-time snapshot perspective of profit and loss. Create a profit and loss statement for each business day of any business, and more than likely the income realized will be different. Indeed, in large businesses, that snapshot likely changes by the minute as revenues and expenses continually flow throughout the day. Because income is a concept, income never can be the subject of a tax. Income is indeed property but is not tangible or fixed. Unlike a bank deposit or fund, income does not exist at a certain place or time as an object. Income can be used only to measure any possible tax owed. If income is used to measure the tax owed, then what is being taxed must be something else.

Income is not revenues received (receipts). Income is personal property. The Pollock court affirmed that difference and the Supreme Court justices have said several times that gross

receipts do not equal income. A tax on total receipts (everything that came in) would essentially be a tax on the activity of selling goods and services — an excise tax in the nature of a sales tax. A tax on gain would be a tax on profits. A tax on personal property is a direct tax on property. This is the essential difference and reason why the Pollock struck down the 1894 act as unconstitutional. Direct taxation must be governed by the rule of apportionment — with the exception of incomes.

Yet, readers should see that not only is that distinction between direct and indirect taxation easily misconstrued, but that the word income is easily twisted. Income is generally meant to mean whatever comes in — the opposite of outgo (expenses). However, if the Court justices has declared that income is synonymous with profit and gain, then income is also synonymous with net income. What is net income? Net income implies deducting expenses from receipts to derive net gain or profit. Income cannot be both, what comes in — gross receipts, and what is left over — gain or profit. Slowly but surely the reason becomes more clear why this issue is so easily convoluted.

Regardless, profit and gain is property, and historically, taxing property is a direct tax. Income is not easily distinguished or severed from the source of that profit or gain. Therefore, such taxes must be apportioned. That was the exact issue discussed in Pollock. The legislator's solution? Simply remove the requirement of apportionment for the specific property of income.

The 16th Amendment did not eliminate the requirement for apportionment when a direct tax is levied on other property, nor did the 16th Amendment reclassify income as anything but property, nor did the 16th Amendment subject taxes on income to the rule of uniformity; the 16th Amendment merely removed, from the requirement of apportionment, the specific class of property known as income. In other words, income was and is still considered property, and a tax on income is still considered a direct tax, but the rule of apportionment no longer applied to that specific class of property.

Similar to Springer, the Supreme Court justices in 1916 did not see the flaw in their logic. The Court justices believed that if the rule of apportionment was removed from the property known as incomes that such a decision automatically moved such taxes into the class of indirect taxes. In short, the Court justices goofed. Big time.

Yet, the entire challenge could have been resolved rather easily, all without the often confusing 16th Amendment. All legislators had to do was tax the activity of doing business in any organized form, such as a corporation, partnership, or registered "doing business as," and use the business's income (net income or profits) as a means to measure the tax owed. Whether a corporation, partnership, or sole proprietorship is irrelevant because profit and loss is calculated in the same manner. Simply declare the tax to be an excise tax. In other words, levy an excise tax; and use derived income to serve as a yardstick to determine the tax owed for operating a business in commerce. No amendment was necessary to levy an excise tax measured by net income.

This is exactly what legislators did with the Corporation Excise Tax of 1909. Legislators wanted to tax those profits and gains, but could not because of Pollock (at least not without apportionment). So they simply changed the definitions. Legislators taxed corporations for the "privilege" of operating as a corporation; that is, being an artificial creature of the state seeking the protections of operating with a limited liability. The final tax owed was measured by income (profit and gain). One of the obvious challenges to that tax, however, was that incorporation charters are issued by state legislators, not congressional legislators. Therefore, some people argued that the state legislators should levy such a tax, not congressional legislators. Another argument was that an individual (proprietor or partnership) engaged in the same business as a corporation would escape the tax but the corporation wouldn't. Both arguments were rendered moot by the Supreme Court justices in Flint v. Stone Tracy Company.

To reconcile Brushaber and Stanton with Peck and Co. v. Lowe and Eisner v. Macomber, what the Court justices must have meant was that "income" taxes on businesses was in actuality an excise tax, and incomes were used only to measure the tax owed. That is, any tax labeled as an "income" tax, was, with respect to businesses, by inference, a tax on an activity. The Court justices easily could have said so without the enormous twistifications, camouflage, and gyrations. Nonetheless, what the 16th Amendment established was that even if legislators "forgot" to declare a tax to be an excise tax measured by income, they would no longer would have to worry about their sloppy legislative efforts because the 16th Amendment allowed courts to no longer look for any rules with respect to taxes levied on the property of incomes.

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Endnotes

[1] Volume 53 Statutes at Large, 76th Congress Session I, Part I, enacted February 10, 1939.

[2] Volume 68A Statutes at Large, 83rd Congress Session II, Chapter 736, enacted August 16, 1954.

[3] 348 U.S. 426 (1955), at page 432, footnote 11.