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Robert C. Brown
Indiana University School of Law

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CONSTITUTIONAL LIMITATIONS ON PROGRESSIVE TAXATION OF GROSS INCOME

ROBERT C. BROWN†

Basic in the future of income taxation by the states is the question of the constitutional validity of a state tax upon gross income at progressive rates. For in the determination of that question lies the answer to the important query whether exemptions and deductions in the state acts⁴ are to be controlled by statutory grace or by constitutional limitation. The following discussion is an attempt to hazard an answer to this controlling question; major emphasis is placed upon the matter of deductions from gross income but necessarily intertwined with this is the problem of differentiating capital from income.

The principal problem which will arise in connection with state constitutional restrictions is the so-called “equality and uniformity” clause unfortunately common, though by no means universal, in state constitutions. Since the application of such a clause depends largely upon the kind of tax in question, it is necessary in the first place to determine the nature of the income tax. This has been, and still is, a very troublesome problem for the courts; and the conclusions reached are by no means consistent, even with the same court. At times an income tax is treated as essentially a personal tax;² more often apparently as an excise tax,³ especially where the taxpayer is a corporation.⁴ There has been a growing understanding of the fact that the income tax cannot well be put in any definite

† Professor of Law, University of Indiana.

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¹ The provisions now existing in state income taxes on exemptions and deductions are exhaustively outlined in Neuhoff, supra this issue, p. 185. [Ed.]

² Cook v. Tait, 265 U. S. 47 (1924).

³ Shaffer v. Carter, 252 U. S. 37 (1920); Hattiesburg Grocery Co. v. Robertson, 136 Miss. 34, 88 So. 4 (1921); State ex rel. Knox v. Gulf, etc. R. R., 138 Miss. 70, 104 So. 689 (1925). Cf. O'Connell v. State Board, 95 Mont. 91, 25 P. (2d) 114 (1934), where the court after approving the statement that an income tax is sui generis added that it is “in the nature of an excise tax”.

category, and that it is really *sui generis*. Thus the Indiana Appellate Court has held that an income tax is neither an excise nor a property tax but "an assessment against one's personal income", whatever that means.

Inasmuch as the equality and uniformity clauses of state constitutions are generally held to apply only to property taxes, the fundamental problem for consideration here is simply as to whether an income tax is a property tax. There is considerable authority so holding. Even the Federal Supreme Court originally so held, in deciding that a tax on income derived from property was essentially a tax on property and, therefore, a direct tax, required to be apportioned prior to the Sixteenth Amendment. The Court at times seems still to adhere to this view, although there are other decisions which it is impossible to reconcile with such a theory. A number of state courts have, however, maintained this position with more or less consistency. It is evident that these states cannot have an income tax at progressive rates, whether it be based upon net or gross income; such a tax would violate the uniformity and equality clauses of their state constitutions, which would certainly seem to prevent a graduated property tax. Such a state, if it desires an effective income tax, must follow the example of the Federal Government and amend its con-

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9 Cook v. Tait, 265 U. S. 47 (1924), holding that a United States citizen, resident and having all his property in Mexico, is subject to United States income tax; Lawrence v. State Tax Comm., 286 U. S. 276 (1932), holding that a state may tax a resident upon all his income, though derived from sources outside the state.


stitution so as expressly to provide for an income tax at graduated rates, as Massachusetts and some other states have done. Where the amendment takes the usual form, referring merely to "income taxes" or "taxes imposed upon incomes", there is some possibility that judicial interpretation will limit its scope to net income taxation, thus leaving taxes on gross income and on capital subject to property tax restrictions. But such an amendment clearly permits a net income tax at graduated rates; and the problem of the validity of a progressive gross income tax may well depend basically upon the interpretation of certain provisions of the Federal Constitution to be hereafter considered.

With the majority of states which have now reached the conclusion that an income tax is not a property tax, the equality and uniformity clauses are presumably not applicable. For such states there would therefore appear to be, so far as state constitutions are concerned, no obstacle to progressive taxation of income. But even here a distinction is sometimes made between a net income tax and a gross income tax. This is well brought out by Redfield v. Fisher where the Oregon court held a tax on the net income of

12 On the judicial definition of "income" as meaning net or gross, see the discussion of federal and state views infra this article, pp. 258-261. Cf. also State v. United States Express Co., 60 N. H. 219 (1880), discussed infra this article, p. 262; in view of the New Hampshire court's attitude in this case it is possible it would condemn a gross income tax at graduated rates even though the state constitution were so amended as clearly to permit net income taxation.

For the possibility that even after amendment taxation of "capital" would not be tolerated at progressive rates, see the discussion of Comm'r v. Simmon, 198 N. E. 741 (Mass. 1935), in Traynor, infra this issue, at p. 281 [Ed.]; also Norris v. Wisconsin Tax Comm., 205 Wis. 626, 237 N. W. 113, 238 N. W. 415 (1931); Rotschaefer, The Minnesota State Income Tax (1933) 18 Minn. L. Rev. 93, 124-125.

13 See cases cited in notes 3, 5 and 6, supra; also State ex rel. Moon Co. v. Wisconsin Tax Comm., 166 Wis. 569, 165 N. W. 639 (1917); Young v. Illinois Athletic Club, 310 Ill. 369 (1923); Standard Lumber Co. v. Pierce, 112 Ore. 314, 228 Pac. 812 (1924); Maxwell v. Kent-Coffey Mfg. Co., 204 N. C. 365, 168 S. E. 397 (1933).

