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Hobby Losses Section of the Internal Revenue Code--An Unconstitutional Income Tax Statute

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THE "HOBBY LOSSES" SECTION OF THE INTERNAL REVENUE CODE — AN UNCONSTITUTIONAL INCOME TAX STATUTE?

You tax me for a wizard—you may as well tax me for a buzzard: I have done no harm.

— A defendant. Salem, 1692.

At a time when Congress and the Treasury are comprehensively reviewing the Internal Revenue Code with a view to providing a more rational tax system, it is to be hoped that Section 130 [1] — the so-called "hobby losses" section of the Code — will be scrapped.[2] For the additional tax imposed by Section 130 is a foolish tax — so foolish, indeed, as to raise a serious question as to its constitutionality.

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1 58 STAT. 48, 26 U.S.C. § 130 (1944) (INT. REV. CODE § 130): "(a) Recomputation of Net Income. — If the deductions (other than taxes and interest) allowable to an individual (except for the provisions of this section) and attributable to a trade or business carried on by him for five consecutive taxable years have, in each of such years, exceeded by more than $50,000 the gross income derived from such trade or business, the net income of such individual for each of such years shall be recomputed. For the purpose of such recomputation in the case of any such taxable year, such deductions shall be allowed only to the extent of $50,000 plus the gross income attributable to such trade or business, except that the net operating loss deduction, to the extent attributable to such trade or business, shall not be allowed."

See also U.S. Treas. Reg. 118, § 39.130-1 (a) (2) (1953): "If an individual carries on several trades or businesses, the deductions attributable to such trades or businesses, and the gross income derived from such trades or businesses, shall not be aggregated in determining whether the deductions (other than those for interest and taxes) exceed the gross income derived from such trades or businesses by more than $50,000 in any taxable year. Each trade or business shall be considered separately. The trade or business carried on by the individual must be the same in each of the five consecutive taxable years in which the deductions (other than those for interest and taxes) exceed the gross income derived from such trade or business by more than $50,000."

2 The Joint Congressional Committee on Internal Revenue Taxation, which overhauled many sections of the Internal Revenue Code, does not recommend outright repeal of § 130. Rather, the Committee has recommended that for purposes of § 130 the following deductions (in addition to those for interest and taxes) will not be taken into account: casualty losses, farming losses and expenses which are directly attributable to drought, and expenditures with respect to which the taxpayer is given an option either to deduct as expenses when incurred or to defer or capitalize. H.R. 8300, 83d Cong., 2d Sess. § 270 (1954). See H.R. REP. No. 1337, 83d Cong., 2d Sess. (1954).

Section 130 limits the extent to which wealthy taxpayers can take deductions against other income for business enterprises which they operate either as individuals or as partners.[3] It provides that where, for five consecutive years, an individual's allowable deductions (exclusive of interest and taxes) in respect of a trade or business are more than $50,000 in excess of the business' gross income, then the taxpayer's income tax for the five years must be recomputed by reducing to $50,000 for each year the amount whereby these deductions have exceeded gross income. In the recomputation, no net operating loss deduction is allowed.

At the time of its enactment in 1944, Section 130 was popularily known as "the Marshall Field bill":[4] It was believed that Mr. Field was operating his liberal newspapers *PM* and the Chicago *Sun* as a sole proprietorship, and that, since they were both thought to be losing money at that time, the Government was, in a sense, "financing" these publications in part out of taxes that Mr. Field otherwise would presumably have had to pay. Senator Clark of Missouri, a member of the Senate Finance Committee, stated, in effect, that it was only on the basis that the proposed amendment would have some adverse effect on Mr. Field's publishing operations that the amendment was carried in the Committee.[5]

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[3] Rev. Rul. 155, 1953 INT. REV. BULL. No. 17 at 6 (1953): ". . . it is held that Section 130 is applicable to a trade or business carried on in the form of a partnership by individuals. However, as Section 130 is applicable only if an individual's loss from a trade or business carried on by him is in excess of $50,000, it is further held that such section should be applied to a business of an individual operated in partnership form only where the individual partner's distributive share of a partnership loss is in excess of $50,000, exclusive of interest and taxes."

See also Rev. Rul. 221, 1953 INT. REV. BULL. No. 21 at 13 (1953), which holds: ". . . that where a particular business of an individual is conducted in one or more forms such as a partnership, joint venture, or individual proprietorship, the individual's share of the profits and losses from each business unit must be aggregated to determine the applicability of Section 130 of the Code."

[4] "Senate puts 'Field Amendment' in Tax Bill, Cutting Loss-Taking." N.Y. Times, Jan. 16, 1944, § 1, p. 1, col. 2. See also 90 CONG. REC. 226 (1944).

[5] 90 CONG. REC. 223-24 (1944). The bill passed the Senate by a vote of 37 to 26, with 27 Republicans in the majority, and two voting against. The same bill (but with a $10,000 annual limit) had been defeated in the Senate Finance Committee by

Senator Danaher (R. Conn.), sponsor of the bill, disavowed any purpose to reach Mr. Field specifically, but, rather, put his argument on the grounds that the bill was designed to prevent wealthy taxpayers from indulging their hobbies "at the expense of other taxpayers." He referred to decisions[6] in which the courts had found that activities of the rich in such enterprises as horse racing, farming, and polo pony breeding constituted trades or businesses, thereby entitling the taxpayers to deduct business expenses and other business deductions against other income. Senator Danaher was frank to say that his bill was intended to set up a presumption (necessarily conclusive) that persons whose annual operating losses from a particular trade or business exceeded $50,000 for five successive years were indulging a hobby.

Senator Barkley (D. Ky.) led the attack on the bill. He and his supporters appear to have been principally concerned over the effect that the proposed law would have on breeders of thoroughbred cattle and horses. Their argument was that the improvement of the breed normally involves substantial continuing expenditures over a period of years before the strain produces.[7] In many cases, evidently, breeding is undertaken as an individual operation by persons financially able to nurse the venture through its first unprofitable years; these persons have to rely upon other sources of income to cover expenses of their breeding operations. These enterprises are

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one vote in 1942. 88 CONG. REC. 8034 (1942). Senator Danaher had thereupon introduced it from the floor, where it passed the Senate, only to be discarded in conference. H.R. REP. No. 2586, 77th Cong., 2d Sess. 57 (1942).

