

Exhibit 3

THE FEDERAL INCOME TAX

BY
ROY G. BLAKEY
and
GLADYS C. BLAKEY
UNIVERSITY OF MINNESOTA

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CHAPTER I

THE BEGINNINGS OF THE REVOLUTION IN NATIONAL TAXATION

A new era of national taxation was ushered into the United States with the adoption of the Sixteenth (Income Tax) Amendment to the Constitution, February 3, 1913. The first federal income taxes were supplementary emergency measures of the Civil War period,¹ but it was not possible for the United States to have a broad general income tax as a main source of revenue, for peace times as well as for war and other emergencies, until the adoption of the Sixteenth Amendment.

ANTECEDENTS OF THE SIXTEENTH AMENDMENT

The two great battles which made that amendment possible were fought in 1894-1895 and 1909-1913. The abortive income tax of 1894 (declared unconstitutional in 1895) had only a loose causal connection with the Civil War income taxes; it was really the result of a great equalitarian movement generated by two prolonged post-war depressions of great severity. Although frustrated for nearly two more decades, the leaders of this democratic movement won in 1909 what later proved to be a decisive victory by forcing a conservative President and even more conservative congressional leaders to submit a Constitutional amendment to the states and, also, by forcing them to authorize an entering-wedge income tax under the guise of an excise tax on corporations. These two 1909 income tax measures were not originated by immediate and urgent fiscal pressures, rather they were results of a no longer postponable conflict between holders of opposing economic interests and political philosophies. The ratification of the amendment by three fourths of the states — contrary to the expectations of the conservative leaders — showed on which side the victory lay, and was followed promptly by the adoption of a general income tax which included the previous tax on corporations and much more besides.

¹ An income tax was suggested during the War of 1812.

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These short and simple laws were the forerunners of a series of measures that were soon to multiply many fold the revenues of the government, and to affect profoundly and permanently, not only the national government, but also state and local governments, all industry and finance in the United States and, consequently, the lives of its millions of citizens.

The really new era which got well under way in 1909 and 1913 is the one with which this treatise is chiefly concerned, though a brief account of what went before will assist in understanding why and how this era came into existence, and will aid also in evaluating the significance of later developments.

Prior to the Civil War the national government was financed chiefly by receipts from customs duties. Some revenue was received from the sale of public lands and from a few temporary excise and other internal taxes. (Table 1.) The tariff, although the main source of revenue, was not ideal for several reasons, one of them being that the yield fluctuated violently according to the condition of business and bore little relation to the needs of the government. At times the government faced a deficit. Then it borrowed, relying on a hoped-for surplus some time in the future. At times the surplus became embarrassing and tempted Congress to spend recklessly. Twice at least, in the 1830's and again in the decade preceding the panic of 1893, such surpluses were important factors contributing to economic depressions, though other factors were more important in the latter period.

THE CIVIL WAR TAXES

When the opening gun of the Civil War was fired on Fort Sumter, the national government was neither financially nor psychologically prepared for the long struggle. The panic of 1857 had left its mark on business and the decline in receipts from customs had left a Treasury deficit. Disagreement as to financial policy between northern and southern members of Congress and President Buchanan's apparent indifference or indecision forced the Treasury to borrow more and more.

Even before the war broke out the national credit was so poor that New York banks were reluctant to lend to the government. For example, in December 1860 the Administration experienced great difficulty in floating a \$5,000,000 issue of treasury notes bearing 12% interest.²

In the first months after the outbreak of war neither Congress nor the Secretary of the Treasury had much courage when it came to imposing taxes, but perhaps it is difficult now to appreciate the

² 36th Congress, 2d Session, *House Miscellaneous Document 20*, p. 3.

THE REVOLUTI

psychology of a people t support of the national tariff. There had not b liquors since 1817 wher Furthermore, no one e: difficult or of long durat

RECEIPTS OF THE
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Year	Customs (including tonnage tax) ^b	Internal
		Income and Profits Taxes
1789-91	\$4.39
1800	9.08	.....
1810	8.58	.....
1820	15.01	.....
1830	21.92	.....
1840	13.50	.....
1850	39.67	.....
1860	53.19	.....
1865	84.93	\$60.98
1870	194.54	37.78
1880	186.52	.....
1890	229.67	.....
1900	233.16	.....
1910	333.68	20.95
1919 ^e	184.46	3,018.78
1920	322.90	3,945.95
1930	587.00	2,410.99
1932 ^f	327.75 ^b	1,057.34
1937	486.36	2,157.53
1938	359.19	2,634.62
1939 ^g	318.84	2,182.30

^a Compiled from *Report of the* annual receipts, 1908-1939, see Ta

^b Beginning in 1932, tonnage t revenue.

^c Includes sales of public lands, and other postal revenues.

^d Less than \$100,000.

^e Included because it was the ye

^f Included because it was the ye

^g From Daily Statement of the T

Aside from borrowing, finance the war: (1) fiat revenue system, that is, ex sumption goods, licenses o certain corporations; and the eloquent Morrill expla

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law the rates were graduated according to the amount of income — 3% on a person's income in excess of \$600 and not in excess of \$10,000, and 5% on income in excess of \$10,000. In the 1864 law the rates were 5% on income over \$600 and not over \$5000, 7½% on income over \$5000 and not over \$10,000, and 10% on income over \$10,000. The next law, that of 1865, taxed income in excess of \$5000 at 10%. By 1867 the war was over and, although the debt remained, Congressmen were eager to reduce the tax burden; therefore, the personal exemption was increased to \$1000 and the rate lowered to 5%. In 1870 the exemption was raised to \$2000 and the rate was reduced to 2½%.⁵

Several features of these laws were important as precedents for later legislation. One was the direct dealing between the national government and large numbers of individuals in the collection of non-shiftable personal taxes; another and somewhat opposite was the partial adoption of the British "stoppage-at-the-source" method of collecting the tax; for example, on government salaries and certain corporation dividends and interest.

The concept of taxable net income was evolved gradually. In drafting the first two laws members of Congress were not sure whether gross or net income was what should be taxed. They were afraid to say "net" income for fear that taxpayers would take out too many personal expenses.⁶ In the laws of 1861 and 1862 the only specified deductions were "national, state, and local taxes." The law of 1864 allowed deductions for business expenses, interest, taxes, rent — even rent paid for homes — but did not mention depletion of natural resources, although this matter was debated. The law of 1866 and succeeding measures permitted the allowance of "losses actually sustained during the year arising from fires, shipwreck, or incurred in trade, and debts ascertained to be worthless but excluding all estimated depreciation of values." Much of the phraseology of the Civil War laws was carried over into the laws written after the adoption of the Sixteenth Amendment.

Members of Congress in the Civil War period were as puzzled as those in recent times over the taxation of profits from sales of capital assets. The law of 1864 taxed net profits realized from sales of real estate purchased within the year for which income was estimated. In 1867 an amendment was made to tax net profits from sales of real estate purchased within two years previous to the year for which income was estimated. Efforts to extend this provision to personal property were unsuccessful.

Mention has been made of the establishment of the office of Com-

⁵ For rates and personal exemptions of other laws, see Chap. XXII below.

⁶ *Congressional Globe*, 37th Congress, 1st Session, p. 315.

on, p. 1194.
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em. In fact, the tax was a failure,
turned to the states in the 1890's,
duce the Treasury surplus of that
the rates of the protective tariff.