14 But see State v. United States Express Co., 60 N. H. 219 (1880), discussed infra this article, p. 262, where a uniform gross receipts tax was invalidated because not "proportional" as required by the New Hampshire Constitution. It would seem on principle that the requirement of proportionality, like the equality and uniformity restriction, should apply only to property taxes. And of., also Sims v. Aherns, 167 Ark. 557, 271 S. W. 720 (1925), cited and quoted infra note 73.

15 135 Ore. 180, 292 Pac. 813 (1930).
corporations an excise tax, but a tax on the gross income of individuals a property tax both on the property from which the income was derived and on the income itself as property. The individual gross income tax was, therefore, held invalid as discriminatory with respect both to property and to corporations. Perhaps the court was thinking of the distinction more as one between a tax on corporations (which may always be regarded as an excise tax)\textsuperscript{18} and a tax on individuals; but the reasoning is at least partly based upon the distinction between a net and gross income tax. Certain it is that some courts seem to regard a net income tax as not necessarily a property tax and to regard a gross income tax as a tax upon the property from which the income is derived.\textsuperscript{17}

So far as a gross income tax is in fact an income tax, there does not seem to be much justification for this. Undoubtedly a gross income tax is a greater burden upon the taxpayer and upon his property than is a net income tax; but this is after all merely a matter of degree—a problem which will be more fully discussed hereafter. On the other hand, it is entirely clear that what is undoubtedly a property tax may masquerade as a gross income tax. This is so if the so-called gross income tax is in lieu of property taxes, the purpose being merely to compute the value of the property through the income which it earns. It would appear that even under the restrictions imposed by equality and uniformity clauses certain property may be taxed in this manner when it is believed that a computation on the basis of gross income will give a more accurate valuation than a valuation in the more usual manner.\textsuperscript{18} Furthermore, it has been held that a tax may be measured by gross income and still be a property tax.\textsuperscript{19}

Nevertheless, the situation with respect to equality and uniformity and similar provisions of state constitutions seems relatively clear. If an income tax is regarded as a property tax, such provisions prevent a graduated income tax, whether such tax be

\textsuperscript{18} See note 4, supra, and text to which it is appended.


\textsuperscript{19} Culliton v. Chase, 174 Wash. 363, 25 P. (2d) 81 (1933).
based upon net or gross income. If, on the other hand, an income tax is regarded as not a property tax, the equality and uniformity provisions of the state constitutions should have no bearing. The same would seem to be true if a state which regards the income tax as a property tax has amended its constitution so as to permit an income tax at progressive rates. In either case, a net income tax at progressive rates is justified by the state constitution; and it would seem, despite some scattered judicial language tending to the contrary, that a gross income tax at progressive rates should likewise be justifiable, so far as the state constitution is concerned. The main problem as to the validity of a state gross income tax at graduated rates in such jurisdictions, therefore, would seem to be its consistency with the provisions of the Federal Constitution. This problem must now be considered.

While the validity or invalidity of progressive gross income taxation by the states will turn primarily upon the interpretation of the Fourteenth Amendment, consideration must also be given to the effect of the Commerce Clause. Under the well settled doctrine that a state tax determined to impose an unreasonable burden upon interstate or foreign commerce will be held unconstitutional as violating this clause, there is now no doubt of the invalidity of a state tax upon gross income derived from foreign or interstate commerce, although a state gross income tax limited to income from intra-state commerce clearly is not an offender. The only exception to this rule of invalidity is in the situation where a gross income tax is laid in lieu of one upon the property of a carrier; in such case the impost is essentially a property tax. Even a tax upon gross earnings from interstate or foreign com-

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20 The provision of the Federal Constitution requiring uniformity of excise taxes need not be considered in this connection, since it relates only to federal taxes and has no bearing whatever upon state taxes. Even as to federal taxation its effect is to require merely geographical uniformity. Patton v. Brady, 184 U. S. 608 (1902); Bromley v. McCaughn, 280 U. S. 124 (1929).

21 See Brown, Restrictions on State Taxation Because of Interference with Federal Functions (1931) 14 Va. L. Rev. 325.


23 Ohio Tax Cases, 232 U. S. 576 (1914).

merce seems also to be unconstitutional. However, a tax upon gross earnings or gross sales which are not the direct product of interstate or foreign commerce is not necessarily unconstitutional merely because the taxpayer is engaged in such commerce.

Quite different is the rule with respect to a net income tax. It seems to be well settled that a state may validly impose a net income tax upon income derived directly from interstate or foreign commerce. The burden of such a tax upon the commerce is not considered sufficiently heavy to invalidate the tax. The reasoning by which this result is reached is well shown by the leading case of United States Glue Co. v. Oak Creek, as follows:

"The difference in effect between a tax measured by gross receipts and one measured by net income, recognized by our decisions, is manifest and substantial, and it affords a convenient and workable basis of distinction between a direct and immediate burden upon the business affected and a charge that is only indirect and incidental. A tax upon gross receipts affects each transaction in proportion to its magnitude and irrespective of whether it is profitable or otherwise. Conceivably it may be sufficient to make the difference between profit and loss, or to so diminish the profit as to impede or discourage the conduct of the commerce. A tax upon the net profits has not the same deterrent effect, since it does not arise at all unless a gain is shown over and above expenses and losses, and the tax cannot be heavy unless the profits are large."  

