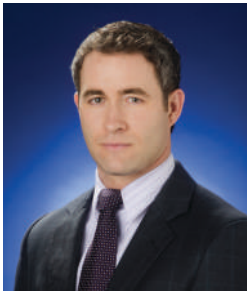


A Look Back at More than a Century: The Federal Income Tax

By Jason B. Freeman, JD, CPA | Column Editor

Every April, millions of Americans brave the spring ritual of filing an income tax return. In the rush to complete their returns (and, if they are lucky, claim a refund), most give little thought to the fascinating origin and history of the tax that will celebrate its 102nd birthday this October. Our modern federal income tax represents a defining marker in our nation’s history and character, with foundational – and, some might say, uniquely American – justifications rooted in ideas of social justice, democratic values and economic theory. A tax with Civil War origins, it played a key role in the course of American class politics, evolving from a limited-scope “class tax” to the “mass tax” that became the backbone of our federal system.



In the early years of our nation, the federal government was funded largely through tariffs, customs duties and excise taxes – regressive taxes that were imposed on the purchase of such wares as whiskey, tobacco, sugar and carriages. There was no federal tax on “income.” But an income tax was by no means an unknown concept.

Adam Smith, in his 1776 treatise *The Wealth of Nations*, had written about the tax. England imposed taxes on income to subsidize the Napoleonic Wars. Why, then, was the income tax – the tax that is now so central to our nation’s tax structure – not a “permanent” part of our federal revenue machinery until 1913?

Much of the answer lies in the constitutional restriction against “direct” taxes without apportionment. The rest of the answer lies in the lack of political support for such a tax and the long-run absence of a need for high levels of revenue at the federal level. In our country’s early years, the federal government played nowhere near the predominant role that it now plays. For instance, from 1789 to 1849, the first 60 years of our nation’s existence, federal tax revenues totaled an estimated \$1.16 billion.¹ Today, annual receipts from the income tax alone exceed that 60-year total by a multiple of more than 1,000, topping a trillion dollars.

Several of the major milestones in the evolution of the income tax are marked by our nation’s defining wars. Indeed, it was the exigencies of war that gave rise to our first income tax, the predecessor to the modern income tax. The income tax was first introduced during the Civil War when, in 1862, Congress enacted and President Lincoln signed, the nation’s first income tax.² The Civil War-era income tax provided for a progressive levy: 3 percent on income over \$600 up to \$10,000, and 5 percent on income over that amount. The reach of the tax was limited. Only a small portion of the population (roughly 1 percent) was actually subject to the tax; it was, in other words, a “class tax.”

Editor’s Note

In this issue of *Today’s CPA* magazine, Jason Freeman, JD, CPA-Dallas, will begin writing the Tax Topics column. Freeman is an attorney-CPA with Meadows Collier Reed Cousins Crouch & Ungerman in Dallas and an adjunct law professor at SMU’s Dedman School of Law. He is an active volunteer member of TSCPA and the Dallas Chapter. TSCPA welcomes Freeman as the new column editor for *Today’s CPA* magazine.

The tax, as one might expect, was not universally accepted. And it was challenged on constitutional grounds. However, in *Springer v. United States*, a case that is often overlooked by the history books, the Supreme Court actually upheld the Civil War-era income tax as a constitutional levy.³ The tax remained on the books for a decade before Congress allowed it to expire in 1872.

As the country then adopted a postbellum revenue policy that depended on protective tariffs, calls to renew the Civil War-era income tax grew. The tariffs, which were regressive and protected Northern manufacturing interests from foreign competition at the cost of higher prices for manufactured goods, once again brought geographical and class differences to the forefront, rousing agrarian and populist sentiments in favor of an income tax.

In 1894, Congress gave in to those sentiments and enacted a new income tax. Shortly thereafter, the tax was again challenged as an unconstitutional levy. By this time, however, the political winds, and the makeup of the Supreme Court, had changed and in 1895, in the infamous case of *Pollock v. Farmers’ Loan & Trust Company*, the Supreme Court reversed field and ruled that the income tax was unconstitutional. It was, the court now held, a “direct” tax imposed without apportionment.