[6] Senator Danaher mentioned by name George D. Widener, 8 B.T.A. 651 (1927), *aff'd*, 33 F.2d 833 (3d Cir. 1929) (racing stable); and Plant v. Walsh, 280 Fed. 722 (D. Conn. 1922) (farm). 90 CONG. REC. 224, 226 (1944). He also mentioned an unreported 1932 case involving Marshall Field's racing stables, which covered years subsequent to those in issue in Commissioner v. Field, 67 F.2d 876 (2d Cir. 1933), where the business nature of Mr. Field's racing stables was upheld. In introducing the same bill in 1942, Senator Danaher also cited Whitney v. Commissioner, 73 F.2d 589 (3d Cir. 1934) (racing stable); and Farish v. Commissioner, 103 F.2d 63 (5th Cir. 1939) (racing stable and polo pony breeding). 88 CONG. REC. 8035 (1942).

[7] *Cf.* James M. McDonald, 17 T.C. 210, 212 (1951), where the court found that not until bulls are five years old can their worth as sires be established; and that cows can be as old as eight before the quality of their calves can be known.

in most cases bona fide business ventures. Therefore, the bill would reach many persons who were not engaged in practices which the bill was designed to curb. Senator Barkley estimated that "hundreds of thousands" of such taxpayers would be affected by the bill (which contained a yearly figure of $20,000, instead of the present $50,000).[8] And, although this estimate was doubtless high, nevertheless it is interesting to note that the first case that Section 130 has spawned involved the breeder of one of the best herds of Guernsey cattle in the United States.[9]

Because Section 130 is directed against the wealthy, no popular clamor for its repeal can be expected. Yet, in the belief that the rich are entitled to as rational a system of taxation as others, it is here proposed to point out some of the questionable features of Section 130 and to suggest doubt as to its constitutionality.

I.

The basic absurdity of Section 130 is that it imposes an additional tax because a man has lost money — more than $50,000 of it for each of five successive years — in the bona fide pursuit of profit.[10] His business can be any kind — manufacturing, oil, newspapers, hotels — indistinguishable in character from those generally carried on in corporate form. And

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8 90 CONG. REC. 227 (1944). The amount was $20,000 in the original bill which passed the Senate; it was raised to $50,000 in conference. H.R. REP. No. 1079, 78th Cong., 2d Sess. 56 (1944).

9 James M. McDonald, 17 T.C. 210 (1951). The only other § 130 case that has reached the courts is Fred MacMurray, 21 T.C. No. 2, P-H 1953 T.C. REP. DEC. ¶ 21.2 (1953), where the Government unsuccessfully sought to apply § 130 to a husband and wife who owned as community property, ranch properties which had incurred losses of from $61,000 to $128,000 annually over a five-year period.

10 Technically an additional tax is not imposed but the tax in respect of each of the five years is increased by limiting the deduction. Incidentally, it could be argued from a literal reading of §§ 130 (b), 130 (c), 292 (a) and 56 (a) that the taxpayer would have to pay interest on each of these deficiences computed from the time when the tax to which it relates was initially due. However, this result is so incongruous and so contrary to the basic concept of interest that it is doubtful that it would ever seriously be urged, or, if urged, accepted.

it can be the kind of business, hotels for example,[11] which may be a losing proposition in hard times, and which can be a bonanza in good; or it can be the kind of business, stock breeding for example,[12] which by its very nature cannot normally be expected to produce profits for the first five years.

Actually, of course, the principal effect of Section 130 on those whom it might reach is simply to limit their freedom of action to conduct such businesses as they wish in their individual capacity, or as partners. Thus, when a taxpayer is threatened by this section and is forewarned,[13] he will normally seek to avoid it by following one of three courses of action: (1) he can reduce his fifth-year operating loss to less than $50,000 by such means as are open to him;[14] (2) he can incorporate; or (3) he can sell his business. The effect is that the taxpayer must take a course of action which he believes to be uneconomical; and, if he is correct in his estimate of his own best interests, then it is the Treasury that is the loser in the end. For this reason it is problematic whether Section 130 is producing any additional revenue at all; and it is not surprising that at the time of its enactment the

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11 "The depression . . . bankrupted probably 85 per cent of United States hotels. . . ." Saturday Evening Post, Jan. 2, 1954, p. 39, col. 2.

12 *Cf.* James M. McDonald, 17 T.C. 210 (1951), and Farish v. Commissioner, 103 F.2d 63, 64 (5th Cir. 1939), where it was shown that the breeding, development and training of polo ponies requires about eight years before they are salable.

13 Presumably no taxpayer would expose himself to § 130 if he could avoid it. Yet it is certain that there will be taxpayers who fail to do so because they are uninformed or have been misadvised. The numerous cases under the personal holding company tax (*e.g.*, those cited in note 69 *infra*) bear witness to the fact that the wealthy do not always retain lawyers or accountants, or that when they do, the advisers are not always alert to the traps that their clients might have avoided in the Code. So, too, in the case of a taxpayer who must pay the tax under § 130, the Treasury is enriched because he did not hire an alert lawyer or accountant. The application of the tax, then, has a strong element of unfairness and unjust enrichment in the sense that the Government is collecting a tax which it would not have received had the taxpayer been aware of its existence. These considerations suggest the desirability of making any repeal of § 130 retroactive.

14 The owner of a racing stable, for example, may be in a position to sell off some horses at a profit. *Cf.* Commissioner v. Field, 67 F.2d 876, 877 (2d Cir. 1933), where it was shown that the taxpayer could have made a profit for the year in question by selling his brood mares, but to the ultimate detriment of his stables.

Treasury could make no estimate of the additional revenue, if any, that Section 130 might produce.[15]

If there were some important tax abuse that was being dealt with by Section 130, its consequences might be justified. It is submitted, however, that a review of the cases in the area[16] which most concerned the proponents of the bill does not disclose any pattern of judicial error in applying the concepts underlying business deductions. Some cases there are where the reader might disagree with the decision,[17] but it is fair to state that the whole of the decisions in this area does not create a tax loophole of any sort.

Assuming that these decisions were wrong, they were wrong because the kind of enterprise involved, racing stables for example, as well as the extent of the losses, stamped it as a personal, and not a business, operation. If this, then, was the loophole which Congress wished to close, the statute should have set up a classification in terms of the kind of business as well as the extent and duration of the losses.

Moreover, is there not something basically fallacious about the notion that a taxpayer who deducts business operating losses from other income is conducting his business "at Government expense" or "at the expense of other taxpayers"?

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15 90 CONG. REC. 224 (1944). Senator Danaher believed that Section 130 would produce "millions in revenue"; and he had in mind six or eight cases whose files had been supplied to him. *Id.* at 227. In view of the avenues of avoidance that are open, *e.g.*, incorporation, this claim seems extravagant. The Treasury took no position on the bill, but one of its representatives indicated that the Treasury did not want it. *Id.* at 227, 232.