In the sense that unconstitutionality clearly depends upon the nature of the tax and not upon its rate, these commerce cases do not bear directly on the question of the validity of progressive gross income taxation. But if a state gross income tax at a uniform rate upon income from interstate or foreign commerce is unconstitutional as burdening that commerce, a gross income tax at progressive rates must also as clearly be unconstitutional; and this fact means that an additional constitutional pitfall lurks in the path of those states which do not hew to something like true net income in the administration of their progressive income tax laws. Furthermore, these Commerce Clause authorities are, by the same token, of aid in that difficult problem of defining the distinction.

28 United States Glue Co. v. Oak Creek, 247 U. S. 321, 328-329 (1918).
between a gross income and a net income tax; and some of them will be referred to again in that connection.

More significant certainly to the controlling question of the constitutional validity of state gross income taxation at graduated rates is the Fourteenth Amendment. Despite an absurd, and now thoroughly repudiated, idea of Mr. Chief Justice White that the corresponding provision of the Fifth Amendment of the Constitution did not restrict the federal taxing power, there seems never to have been any doubt that the due process clause of the Fourteenth Amendment restricts the state taxing power. Thus it requires that state income taxes be properly apportioned as to taxpayers doing business in other states than the one imposing the tax; and it also prohibits, or at least rigidly restricts, multiple taxation by different states of the same economic interest. It may be added that the question whether the due process clause prohibits multiple income taxation is, as yet, not definitely settled; but there is no doubt that such taxation cannot be sustained unless it is considered to constitute due process of law. Nevertheless, it is clear that the limitation of due process in taxation is primarily one affecting taxation by more than one jurisdiction. Progressive and even retroactive excise and income taxation have been sustained under the due process clauses, though undoubtedly there must be some limit to this. Clearly the problem of the validity of a progressive state tax on gross income is primarily one of the meaning of the equal protection clause.

While the equal protection clause is undoubtedly a limitation upon the state taxing power, it has never been regarded as requiring

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31 See Brown, Multiple Taxation by the States—What is Left of it (1935) 48 Harv. L. Rev. 407.
32 It has been held that a state may tax a resident upon all his income from whatever source derived. Lawrence v. State Tax Comm., 286 U. S. 276 (1932). However, there is still some doubt whether this tax base can include income from outside realty. See the discussion in Rottschaefer, infra this issue, at pp. 303 et seq., and Traynor, infra this issue, at p. 272.
34 Cohan v. Comm'r, 39 F. (2d) 540 (C. C. A. 2d, 1930); Appeal of Van Dyke, 217 Wis. 528, 259 N. W. 700 (1935).
absolute uniformity; in other words, it is not a reenactment of the equality and uniformity provisions of state constitutions. The Federal Supreme Court has used the following emphatic and often quoted language with respect to this matter:

"The provision in the Fourteenth Amendment, that no State shall deny to any person within its jurisdiction the equal protection of the laws, was not intended to prevent a State from adjusting its system of taxation in all proper and reasonable ways. It may, if it chooses, exempt certain classes of property from any taxation at all, such as churches, libraries and the property of charitable institutions. It may impose different specific taxes upon different trades and professions, and may vary the rates of excise upon various products; it may tax real estate and personal property in a different manner; it may tax visible property only, and not tax securities for payment of money; it may allow deductions for indebtedness or not allow them. All such regulations, and those of like character, so long as they proceed within reasonable limits and general usage, are within the discretion of the state legislature, or the people of the State in framing their Constitution. But clear and hostile discriminations against particular persons and classes, especially such as are of an unusual character, unknown to the practice of our government, might be obnoxious to the constitutional prohibition. It would, however, be impracticable and unwise to attempt to lay down any general rule or definition on the subject, that would include all cases. They must be decided as they arise. We think that we are safe in saying, that the Fourteenth Amendment was not intended to compel the State to adopt an iron rule of equal taxation. If that were its proper construction, it would not only supersede all those constitutional provisions and laws of some of the States, whose object is to secure equality of taxation, and which are usually accompanied with qualifications deemed material; but it would render nugatory those discriminations which the best interests of society require; which are necessary for the discouragement of intemperance and vice; and which every State, in one form or another, deems it expedient to adopt."

Accordingly a progressive state tax on gross income is not a denial of the equal protection clause of the Federal Constitution unless the Supreme Court considers that the progressive feature is so seriously discriminatory as to be unjustifiable. It is, therefore, necessary to determine, as precisely as possible, the difference

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between a net income tax and a gross income tax. It will soon appear that this distinction is by no means easy to draw either on principle or authority.

Preliminary to essaying this task it is necessary to distinguish between income taxes, whether gross or net, and other types of taxes. Courts have seemed to draw a distinction between an income tax and a tax which is not an income tax at all but merely “measured by” income. But unless the tax can be regarded as a property tax, the distinction seems wholly unrealistic. The New York Court of Appeals has held that a so-called “franchise” tax on corporations based on net income is in effect an income tax subject to the rules applicable to such a tax; and it is submitted that this is entirely sound. The distinction between a tax “upon” and one “measured by” income seems to be purely verbal.