The *Pollock* decision has given rise to a widespread and enduring misconception that the court found the income tax to be inherently unconstitutional. In fact, the court never held that the tax was unconstitutional per se. The tax has probably always been within Congress’s broad-taxing power. The *Pollock* court, instead, technically struck the tax because it was implemented without apportionment – a political impossibility and a requirement that, for all intents and purposes, sounded the death knell for the income tax. The death knell, that is, until the tax was revived from the dead by the ratification of the 16th Amendment, which freed the income tax from the requirement of apportionment and ushered in a new era in federal taxation.

The 16th Amendment was ratified in February of 1913. The amendment was followed later that year by the passage of the Revenue Act of 1913, which was signed into law by President Woodrow Wilson,

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imposing the modern income tax. The basic structure of the tax, however, was based largely on the Civil War-era income tax; in other words, our modern income tax structure traces its origins directly back to the Civil War.

The tax was, again, a progressive one. It provided for a 1 percent tax on income up to \$20,000 with graduated marginal rates up to 7 percent. Because of a sizable exemption, however, only about 2 percent of households were subject to the tax. Proponents of the progressive income tax argued that it was fairer than the regressive tariffs that had characterized federal tax policy and that it aligned tax burdens with the ability to pay.

The early income tax laws were a model of simplicity, at least compared to our current tax code and regulations. The original “tax code,” for example, drew no distinction between capital gains and ordinary income (a distinction that is the source of significant complexity) and covered a mere handful of pages in length. Contrast that with the later proliferation of code provisions, regulations, rulings and other authoritative rulings, which now span about 75,000 pages.

The tax was quite successful too, and the federal government quickly realized its potential. With the fiscal demands of World War I, Congress raised the top marginal tax rate to 77 percent in 1918. However, rates dropped in the years following the First World War after the immediate need for war revenues subsided. In the following years, Congress regularly enacted new tax acts, with each new act superseding the previous acts, and the task of navigating the tax laws grew more and more complex. But Congress took an important step towards simplifying tax administration in 1939 with the first codification of the tax laws.

Soon thereafter, the demands of World War II put renewed pressure on the income tax, and Congress raised the top tax rate to a now almost-unimaginable 94 percent. These rate increases, combined with lower filing thresholds and the introduction of withholding during World

War II, transformed the income tax from a “class tax” to a “mass tax,” with a greater percentage of the population represented on a return than ever before. The federal income tax was now clearly the centerpiece of the nation’s tax system.

In the following years, federal income tax policy was increasingly used not just as a tool for raising revenue, but as an instrument to influence social and economic behavior. As Congress used the tax to incentivize investments, control inflation and redistribute wealth, it became more and more ingrained in our nation’s economic and social fabric.

The income tax, of course, continued to evolve from these origins into the tax that we know today. While the chapters of the story that build on its origins are littered with important milestones that are too numerous to recite here, among the more significant landmarks were the 1954 re-codification of the tax laws (the second major codification of the tax code) and the 1986 re-codification, which gave us the current tax code and implemented significant tax-rate reductions.

Although the tax code underwent changes almost every year following these codifications, the fundamentals of the federal income tax have largely stayed the same. In these respects, at least, it has mimicked the society that it is imposed upon. Indeed, the tax that has now seen more than a century of social and economic change continues to reflect not only a number of fundamental American ideals, but the changing values of a complex and evolving society. ■

Footnotes

1. Office of Management and Budget, Historical Table 1.1, available at <https://www.whitehouse.gov/omb/budget/Historicals>.
2. In fact, such a tax was first enacted in 1861, but it was never collected and was repealed by the 1862 tax. The 1862 tax was the first federal income tax to generate tax revenue.
3. *Springer v. United States*, 102 U.S. 586 (1881).

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