16 In addition to the cases mentioned in note 6 *supra*, see, *e.g.*, Tatt v. Commissioner, 166 F.2d 697 (5th Cir. 1948) (farm); Wilson v. Eisner, 282 Fed. 38 (2d Cir. 1922) (racing stable); DuPont v. United States, 28 F.Supp. 122 (D. Del. 1939) (farm); Lillie S. Wegeforth, 42 B.T.A. 633 (1940) (horsebreeding). *Cf.* Breckwoldt and Lockwood, *Gentlemen Farmers*, 28 TAXES 603 (1950).

17 *E.g.*, Plant v. Walsh, 280 Fed. 722, 725 (D. Conn. 1922). There the court, in dictum, expressed the view that ". . . farming, when engaged in as a regular occupation and in accordance with recognized business principles and practises, is [not] any the less a business within the meaning of the statute, because the person engaging in it is willing to do so without regard to its profitableness, because of the pleasure derived from it." Judge Learned Hand disputes this statement in Thacher v. Lowe, 288 Fed. 994, 995 (S.D.N.Y. 1922), and there is no question that it represents an erroneous view of the law.

It is submitted that this thought, as the basis for Section 130, presents more than a mere chicken-and-egg question, but, instead, an important question of tax policy. For this inverted reasoning assumes that because the state imposes high taxes, it may *for that reason* have an interest in inhibiting lawful and necessary business activities the expenses of which have the effect of reducing currently taxable income.

What Section 130 does in effect is to set up a conclusive presumption that, to the extent that a person's losses are excessive under its limitations, they are not really incurred for business purposes. However, in one context the extent and duration of the loss may evidence a non-business intent; in another it may evidence a business intent; or in a third, it may prove nothing at all.[18] And is it not more properly a judicial than a legislative function to weigh the probative effect of this factor in different cases? For, the judicial margin of error is no greater here than anywhere else where the courts are called upon to apply black-or-white statutory tests to particular cases; on the other hand, legislative fiat which can require giving probative effect to a set of facts that are not in fact probative, defeats the very purpose of the statute it was intended to implement.

Section 130 is a Congressional aberration which should be repealed, and if so the repeal should be retroactive.[19]

II.

Is Section 130 so lacking in sense as to be unconstitutional? This depends upon whether the due process clause of the Fifth

[18] For example, the losses might be attributable to economic factors such as a depression. *Cf.* DuPont v. United States, 28 F. Supp. 122, 124 (D. Del. 1939): "No one test has ever been put forward as competely decisive. What appeals to one judge may not appeal to another. For example, some courts have held that where it appears that a wealthy individual has, over a period of years, succeeded only in incurring a succession of heavy losses, sufficient to put the average farmer out of business, this is evidence that his farming is not a business but merely an expensive hobby. It is, of course, a matter to be considered, but I am inclined to think that it is entitled to less weight in the final verdict than some courts have accorded it."

[19] See note 13 *supra.*

Amendment limits Congress' power to impose an income tax under the Sixteenth Amendment,[20] and whether Section 130 is "arbitrary and unreasonable."

Due Process and Income Tax Statutes

Two recent surveys of the status of federal taxation and the due process clause in constitutional law pretty well summarize the prevalent understanding of the relationship between the judicial and legislative branches of the Government in these two fields:

Charles L. B. Lowndes, in discussing "Current Constitutional Problems in Federal Taxation," states that:[21]

> The most significant constitutional problem in federal taxation today is the absence of constitutional problems. The federal income, estate and gift taxes all encountered an extremely critical reception at the hands of the courts and suffered serious constitutional set-backs early in their careers. Today, however, they function in a constitutional climate as benevolent as it was formerly hostile. A microscopic analysis of the present federal tax system may reveal minor irregularities which might conceivably be magnified into major constitutional issues. From a practical point of view, however, the chance of invalidating a federal tax assessment on constitutional grounds is infinitesimal.

And, in a companion piece, Robert L. Stern summarizes the Court's current attitude toward "substantive due process" under the Fifth and Fourteenth Amendments as follows:[22]

> Although there is no longer any doubt as to how the Court will decide cases [involving purposeful social and economic legislation], it cannot be said that the Court has limited the due process clause to procedural matters and repudiated the concept of due process as a bar to sufficiently arbitrary or

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20 U. S. CONST. AMEND. V: "No person shall . . . be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." *Id.* AMEND. XVI: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

21 4 VAND. L. REV. 469 (1951).

22 *The Problems of Yesteryear — Commerce and Due Process,* 4 VAND. L. REV. 447, 450 (1951).

> irrational substantive legislation—although Mr. Justice Black's opinion in the *Lincoln Union* [23] case looks strongly in that direction. The Court has certainly not so stated in express terms, and the opinions still continue to examine legislation under attack to see whether it has a rational basis or is "substantially related to a legitimate end sought to be attained." [24] But, as the Court recently declared, "a pronounced shift of emphasis . . . has deprived the words 'unreasonable' and 'arbitrary' of the content" which they formerly held.[25] The self-abnegation with which the Court now applies the rationality test may, as a practical matter, make it unnecessary for the Court to decide whether it must reconsider the basic doctrine.

Accordingly, it is not surprising that "due process" issues are seldom raised any more in federal tax cases,[26] and that in neither of the two cases that Section 130 has so far produced, was its constitutionality attacked. On the other hand, where the accepted constitutional principles just outlined would produce a decision that outrages a court's sense of

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23 Lincoln Federal Labor Union v. Northwestern Iron & Metal Co., 335 U.S. 525 (1949) (footnote added).

24 *E.g.*, Cities Service Gas Co. v. Peerless Oil & Gas Co., 340 U.S. 179, 186 (1950).

25 Daniel v. Family Security Life Ins. Co., 336 U.S. 220, 225 (1949).

26 Two constitutional issues have recently been raised, inconclusively, in tax litigation. The first is found in the line of cases stemming from Lela Sullenger, 11 T.C. 1076 (1949), *aff'd and dism'd*, 4 P-H 1950 FED. TAX SERV. ¶ 71,055 (1950) (5th Cir.), where the court held that the Commissioner could not constitutionally disallow over-ceiling prices (paid during World War II) from being taken into account in computing cost of goods sold; that is, constitutionally speaking, gross income means gross receipts less cost of goods sold, and that not until cost of goods sold was ascertained could the rest of the equation be figured. But in Commissioner v. Weisman, 197 F.2d 221 (1st Cir. 1952), the court held that Congress had not intended that such over-ceiling payments should be disregarded, or else it would have expressly so provided as it did later in § 405 of the Defense Production Act of 1950, 64 STAT. 807 (1950), as amended, 65 STAT. 136 (1951), 50 U.S.C. APP. § 2105 (Supp. 1952); hence no constitutional question was involved in its decision.