Even the distinction between a true income tax and a tax on property measured by income is difficult to draw. The Federal Supreme Court has said:

“Since the commercial value of property consists in the expectation of income from it, and since taxes ultimately, at least in the long run, come out of income, obviously taxes called taxes on property and those called taxes on income or receipts tend to run into each other somewhat as fair value and anticipated profits run into each other in the law of damages.”

This tendency was especially apparent in the recent case of Senior v. Braden where a state tax on transferable certificates representing beneficial interests in land situated partly outside the state but measured by income from such land was held to be a property tax and so not sustainable even when the certificates were held by a resident of the taxing state. Certainly the distinction between an income and a property tax is not very evident in this situation. It would seem that the only realistic solution is to say that a tax measured by income, even from property, is still an income tax except where it is in lieu of an ordinary tax upon the property. If this is true, Senior v. Braden was wrongly decided, unless the

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36 Flint v. Stone Tracy Co., 220 U. S. 107 (1911), is the leading case.
37 Galveston, etc. Ry. v. Texas, 210 U. S. 217 (1908).
40 295 U. S. 422 (1935).
court is going to restrict multiple income taxation in a similar manner to that already effected with regard to property and inheritance taxation. At any rate, it does not seem necessary to distinguish for any practical purpose between a tax "upon" and a tax "measured by" gross income.

Another problem as to the distinction between income and other sorts of taxes is raised by the so-called "occupation taxes". In several cases, taxes measured by gross income have been regarded as occupation taxes. However, the chief point of all this is that such a tax is an excise rather than a property tax. Since excise taxes may be imposed at a graduated rate, it seems immaterial, so far as the present question is concerned, whether the gross income tax is regarded as a true income tax or as an excise tax. If, however, an occupation tax is not dependent strictly upon income, but the classification is made upon another basis, it is not an income tax at all.

Another denomination of taxes which appear in the statute books and the cases is the so-called "gross receipts tax", at times called an occupation tax and at other times not separately classified. The real problem is whether there is any distinction other than verbal between a gross receipts tax and a gross income tax. The Texas Court of Civil Appeals apparently thinks there is, for it has said with reference to a gross receipts tax on railways imposed in that state, "If the Legislature had intended this as merely an income tax it would have imposed a tax upon incomes from all sources, and not merely the receipts." This statement does not seem very lucid. If the court means that an income tax must cover all income, then there never has been an income tax; for all net

41 See notes 31 and 32, supra, including references to discussions on this to be found elsewhere in this issue.
42 Glasgow v. Bowse, 43 Mo. 479 (1869); Wright v. Southern Bell, etc. Co., 127 Ga. 237, 56 S. E. 118 (1906). Cf. Sims v. Ahrens, 167 Ark. 557, 271 S. W. 720 (1925), holding that a gross income tax is both an occupation and an income tax.
43 Atlanta, etc. Ass'n v. Stewart, 109 Ga. 80, 35 S. E. 73 (1900).
45 Lincoln Traction Co. v. Lincoln, 84 Neb. 327, 121 N. W. 435 (1909). And see cases cited in notes 42 and 43, supra.
income tax statutes, both federal and state, carry some exemptions and not infrequently gross income taxes are imposed only upon certain classes of gross income. If, however, the court is making a distinction between gross income and receipts, it does not specify exactly what the difference is.

It is submitted that there is really no distinction between gross income and gross receipts, or rather that these phrases mean the same thing. The Illinois Supreme Court so held in State v. Illinois Central Railroad Co., where it laid down the proposition that gross income, receipts or earnings, all these terms being used somewhat indiscriminately in the charter of the railroad, mean exactly the same thing. As will presently appear, the court does not seem to be correct in its statement that gross receipts and gross earnings are identical; otherwise, however, its position seems realistic and sensible. No deductions for business expenses or cost of goods sold are allowable in computing gross receipts, but the same is true of gross income. A further authority to the same effect is Miles v. Department of Treasury, where the Indiana Supreme Court in upholding the gross income tax of that state declared that the term "gross income" "is understood by lexicographers, and in common usage, to mean total receipts". It is submitted, therefore, that no distinction between gross income taxes and gross receipts taxes is necessary or proper; both are gross income taxes for present purposes.

Another important classification of taxes of this general nature is the sales tax. Such exactions are certainly not regarded as identical with gross income taxes, and the Supreme Court of Virginia is, therefore, representing the popular opinion when it holds that a tax on the sale of oysters is not an income tax. The

48 For discussion see Neuhoef, supra this issue, p. 185. [Ed.]
49 See Mutual Reserve, etc. Ass'n v. Augusta, 109 Ga. 73, 36 S. E. 71 (1900); Rhinehart v. State, 121 Tenn. 420, 117 S. W. 508 (1908).
50 246 Ill. 188, 92 N. E. 814 (1910). See also, Crew Levick Co. v. Pennsylvania 245 U. S. 292 (1917); State v. Welsh, 61 S. D. 593, 251 N. W. 189 (1933). In Meyer v. Wells, Fargo & Co., 223 U. S. 298 (1912), a state "gross revenue" tax was treated by the United States Supreme Court as a gross receipts tax.
51 Sandusky Gas, etc. Co. v. State, 114 Ohio St. 479, 151 N. E. 685 (1926).
54 Commonwealth v. Brown, 91 Va. 762, 21 S. E. 357 (1895). The power to levy income taxes was limited by the state constitution.
court merely said, "The tax is assessed on sales and not on income." If, when one speaks of income taxes he is thinking of net income taxes, the distinction is, of course, very clear. But the only difference between a gross income tax and a sales tax is that the gross income tax covers substantially all gross receipts, including wages, salaries, and receipts from the sale of capital assets, while the sales tax usually covers only receipts from sales by retailers in the ordinary course of business. Accordingly, it seems that a sales tax, based upon the total receipts from sales covered by it and without deductions, is essentially a gross income tax—restricted, to be sure, to one form of gross income, but a gross income tax for all that. This problem will be further considered in connection with cases on progressive sales taxation but it is submitted that here too we have a distinction without more than a verbal difference.

Quite different is the situation with respect to taxes on gross earnings or profits. These may very probably be regarded as income taxes; but they are certainly dissimilar from gross income taxes. The difference is that a gross earnings tax permits the deduction from the gross income of the direct cost of goods sold or of the services rendered, though it differs from a net income tax in not permitting the deduction of general overhead expenses and losses on the sale of capital assets. As already seen, a gross profits tax upon income from interstate commerce is probably unconstitutional; yet the fact remains that the burden of such a tax is substantially less than a tax on gross income or receipts. A progressive tax on gross earnings may therefore be constitutional even if such a tax on gross income is not.

One other form of taxation must be considered in this connection. This is the so-called gross production tax, frequently imposed upon mining and similar enterprises. The tax is based upon the

55 See Waring v. Savannah, 60 Ga. 93 (1878).
56 People ex rel. Brooklyn Union Gas Co. v. Morgan, 114 App. Div. 266, 99 N.Y. Supp. 711 (1906), holding that a gas company may deduct for the purpose of computing its "gross earnings" subject to tax, the cost of coal used as a material in making gas, but not the cost of coal used as a fuel for running the plant. See also State v. Wells Fargo & Co., 146 Minn. 444, 179 N.W. 221 (1920).
58 State v. Wells, Fargo & Co., 146 Minn. 444, 179 N.W. 221 (1920), cited supra note 25.
59 Foster v. Hart, etc. Mining Co., 52 Colo. 459, 122 Pac. 48 (1912).
amount of minerals or other similar products actually extracted, without regard to the value, the cost of production, or the selling price. Such a tax is obviously neither a gross nor a net income tax.

But if the distinction between income and other taxes is troublesome, the problem of differentiating a net income tax from a gross income tax is far more so. The average person undoubtedly regards the distinction as rather obvious, and also thinks that an "income tax" means a net income tax. Indeed, this common view of the term "income tax" has been used by the courts in problems of interpretation of tax law; and also, as already noted, in determining the validity of a state tax upon interstate or foreign commerce.

From this it might be thought to follow that the Federal Government is given by the Sixteenth Amendment only the power to impose a net income tax and that it therefore has no authority to impose a gross income tax. This is, however, by no means certain. Indeed, the Supreme Court has rather clearly intimated the contrary. Thus it has said that

"The power to tax income . . . is plain and extends to the gross income. Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed." 64

Probably justified, then, is the conclusion of the Circuit Court of Appeals for the Seventh Circuit that "Under the Sixteenth Amendment all income, whether net or gross, may be taxed by Congress, and the deductions allowed from gross income are given as a matter of grace." 65

While the federal situation is of no direct interest with respect

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60 However, an allowance for waste is sometimes given. Stanolind, etc. Co. v. Cornish, 16 F. Supp. 464 (W. D. Okla. 1935).
61 Burnet v. John F. Campbell Co., 50 F. (2d) 487 (App. D. C. 1931). See also Tax Comm'r v. Putnam, 227 Mass. 522, 526, 116 N. E. 904, 907 (1917), where the court said: "In its ordinary and popular meaning, 'income' is the amount of actual wealth which comes to a person during a given period of time."
62 United States Glue Co. v. Oak Creek, 247 U. S. 321 (1918), cited supra note 27.
63 See Note, Taxability of Gross Income under the Sixteenth Amendment (1936) 36 Col. L. Rev. 274.
65 Avery v. Comm'r, 84 F. (2d) 905, 907 (C. C. A. 7th, 1936).
to state taxation, it does have a rather direct bearing upon the distinction between gross and net income taxes. The Supreme Court has recognized that the definition of "gross income" is rather difficult; but the proper definition of "net income" is even less clear. To date, the Federal Government has not purported to impose anything save a net income tax; yet in fact federal taxes have been imposed which go a long way toward constituting taxes on gross income or even on capital. For example, the original Corporation Excise Tax of 1909, which was essentially a net income tax, declined to permit the deduction by mining corporations of the depletion of their ore lands. This provision was upheld by the Supreme Court in *Von Baumbach v. Sargent Land Co.*, where the Court conceded that the denial of such an allowance was somewhat inequitable but nevertheless held it to be within the power of Congress. It is clear that such a tax is partly a gross income tax and indeed a rather direct burden upon the capital of the corporation.