The second arose in Commissioner v. Clark, 202 F.2d 94 (7th Cir. 1953) where the court, in an alternative holding, held the ten-year provision of the "Clifford Regulations," then U.S. Treas. Reg. 111, § 29.22 (a)-21(c) (1) (1945), unconstitutional as setting up a conclusive presumption of fact. The regulations treat as the taxable owner of income from a living trust, any grantor who reserves a reversionary interest which will, or which may reasonably be expected to take effect in possession or enjoyment within ten years from the date of the transfer. The court relied principally on Heiner v. Donnan, 285 U.S. 312 (1932) and Schlesinger v. Wisconsin, 270 U.S. 230 (1926). *Cf.* Note, 66 HARV. L. REV. 1532 (1953).

injustice, it is submitted that the due process clause should be available to produce the just result.[27]

Historically, the Supreme Court has never declared an income tax statute, passed since the Sixteenth Amendment, to be unconstitutional under the due process clause of the Fifth because it was "arbitrary and unreasonable." But the power to declare Congressional enactments unconstitutional under the due process clause of the Fifth Amendment has been exercised in three cases[28] involving statutes passed under the general taxing power.[29] In principle, there is no reason for treating with greater deference a statute passed under the Sixteenth Amendment than one passed under the general taxing power.

In two of these three cases,[30] as in the line of cases where various state tax statutes were invalidated under the due process or equal protection clauses of the Fourteenth Amendment,[31] a dissenting chorus consisting (depending upon their presence) of Justices Holmes, Brandeis, Cardozo, and Stone was heard. But these dissenters never went so far as to ques-

27 For example, were there no other escape in Foley Securities Corp. v. Commissioner, 106 F.2d 731 (8th Cir. 1939), the due process clause should have been relied on to produce the right result. See note 42 *infra* and accompanying text. *Cf.*, generally, CAHN, A SENSE OF INJUSTICE (1949).

28 Heiner v. Donnan, 285 U.S. 312 (1932) (estate tax provision creating conclusive presumption that gifts made within two years of death were made in contemplation of death); Untermyer v. Anderson, 276 U.S. 440 (1928) (retroactive gift tax); Nichols v. Coolidge, 274 U.S. 531 (1927) (retroactive estate tax). *Cf.* Blodgett v. Holden, 275 U.S. 142 (1928); Ballard, *Retroactive Federal Taxation*, 48 HARV. L. REV. 592 (1935).

29 U.S. CONST. ART. 1, § 8: "The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States."

30 The *Heiner* and *Untermyer* cases, *supra* note 28. In the third, Nichols v. Coolidge, 274 U.S. 531 (1927), Justices Holmes, Brandeis, Sanford and Stone concurred in the result only, presumably upon the ground that, as a matter of construction, Congress had not intended the tax to apply in the situation there in issue.

31 *E.g.*, Colgate v. Harvey, 296 U.S. 404 (1935); Liggett Co. v. Lee, 288 U.S. 517 (1933); Hoeper v. Tax Commission, 284 U. S. 206 (1931); Coolidge v. Long, 282 U.S. 582 (1931); Louisville Gas & Electric Co. v. Coleman, 277 U.S. 32 (1928); Schlesinger v. Wisconsin, 270 U.S. 230 (1926); Royster Guano Co. v. Virginia, 253 U.S. 412 (1920).

tion the Court's power to hold a statute unconstitutional on the grounds that it was arbitrary and unreasonable;[32] rather, finding a reasonable justification for the tax, they challenged the propriety of the Court's substituting its judgment for that of the legislature.

Thus, Justice Stone's dissent in *Heiner v. Donnan*,[33] which is characteristic of the Holmes-Brandeis-Stone approach to this question, cites with apparent favor Judge Learned Hand's concurring opinion in *Frew v. Bowers*[34] to the effect that the estate tax provision there in issue was "too whimsical to stand"; and Judge Hand's answer[35] to the government's argument that the Fifth Amendment does not apply to federal taxation gains added pertinence:

> I quite agree that the Supreme Court has in many cases implied or said as much. . . . If the rule is to be taken unconditionally, taxpayers may be selected by lot and assessments may vary with the price of wheat. [But a] tax may be so "arbitrary and capricious," its "inequality" so "gross and patent," that it will not stand, and as I can think of no other pertinent constitutional limitation, but the Fifth Amendment, it seems to me that the rule is not as stark as the defendant argues.

To ask whether the Court has power to declare unconstitutional an arbitrary and unreasonable statute provides its own answer; for the Court's responsibility is to dispense justice, and the citizen's right to justice carries with it a right to a rational explanation for the sanction or exaction which the legislature has sought to impose upon him. This right rests not alone in the content which the courts have given to the Fifth and Fourteenth Amendments, but also in the funda-

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32 *Cf.* Justice Brandeis dissent in New State Ice Co. v. Liebmann, 285 U.S. 282, 286-87 (1932): "Our function is only to determine the reasonableness of the legislature's belief in the existence of evils and in the effectiveness of the remedy provided."

See also FRANKFURTER, MR. JUSTICE HOLMES AND THE SUPREME COURT 30 (1938): ". . . it is subtle business to decide, not whether legislation is wise, but whether legislators were reasonable in believing it to be wise."

33 285 U.S. 312, 350 (1932). See notes 28, 30, *supra* and accompanying text.

34 12 F.2d 625, 630 (2d Cir. 1926), *dismissed*, 275 U.S. 578 (1927).

35 *Id.* at 630.

mental structure of the Constitution: for the power of taxation, like all other legislative powers, is a delegated power, a power delegated by the sovereign people; and it simply does not make sense to say that the people — the sovereign — would delegate a power which could be exercised so as to take away their life, liberty or property without reason.[36]

However, because of the "variable and relative" conceptions of reasonableness,[37] there is a line to be drawn between the irrational (*i.e.*, the arbitrary) statute and the merely unreasonable statute in the sense that "irrational" suggests an absence of reason as a faculty of the legislature's collective mind in enacting the statute, and "unreasonable" suggests a judgment based upon considerations of practicality.[38] Thus, the legislature may be deemed to have acted irrationally where there is no connection between the purpose and application of a statute; and it is unjust, and it should be unconstitutional, to give effect to an irrational application of a

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36 U.S. CONST. AMEND. X: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." *Id., Preamble*: "We the People of the United States . . . do ordain and establish this Constitution for the United States of America."

Cf. Corwin, *The "Higher Law" Background of American Constitutional Law*, 42 HARV. L. REV. 148 and 365, 390 (1928), discussing Locke's influence on the Founding Fathers: "In detail, the limitations which Locke specifies in his Second Treatise on Civil Government to legislative power are the following: First, it is not arbitrary power. Not even the majority which determines the form of the government can vest its agent with arbitrary power, for the reason that the majority right itself originates in a delegation by free sovereign individuals who had 'in the state of nature no arbitrary power over the life, liberty, or possessions' of others, or even over their own. In this caveat against 'arbitrary power,' Locke definitely anticipates the modern latitudinarian concept of due process of law."

But see 1 CROSSKEY, POLITICS AND THE CONSTITUTION 675-708 (1953), contending that, to the authors of the Constitution, "delegated" in the Tenth Amendment meant "alienated, absolutely parted with, or vested exclusively"; and that: "The use of the word 'reserved' . . . implied . . . that the whole thing — 'sovereignty' — out of which the 'reserved powers' of the states were *created* — *i.e.*, 'reserved' — had, at the same time, been conveyed to the nation." Crosskey also contends that the second half of the phrase in the Tenth Amendment, reserving powers "to the states respectively, or to the people," is merely in opposition to the first and that no divergent meaning is intended. *Id.* at 702, 705.

37 GARLAN, LEGAL REALISM AND JUSTICE 59 (1941).

38 WEBSTER'S NEW INTERNATIONAL DICTIONARY 2066 (2d ed. 1936): "RATIONAL suggests esp. the possession of reason regarded as a faculty of the mind; REASONABLE implies particularly the exercise of reason, or conformity to reason, esp. from a practical point of view. . . ."

statute. On the other hand, a statute for which some reason exists for applying it may be considered "unreasonable" in terms of the balance of reasons for and against its enactment; but it is not "irrational" so long as some reason exists for its application; and the courts, having found a rational basis for the statute, should not inquire further into its "reasonableness." [39]

So, notwithstanding the deference with which the Supreme Court has come, within the past fifteen years or more, to treat legislative judgment,[40] it nevertheless has continued to insist on logical connections between the purpose and effect of legislation. For example, in *Tot v. United States*[41] the Court held unconstitutional under the due process clause of the Fifth Amendment a provision of the Federal Firearms Act which stated in part that the possession of a firearm by a fugitive was presumptive evidence that such firearm was acquired through interstate commerce in violation of the Act. There was simply no rational connection between the fact to be proved (that defendant was a fugitive) and the fact presumed (that his firearm had been acquired through interstate commerce carried on in violation of the Act).

It seems obvious that statutes should meet the test of rationality. Yet in at least one case where a court squarely faced the issue of an arbitrary income tax statute, it refused to declare it unconstitutional. *Foley Securities Corp. v. Commissioner*,[42] involved the application of the personal holding company tax[43] to a deficit corporation. Consistent with

39 See Richardson, *Freedom of Expression and the Function of Courts*, 65 HARV. L. REV. 1, 47-54 (1951), recommending the same approach to civil liberties legislation. But see Rostow, *The Democratic Character of Judicial Review*, 66 HARV. L. REV. 193, 215 (1952), taking issue with Richardson on this point.

40 *Cf.* Richardson, *supra* note 39, at 47, n. 193. See, generally, WOOD, DUE PROCESS OF LAW (1951), for a recent survey of the course of due process decisions.

41 319 U.S. 463 (1943).

42 106 F.2d 731 (8th Cir. 1939); *accord*, Saxon Trading Corp., 45 B.T.A. 16 (1941). *But cf.* Pembroke Realty & Securities Corp. v. Commissioner, 122 F.2d 252 (2d Cir. 1941), note 45 *infra*.

43 Revenue Act of 1934, § 351, 48 STAT. 680, 751 (1934). *Cf.* INT. REV. CODE §§ 500-508.

the purpose of the tax to compel personal holding companies to distribute current earnings (thus increasing the income and the tax liability of their shareholders),[44] a deduction for dividends paid was allowed in computing the tax base. Taxpayer, which had started the year with an operating deficit, distributed a major part of its earnings for the year to its shareholders; quite obviously, this was done to avoid the surtax.

The court held, however, that the word "dividends" did not include distributions made while capital was impaired: to the extent of the corporation's deficit, its earnings were subject to the surtax.[45] So, assuming both distributed current earnings, a corporation with an initial deficit was taxed, whereas a corporation without a deficit would not be taxed; and the bigger the deficit, the bigger the tax.

The eighth circuit could find no justification for the different treatment of deficit corporations;[46] and it was aware that Congress had already acknowledged the defect in the statute in question by amending the tax to correct it, prospectively.[47] Nevertheless, the court refused to hold the statute unconstitutional, principally, it appears, because the Fifth Amendment limits Congress' power under the Sixteenth Amendment "only in rare and special instances," and the court did not consider this to be "a rare and special instance." [48]

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44 Foley Securities Corp. v. Commissioner, 106 F.2d 731, 734 (8th Cir. 1939).

45 The Circuit Court of Appeals for the Second Circuit, faced with the same problem, construed "dividends" to include the distribution of current earnings even where the taxpayer had an operating deficit at the time of distribution. Pembroke Realty & Securities Corp. v. Commissioner, 122 F.2d 252, 254 (2d Cir. 1941): "It is incredible, in the light of the purpose of the legislation, that a different result was intended in the case of a corporation whose capital happened to be impaired."

46 Foley Securities Corp. v. Commissioner, 106 F.2d 731, 735 (8th Cir. 1939).

47 *Id.* at 734.

48 *Id.* at 736-37: "Since the power of Congress to tax is not limited by the Fifth Amendment (Brushaber v. Union Pacific R.R. Co., 240 U.S. 1, 24; Billings v. United States, 232 U.S. 261, 282) 'except in rare and special instances' (Magnano Co. v. Hamilton, 292 U.S. 40, 44) which are ill defined, and since that Amendment contains no equal protection clause, and it is uncertain that discrimination, even though it be gross, constitutes confiscation, it is apparent that a ruling that Section 351, in dealing unjustly and unreasonably with personal holding companies having an im-

This is a striking injustice — an exaction without reason. And the court, in the face of this result and of the fact that Congress had already corrected its error in a non-retroactive statute, tells the taxpayer, in effect, that his remedy lies with the legislature and not with the courts!

This last approach rests on a theory of legislative supremacy which is foreign to American constitutional principles of judicial review. To the extent that it involves an incorrect application of a statement of Justice Sutherland in *Crooks v. Harrelson*,[49] it is desirable to point out just what that case did decide and what Justice Sutherland meant when he said:[50]

> Courts have sometimes exercised a high degree of ingenuity in the effort to find justification for wrenching from the words of a statute a meaning which literally they did not bear in order to escape consequences thought to be absurd or to entail great hardship. But an application of the principle so nearly approaches the boundary between the exercise of the judicial power and that of the legislative power as to call rather for great caution and circumspection in order to avoid usurpation of the latter. . . . It is not enough merely that hard and objectionable or absurd consequences, which probably were not within the contemplation of the framers, are produced by an act of legislation. Laws enacted with good intention, when put to the test, frequently, and to the surprise of the law maker himself, turn out to be mischievous, absurd or otherwise objectionable. But in such case the remedy lies with the law making authority, and not with the courts.[51]

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pairment of capital, was violative of the Fifth Amendment, could not be justified. In his dissenting opinion in Heiner v. Donnan, 285 U.S. 312, at page 338, Mr. Justice Stone says: 'No tax has been held invalid under the Fifth Amendment because based on an improper classification, and it is significant that in the entire one hundred and forty years of its history the only taxes held condemned by the Fifth Amendment were those deemed to be arbitrarily retroactive. See Nichols v. Coolidge, 274 U.S. 531; Untermyer v. Anderson, 276 U.S. 440; Coolidge v. Long, 282 U.S. 582.'"