While this particular deduction has been allowed by subsequent federal income tax laws, there have frequently been provisions limiting or disallowing deductions which would probably have to be given in order to have a tax strictly upon net income according to the economic conception. Indeed, the present law somewhat rigidly limits deductions for losses on the sale of capital assets; and to the extent, at least, that profits on such sales constitute taxable income, the disallowance creates a rather distinct burden upon capital and consequently constitutes in part a gross income tax. It seems to follow from this either that the federal income tax is in part based upon gross income, as the Supreme Court indicates it can be, or else that the alleged distinction between gross income and net income has no real practical significance.

Some state courts have shown a similar inability to distinguish sharply between net and gross income taxes. Yet the distinction

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**Footnotes:**

66 Save as it provides authoritative precedent on the interpretation of state constitutional amendments permitting graduated taxation of "income". See discussion *supra* this article, at p. 248.
69 242 U. S. 503 (1917).
71 See, *e. g.*, *Waring v. Savannah*, 60 Ga. 93 (1878).
which the federal courts have made with respect to interstate and foreign commerce is reflected by some of the state decisions. This distinction seems to be whether the law permits the deduction of the cost of goods sold or similar direct costs of the business. If such a deduction is allowed, the tax is usually treated as one on net income, even though the ordinary overhead expenses are not permitted to be deducted.\textsuperscript{72} If such deduction is not allowed, it is treated as a gross income tax. The Supreme Court of Arkansas has said:

"The rule of uniformity does not require that all subjects be taxed, nor taxed alike. The requirement is complied with, when the tax is levied equally and uniformly on all subjects of the same class and kind. In doing this, some incomes might be exempted and those taxed may be classified. It is absolutely essential to uniformity that the net income only should be taxed. In business enterprises the profits are variable, and do not bear any fixed relation to the amount of capital invested. For the reason that the relation between the amount of capital and of profits varies widely, a tax on gross profits would necessarily operate in a discriminatory manner and be arbitrary.\textsuperscript{73}

In somewhat similar vein, the Supreme Court of South Dakota has declared, in passing upon a statute of that state imposing a tax upon "gross receipts", that

"While considering the law in its economic phases it is perhaps well to note that, notwithstanding the appearance of the word 'income' in the title of this act and at various places throughout the corpus of the act, it is not in any sense whatsoever an 'income tax law' as the economist customarily employs that phrase. For the economist, as well as for the lawyer, the phrase 'income tax law' signifies the type of act that is sometimes more definitely called a 'net income tax law', wherein the measure of the tax (and possibly both the subject and the measure) is the net gain or profit of the taxpayer over a given interval of time. The true measure of the present tax is not income at all in any proper sense of the word, but gross receipts, a very different and much broader significance which this act itself undertakes, by definition in section 1 (g), to impose upon the phrase 'gross income'. It is extremely unfortunate that the word 'income' should find a place in either the title or the body of a law of this type, for it is entirely misleading (even if unintentionally so) and can only tend to confusion


of thought. Henceforth, in this discussion we shall use the phrase 'income tax' as signifying a net income tax, and to designate the measure of the tax attempted to be set up in the present law we shall employ the term 'gross receipts'.

It is submitted that not all of this rather typical language is entirely sound. Granting that "income" normally means net income, yet, after all, this is merely a matter of terminology which can be of no consequence if the legislature has otherwise made its meaning plain. And to assert that an income tax law, which permits the deduction of only the direct expenses of the business, necessarily insures that no tax will be due unless a profit is realized is not necessarily correct; the overhead charges and other non-deductible expenses may wipe out the profit otherwise realized and which is yet taxable. Nevertheless, there does appear to be a substantial distinction between the income tax statute which permits such a deduction of direct costs of goods sold or similar expenses and one which does not. Conceding that even in the former case a tax may be due without a profit, yet this will be unusual, and normally there is no tax without a profit. Accordingly it seems realistic to treat as a net income tax law any income tax statute allowing deduction of the cost of goods sold or similar direct expenses, even though it restricts or absolutely prohibits the deduction of overhead and other indirect expenses and of all losses on the sales of capital assets. In other words, even a gross profits tax is to be treated for this purpose as a net income tax.

Net income taxes have frequently been imposed at graduated rates, and it is entirely settled that such a tax is constitutional, at least if any income tax is. South Carolina's sustainment of a gross profits tax at graduated rates is in accord, for the tax in question, in providing that gross profits were to be computed by deducting from gross income, business expenses but nothing else, was strictly a net income tax under the distinctions above drawn.

74 State v. Welsh, 61 S. D. 593, 614, 251 N. W. 189, 198 (1933).
75 State v. Frear, 148 Wis. 456, 134 N. W. 673 (1912); State v. Johnson, 170 Wis. 218, 175 N. W. 589 (1919); Standard Lumber Co. v. Pierce, 112 Ore. 314, 228 Pac. 812 (1924); Stanley v. Gates, 179 Ark. 886, 19 S. W. (2d) 1000 (1929); Featherstone v. Norman, 170 Ga. 370, 153 S. E. 58 (1930); Bacon v. Ranson, 331 Mo. 985, 56 S. W. (2d) 786 (1932). On the favorable attitude of the Federal Supreme Court see Shaffer v. Carter, 252 U. S. 37 (1920); Note (1934) 18 Minn. L. Rev. 582, 585.
In *State v. United States Express Co.*,,77 on the other hand, the New Hampshire Supreme Court upset even a uniform two per cent tax upon the gross receipts of express companies; the reason assigned was that such a tax was not "proportional" as prescribed by the state constitution. The court said:

"Gross receipts of one company may be small and net profits large; while of another, gross receipts may be large and profits small . . ., or there may be none at all. It [the statute] makes no allowance for skill, experience, business tact, or enterprise of the owners or managers . . . It is a tax which one class of men are required to pay and from which all others are exempt."78

An attempt is thus made to draw a sharp, though not entirely accurate, distinction between gross and net income taxes. It is to be noted, however, that in the court's view a net income tax, at uniform and even more clearly at graduated rates, would likewise not be "proportional". The decision, therefore, in assuming to condemn a gross income tax, appears to condemn all income taxes and regardless of the graduation of rates. Generally, however, taxes upon gross income as here defined have been successfully imposed at a uniform rate.79 We come then to the direct question in issue. Assuming a gross income tax as previously defined, which will be sustained if at a uniform rate, can it be imposed at graduated rates without violation of the Federal Constitution?

Assuming that a gross income tax is an excise tax, the problem arises as to whether excise taxes can be imposed at graduated rates. The answer would appear to be in the affirmative. It is possible to impose at graduated rates not only inheritance taxes80 but also other varieties of excise taxes81 exacted directly of business. The most conspicuous recent example of this is the chain store tax where steeply graduated rates, obviously often intended to drive chain stores out of business, have nevertheless been generally

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77 60 N. H. 219 (1880).
78 Id. at 244-245.
79 Though not infrequently gross income of different classes is taxed at different rates. See Glasgow v. Rowse, 43 Mo. 479 (1869); Miles v. Department of Treasury, 199 N. E. 372 (Ind. 1935), dism'd, 56 S. Ct. 750 (1936).
80 Magoun v. Illinois Trust & Savings Bank, 170 U. S. 283 (1898); Keeney v. New York, 222 U. S. 232 (1890); see also Clark v. Titusville, 184 U. S. 329 (1902), which will be considered hereafter.
If the gross income tax is to be treated as an excise tax, these cases would seem certainly to justify reasonably graduated rates. And if the gross income tax is not an excise tax, it is *sui generis*, but certainly not subject to more stringent restrictions.

The authority already referred to, that a tax on gross profits may be levied at a graduated rate without violating the equal protection clause or any other part of the Federal Constitution, is only a state court decision, but seems, nevertheless, to be sound. Yet because a tax on gross profits may be regarded for this purpose as a tax on net income, since it normally, though perhaps not invariably, falls within the usual judicial requirement that it be not payable unless a profit is derived from the business, this case is not a square authority that a gross income tax can be imposed at graduated rates. *American Sugar Refining Co. v. Louisiana* is a Federal Supreme Court decision to the effect that a state gross income tax imposed upon sugar refiners is valid though it exempted from the tax those who refine only cane grown by themselves. Here too there was not involved a gross income tax at graduated rates; but the decision is a federal authority that certain distinctions may validly be made in the imposition of such a tax, apart from the amount of the gross income itself.

More squarely in point is *Clark v. Titusville*, where the Court upheld a municipal license tax on merchants at rates graduated according to the amount of gross sales. The opinion is not very helpful as it relies without much discussion upon cases sustaining a graduated inheritance tax. Nevertheless, this seems to be a definite authority since, as already shown, a tax on gross sales is in fact a gross income tax, differing from the conventional form of gross income tax only in that the basis of the tax is restricted to gross income from retail sales. The decision in the *Clark* case,

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83 Mills v. State Board, 97 Mont. 13, 33 P. (2d) 563 (1934), would limit the rates of a net income tax to what is reasonable.
85 179 U. S. 89 (1900).
86 184 U. S. 329 (1902).
therefore, seems a direct precedent for the rule that a state may impose a gross income tax at reasonably graduated rates.\textsuperscript{88}

This idea appears, however, to have received its death blow in the recent decision of \textit{Stewart Dry Goods Co. v. Lewis}.\textsuperscript{89} Here, the problem was as to the constitutionality of a state of Kentucky tax measured by gross sales. The rate varied from $\frac{1}{20}$ of 1\% on gross sales of $400,000$ or less, up to 1\% on gross sales of over $1,000,000$. While this is a considerable graduation, yet it will be noticed that it would never be possible for a taxpayer to pay as much as 1\% on his total gross, since sales up to that amount were taxable at lower rates.

The majority of the court, speaking by Mr. Justice Roberts, held the statute unconstitutional as violating the equal protection clause of the Federal Constitution; in this Mr. Justice Cardozo dissented in an able opinion with which Justices Brandeis and Stone concurred. The opinion of Mr. Justice Roberts is not particularly lucid or satisfactory. Primarily, he seems to be disturbed by the possibility of a taxpayer being compelled to pay a tax on gross sales when the business was actually conducted at a loss.\textsuperscript{90} For example, he says:

"We are told that the gross sales tax in question is in truth a rough and ready method of taxing gains under the guise of taxing sales; that it is less complicated and more convenient of administration than an income tax; and Kentucky for these reasons is at liberty to choose this form, and to ignore the consequent inequalities of burden in the interest of ease of administration. The argument is in essence that it is difficult to be just and easy to be arbitrary. If the commonwealth desires to tax incomes, it must take the trouble equitably to distribute the burden of the impost. Gross inequalities may not be ignored for the sake of ease of collection."\textsuperscript{91}