49 282 U.S. 55 (1930).

50 *Id.* at 60.

51 Justice Sutherland referred to three English cases in this connection: *In re* Alma Spinning Co., 16 Ch. D. 681, 686 (1880) (involved a private company's articles of association); The King v. Commissioners, 5 A. & E. 804, 816, 111 Eng. Rep. 1370, 1376 (K.B. 1836) (involved a private act of Parliament); Abley v. Dale, 11 C.B. 378, 138 Eng. Rep. 519 (1851) (involved a term in the Insolvency Debtors Act). These three cases involve only a rule of construction, and of course, have no relevance to American constitutional principles.

It would indeed be a crowning irony if this statement of Justice Sutherland, one of the high priests of "substantive due process," became an instrument for the destruction of the principle of judicial review on due process grounds — that is, for an uncritical judicial acceptance of legislation without regard to canons even of justice and rationality. An analysis of *Crooks v. Harrelson* discloses no such petard.

In that case, the Court gave effect to what it considered to be the plain language of a federal estate tax provision which included in the gross estate only property which was subject to the payment of charges against the estate *and* the expenses of administration *and* was subject to distribution as part of the estate. Since Missouri real estate was not, as a matter of state law, subject to the expenses of administration, it was not included within the plain language of the statute, notwithstanding the fact that this result might be considered to be without any logical justification. The Court held that the plain language of the statute controlled.

But no constitutional question was presented by the case — merely one of statutory construction: for the due process clause protects only persons — and not the Government — from the consequences of governmental action. Whether the Court should, by implication, extend the coverage of a statute to persons plainly within its purpose but not within its language presents a rule of construction and a different question from that with which we are here concerned.[52] If

An English citation that *is* to the point on the matter of judicial review is Bonham's Case, 8 Co. 113(b), 118(a), 77 Eng. Rep. 646, 652 (K.B. 1610), which contains Lord Coke's famous dictum: "And it appears in our books, that in many cases, the common law will controul Acts of Parliament, and sometimes adjudge them to be utterly void: for when an Act of Parliament is against common right and reason, or repugnant, or impossible to be performed, the common law will controul it, and adjudge such Act to be void." Whatever may be the authority of this concept in English constitutional law, "in his dictum in *Bonham's Case* [Coke] furnished a form of words which . . . became the most important single source of the notion of judicial review [in the United States]. Corwin, *supra* note 36, at 379.

[52] *Cf.* Ayers, *Where Are the Limits of the Judicial Process in Taxation?* PROC. OF THE 41ST NAT'L TAX CONFERENCE 585 (1948); Miller, *Federal Courts as Makers of Income Tax Law*, 6 TAX L. REV. 151 (1951), deploring, in different degree, "judicial legislation" in the field of taxation.

the answer is that the Court should give effect to the language, and not to the purpose, it is then fair for the Court to remit the defeated litigant — the Government — to its legislature for the correction of its error in phrasing the statute.

On the other hand, where a person raises the issue that a statute applies without any reason, a constitutional question is presented. The court is not exercising a "legislative" function by declaring an act unconstitutional because it cannot be rationally explained; rather, it is merely insisting, as a matter of justice to the citizen, that the state shall not take his property without providing him with a reason for its act. And it is hollow advice to remit the citizen to Congress for his remedy.

It is not proposed to elaborate further here on the subject of judicial review otherwise than to point out that the manner in which Section 130 became law suggests the continued desirability of having the judiciary bring the test of reason to bear on statutes that have been hastily, or inconsiderately, enacted.

Section 130, for example, embodies certain factual assumptions as to taxpayers' motivations in spending their money. These assumptions can be controverted from common experience.[53] Yet, they were never put to the test of a public hearing;[54] and the only opportunity which the opposition had for publicly challenging them was in the course of the Senate debate on the bill. Let it be admitted that Senator Barkley and others effectively stated their case; nevertheless, the necessity for a quorum call toward the end of the debate[55]

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53 A professional economic study would have been preferable, particularly with reference to the impact of the statute on bona fide businesses. For example, what conclusion might be drawn from the fact that more than one-fourth of the country's business enterprises normally lose money (Greer, *Cost Factors in Price-Making*, 3 HARV. BUS. REV. 33, 42 (July-Aug. 1952) if the extent and duration of the losses were known?

54 90 CONG. REC. 227 (1944).

55 *Id.* at 230.

suggests that much of this persuasiveness may well have been lost.

In these circumstances, it is not surprising that a bill, plausible on its face, but basically irrational, can become law.[56] Since Congress would not in good faith and after full consideration enact unreasonable legislation, it is fair to say that an inconsiderately-enacted bill which contains irrational features deprives the citizen of his right to have the legislature consider reasons which would persuade it from its foolish course. The failure of the legislative process, then, is a failure of a process of law to which the citizen is entitled.[57] In these circumstances, the desirability for judicial review is manifest.

Finally, it may be asked in the light of Section 130's character as a deduction statute, are not all deductions a matter of legislative grace? [58] This dogma would give Congress absolute authority to enact any kind of deduction statute it wished. It is almost enough of an answer to say with Justice Miller that "the theory of our governments, State and Na-

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56 *Cf.* Cohen, *Towards Realism in Legisprudence,* 59 YALE L.J. 886 (1950), with respect to the problem of arriving at sensible policies through the legislative process.

Cf. EHRLICH, FUNDAMENTAL PRINCIPLES OF THE SOCIOLOGY OF LAW 389 (1936): "... we are all under the influence of the notion of the omnipotence of the state; and this conception has undoubtedly given rise to a series of social thought sequences which . . . dominate the thinking of the whole civilized human race at this time. Chief of these is the thought that the power to legislate is the highest power in modern society, and that resistance to it is to be condemned under all circumstances; that there cannot be any law within the territory of the state that is in conflict with statute law; and that a judge who in the administration of law disregards a statute is guilty of gross violation of duty."

57 *Cf.* CURTIS, LIONS UNDER THE THRONE 327 (1947): "The Court may well treat a statute that is not the result of the democratic process with no more respect and no more restraint than a Court [*viz.*, the pre-1937 Court] which had no respect for that process treated all statutes.

[W]here the democratic process is not working and the statute is not its result, the Court is free to make up its own mind without the exercise of any self-restraint."

58 *E.g.*, New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934); Helvering v. Independent Life Insurance Co., 292 U.S. 371, 381 (1934). *Cf.* Note, *An Argument Against the Doctrine That Deductions Should Be Narrowly Construed as a Matter of Legislative Grace,* 56 HARV. L. REV. 1142 (1943), where the author, evidently Dean Griswold, presumably accepts the dogma, as a constitutional principle, that all deductions are a matter of grace, but deplores its use as a rule that doubtful deduction provisions should be construed against the taxpayer.

tional, is opposed to the deposit of unlimited power anywhere." [59] However that may be, the line, for example, between levying an additional tax of 10% on all Democrats, and denying a deduction for business expenses to all Democrats, is solely a question of the different impact of the two taxing provisions among Democrats. The injustice implicit in the "indecent discrimination" [60] of the statutes is the same. Comparably, the decision in the *Foley Securities* case is no less outrageous because the court was construing a deduction statute. The injustice implicit in its unintentional discrimination remains.

The crux of the matter is that the issue of injustice must always be met. And it proves nothing to point out that there is no equal protection clause in the Fifth Amendment[61] so long as the Supreme Court is committed to dispensing "Equal Justice under Law." [62]

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59 Loan Association v. Topeka, 20 Wall. 655, 663 (U.S. 1874).

60 *Cf.* Llewellyn, *The Constitution as an Institution.* 34 COL. L. REV. 1, 32-33 (1934): ". . . what sense in arguing whether this is 'property,' or whether it is being 'taken,' or whether the confiscatory statute is 'due process'? Any expectation may have value, any valuable expectation may be likened to property, or made into property by judicial fiat, any change in law upsets some expectations, any such upset is a deprivation, any argument on 'taking' is a quibble, and the confiscatory statute is 'due process,' if it stands. The only real question is again whether the deprivation is indecently discriminatory: who is being penalized, and how much, for the benefit of some one else? Can the gain achieved be regarded as at all commensurate to the cost? Were the expectations the kind we want to see perpetuated? Does the need press?"

61 LaBelle Iron Works v. United States, 256 U.S. 377, 392 (1921). *Cf.* the quotation from the *Foley Securities* case at note 48 supra.

62 With respect to the fallacy that because deductions are a matter of legislative grace, anything goes, *cf.* Tot v. United States, *supra* note 41 and accompanying text, where the Government unsuccessfully sought to sustain an arbitrary statute on the grounds that since Congress might have prohibited the possession of all firearms by fugitives, it could establish a presumption (which might be contrary to fact) that involved a lesser exercise of power.

See also Davis v. United States, 87 F.2d 323, 324-25 (2d Cir. 1937), *cert. denied,* 301 U.S. 701 (1937), where Judge Chase first distinguished between two kinds of deductions: those, such as cost-of-goods sold "inherently necessary as a matter of computation to arrive at income" and those deductions "like personal exemptions, deduction for taxes paid; losses sustained in unrelated transactions and other like privileges which Congress has seen fit to accord to income taxpayers under the classifications it has established." He went on to say, "While the first kind of deductions are inherently necessary as a matter of computation to arrive at income, the second may be allowed or not in the sound discretion of Congress; the only

Is Section 130 "Arbitrary and Unreasonable"?

Section 130, it is submitted, fits the description: The purpose behind its enactment was to deny business expense deductions in those doubtful cases where the courts had found that certain enterprises of weathly taxpayers were not bona fide businesses. There is, however, no implicit relationship in reason between the extent of an operating loss and the characterization — business or personal — of the enterprise which produced it. The effect is that many taxpayers who are not guilty of the evil that the statute seeks to correct will be affected by it. It is this characteristic of the statute which justifies labeling it as arbitrary.

This, of course, is not the end of the matter. It is fair to point out that although the Holmes-Brandeis-Stone wing of the Court never disavowed the power to declare a taxing statute unconstitutional under the Fifth or the Fourteenth Amendments, on the other hand they never gave any clear notion of just what might constitute an unconstitutional statute. So, if we were to assume that the view of these justices would exert a major influence on any court which might review Section 130, it would still be impossible to state with certainty what the result would be on the issue of "reasonableness."

One principle which has been applied in the past to justify a statute which reaches those not within the evil with which it treats, is that ". . . the law allows a penumbra to be embraced that goes beyond the outline of its object in order that the object may be secured." [63] This so-called "penumbra doc-

restriction being that it does not act arbitrarily so as to set up in effect a classification for taxation so unreasonable as to be in violation of the Fifth Amendment."

63 Justice Holmes dissenting in Schlesinger v. Wisconsin, 270 U.S. 230, 241 (1926), where the Court held unconstitutional under the Fourteenth Amendment a conclusive presumption that gifts made within six years of death were made in contemplation of death for purpose of the Wisconsin inheritance tax. Just before the quoted sentence, Justice Holmes said: "Of course many gifts will be hit by the tax that were made with no contemplation of death." See Shea, *The Validity of an Inheritance Tax on Gifts Inter Vivos Within Six Years of Death,* 9 MARQ. L. REV.

trine" quite possibly contains within itself a standard of reasonableness against which the Holmes-Brandeis-Stone school might test statutes. If so, it seems apparent that Section 130 is unconstitutional for the reason that, because of their numbers and importance, there is nothing "penumbral" about the relationship to the statute of the taxpayers who, although not within the purpose of the statute, are nevertheless affected by it.

Since, however, this fact is not susceptible of proof by the taxpayer, a court might be reluctant to substitute its estimate of the impact of the statute for that of Congress. Then, any decision on the constitutionality of Section 130 might well depend upon the force that the court would give to *Heiner v. Donnan*[64] as a precedent. This is not necessarily so, but the cases both contain the element that Congress, to correct an assumed judicial misconception of its intention, passed statutes which, in correcting the misconception, nevertheless intentionally brought within their scope taxpayers who were not guilty of the evil that the statute sought to remedy.

Defense of the majority opinion in *Heiner v. Donnan* involves a kind of devil's advocacy, for the holding has been almost uniformly condemned in comment on the case in the academic legal literature.[65] Nevertheless, it is submitted,

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1 (1924), criticizing the statute in question before the case reached the Supreme Court.