Undoubtedly this argument is not without force; but it is subject to at least two objections. In the first place, as has already been shown, the ordinary net income (including the one imposed by the Federal Government itself) does not permit all deductions which are probably necessary to make it strictly a net income tax; consequently it conceivably, though, it must be admitted, quite improbably, makes possible the imposition of a tax in the absence of

\textsuperscript{89} 294 U. S. 550 (1935).
\textsuperscript{90} Cf. quotations cited in notes 28 and 78, supra.
net profits, and therefore one which is substantially on capital. Furthermore, statistics presented in this very case showed that net profits followed gross income with a rather high degree of accuracy. The correspondence is, of course, not exact; but neither is the correspondence between actual profits and the statutory net income as defined in practically any so-called net income tax statute.\(^2\) It would seem, therefore, that on principle, the case reaches the wrong result, unless indeed the graduation of rates is regarded as too steep—a matter which is not even mentioned by the Court.

Perhaps more illuminating than this is the effort of the court to distinguish *Clark v. Titusville*.\(^3\) An entire page in the official report\(^4\) is given to the attempt to make this distinction; but it does not seem to be very successful. Apparently the only difference the Court can find is that in the ordinance approved in the *Clark* case the graduation was expressed in dollars, whereas the Kentucky statute invalidated in the *Stewart* case computed the graduated rates of taxes on a percentage basis. That is to say, the Titusville ordinance imposed a tax at (say) 5c on a hundred dollars, whereas the Kentucky statute imposed the tax at \(\frac{1}{20}\) of one per cent. If this is more than a verbal distinction, it certainly escapes the notice of anyone except possibly the members of the Court. It is submitted that *Clark v. Titusville* is not distinguished; it is really overruled.\(^5\)

The question remains whether the *Stewart* case is applicable to gross income taxes. In one place Mr. Justice Roberts talks as if it is not. He says:

"As we have said, the statute does not purport to levy a tax on incomes. Plainly it does not in fact do so. A merchant having a gross business of $1,000,000, but a net loss, must pay a greater tax than one who has a gross business of $400,000 and realizes a substantial net profit."\(^6\)

Plainly, however, the Justice has in mind the distinction between gross income and net income taxes, using "income" to refer to the

\(^2\) See the discussion by Mr. Justice Cardozo dissenting, id. at 570-571.

\(^3\) 184 U. S. 329 (1902), cited supra note 86.


\(^5\) The effect on *Clark v. Titusville* and other results of the *Stewart Dry Goods* decision are considered in Note, *Classification for Taxation—Stewart Dry Goods Co. v. Lewis* (1935) 21 Iowa L. Rev. 93. [Ed.]

latter. This is shown by the fact that later in his opinion he cites a number of state sales tax laws at uniform rates as "a practical confirmation of the view that they are effective measures". In this list is included at least one state general gross income tax, which is evidently regarded as a sales tax so far as it covers gross income from retail sales. It is believed that this constitutes an admission by the Court that the principle which it lays down invalidating a gross sales tax at graduated rates is logically and practically applicable to any gross income tax. Accordingly the Stewart case must be regarded as an authority that a state may not levy a gross income tax at graduated rates, on the ground that this violates the equal protection clause of the Federal Constitution.

The doctrine of the Stewart case was confirmed by the still more recent decision of Valentine v. Great Atlantic and Pacific Tea Co., where the Court in a per curiam decision affirmed a decree of a district court in Iowa invalidating in part a tax statute of that state. The precise nature of the Iowa tax can be ascertained from the full report of the case in the lower court. The Iowa statute is especially interesting because imposing two sorts of taxes, somewhat independent but to a large extent having a similar scope. The first one of these was a graduated tax upon chain stores. This tax was sustained. There was also levied a graduated tax "based on the combined gross receipts of each person on all of said business, of each and all stores within this state". The graduation ran up to 10 per cent but only on gross receipts over $9,000, so that no litigating taxpayer was able to show a tax liability over 5 per cent of his gross receipts. It may be noted that the graduation of rates was expressed on the basis of actual amount of tax rather than on a percentage basis; this seems to do away with the distinction made

97 Id. at 563.


99 57 S. Ct. 56 (1936).

100 The Court's only comment was that "The decree is affirmed upon the authority of Stewart Dry Goods Co. v. Lewis."


102 Upon the authority of State Board of Tax Comm'rs v. Jackson, 283 U. S. 527 (1931), cited supra note 82, and cases following it.
in the *Stewart* case as to *Clark v. Titusville*, and further to demonstrate that that case has been overruled.

Since this Iowa gross receipts tax was confined to receipts from stores, it, like the Kentucky statute, constitutes only a gross sales tax; but this in itself gives further evidence that neither legislatures nor courts have found any very definite distinction between gross sales taxes, gross receipts taxes, and gross income taxes. It was this sales tax which, because of its graduated character, was held unconstitutional by the federal district court, whose decision was affirmed by the Supreme Court. Thus the case demonstrates the present position of the Supreme Court to be that a state tax based upon gross income cannot constitutionally be imposed at progressive rates, no matter how conservative the schedule of graduation. But while this appears to be the law, the attitude of the Court seems unreasonable and unsound; for on principle it is difficult to see wherein a gross income tax at reasonably graduated rates violates the equal protection concept of the Federal Constitution.