64 See notes 28, 30 *supra*, and accompanying text.

65 FRANKFURTER, *Social Issues Before the Supreme Court* in LAW AND POLITICS 54-57 (1939); GRISWOLD, CASES AND MATERIALS ON FEDERAL TAXATION 574 (3d ed. 1950); Lowndes, *A Day in the Supreme Court with the Federal Estate Tax*, 22 VA. L. REV. 261, 265 *et. seq.* (1936); Notes, 2 IDAHO B.J. 214 (1932); 22 ILL. B.J. (1933); 27 ILL. L. REV. 456 (1932); 8 IND. L.J. 143 (1932); 16 MINN. L. REV. 851 (1932). But see Notes, 12 B.U.L. REV. 508 (1932); 31 MICH. L. REV. 135 (1932).

Lowndes contends that Helvering v. City Bank, 296 U.S. 85 (1935), and Helvering v. Bullard, 303 U.S. 297 (1938), "have completely repudiated the reasoning upon which [*Heiner v. Donnan*] rested." Lowndes, *The Tax Decisions of the Supreme Court*, 88 U. PA. L. REV. 1, 33 (1939). This is disputable: both the *City Bank* and *Bullard* cases involved classifications that were reasonably related to the purpose of the estate tax — in the *City Bank* case, transfers with a reserved power to alter, amend or revoke, either alone or in conjunction with someone else; and in the *Bullard* case, transfers with a reserved life estate. Neither tax reached persons not within the purpose of the statute.

Justice Stone's dissent never satisfactorily dealt with the injustice implicit in having the tax reach the estate of [66]

> The young man in abounding health, bereft of life by a stroke of lightning within two years after making a gift, [who] is conclusively presumed to have acted under the inducement of the thought of death, equally with the old and ailing who already stands in the shadow of the inevitable end.

Justice Stone accepts the application of the statute to those outside the problem with which the statute treats. He tolerates this because of the administrative-legislative convenience of plugging the contemplation-of-death loophole[67] by means of a statute requiring a presumption that is contrary to fact in some of its applications. In the end, the state takes a person's property because the legislature did not take the trouble to express itself in terms that were limited to the problem with which it dealt.

Granted that the Constitution gives Congress, as an incident to its taxing power, the power to remedy tax avoidance abuses, does it (or, should it) give Congress the power to impose a remedy where there is no abuse? It would certainly seem not, at least if the citizen has a right to a rational explanation for the statutes that apply to him. Moreover, if the Constitution prohibits statutes that are "indecently discriminatory," [68] why should it not prohibit statutes that are irrationally discriminatory: in either case a person's property is being taken without a sensible motive.

On the other hand, it may be suggested that legislative convenience in writing a general statute that overreaches its purpose is of itself enough of a reason for an overreaching application of the statute. "Convenience," however, is no standard at all and it represents no limitations whatsoever on the vagaries of legislative judgment. Nevertheless, in one

66 Heiner v. Donnan, 285 U.S. 312, 327 (1932).

67 This was a judicially created loophole, and it may be that it had been substantially closed by the definitive decision in United States v. Wells, 283 U.S. 102 (1931), the year before *Heiner v. Donnan* reached the court.

68 *Cf.* Llewellyn, *supra* note 60, at 32.

area of income tax legislation, the courts appear to have accepted legislative convenience as a "reason" for the application of the statute to those not within the problem with which the statute treats. In a series of cases[69] the courts have upheld the application of the personal holding company tax to operating companies, such as small loan businesses, notwithstanding the fact that it was evidently the purpose of the tax to reach "incorporated pocketbooks," and small loan companies and the like, did not fit the description.

Of course, one can always argue in the case of "loophole closing" statutes such as Section 130 and the personal holding company tax, that the taxpayer who is not within its purpose should have taken the avenue of avoidance that the statute left open for him.[70] The trouble with this line of reasoning is that, on a practical level, a person who knows he is not within a statute's purpose should hardly be expected to look to the details of its application. The result is that it is the hardship cases that get into the courts — the cases where the taxpayer was ignorant of the law or misjudged its applicability. In these circumstances, it is unfair to turn aside from a rational analysis of the tax *qua* tax on the grounds that the taxpayer should never have allowed himself to become subject to it in the first place.

In the last analysis, one's opinion of the decision in the leading case on the "penumbra doctrine," *Purity Extract Co. v. Lynch*,[71] may tell him how he thinks this issue of justice

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[69] R. Simpson & Co., 44 B.T.A. 498 (1941), *aff'd per curiam*, 128 F.2d 742 (1942), *dismissed*, 321 U.S. 225 (1944); Girard Inv. Co. v. Commissioner, 122 F.2d 843 (3d Cir.), *cert. denied*, 314 U.S. 699 (1941); Noteman v. Welch, 108 F.2d 206 (1st Cir. 1939).

[70] "The committee reports in both the House and the Senate, taking note of the objection that the language of the bill might include some bona fide operating companies which were not formed for any purpose of tax evasion, said that the bill would work no real hardship upon any corporation except one that was being used to reduce the surtaxes of its stockholders, because the corporation 'can always escape this tax by distributing to its stockholders at least 90% of its adjusted net income.'" Noteman v. Welch, 108 F.2d 206, 208-09 (1st Cir. 1939).

[71] 226 U.S. 192 (1912).

and legislative convenience should be resolved. There the Supreme Court upheld a Mississippi prohibition statute which prohibited the sale of all malt liquors without regard to their alcoholic content, even when applied to a non-alcoholic malt beverage which could not be used as a subterfuge for beer. The decision of the 1912 Court was unanimous; but one commentator, who suggests that a prohibition statute could, with as much sense, have bracketed gin and water, is of the opinion[72] that "one will search the law reports in vain to find a case containing such a perversion of logic and common sense"; and this writer, for one, agrees.

Apart from *de minimis* situations, why cannot the law — tax law in particular — be framed so as to secure its object without embracing a penumbra not related to its object? For tax law is concerned with identifiable categories of economic facts; and where there is disparity in the content which the judicial and legislative branches give to these categories, the problem becomes one for the legislature, or the courts, to solve by clearer expression of what the statute means. It is not one which should be solved by catch-all provisions which sacrifice individual justice to spare the legislature the trouble of writing statutes which are limited in effect to those within their object; or to spare the executive problems of proof; or to spare the courts the effort of correctly working out Congressional intent.

Finally, if we must have such catch-all statutes, then what is probably needed to assure justice and at the same time to avoid the assumed conflict and embarrassment involved in declaring a statute unconstitutional, is the increased use of the device of declaring it unconstitutional only in respect of its application to the case before the court.[73] Theoretically,

[72] Black, *The "Penumbra Doctrine" in Prohibition Enforcement*, 27 ILL. L. REV. 511, 512 (1933).

[73] *See, e.g.*, Burnet v. Coronado Oil & Gas Co., 285 U.S. 393 (1932); Indian Motorcycle Co. v. United States, 283 U.S. 570 (1931); Spalding & Bros. v. Edwards, 262 U.S. 66 (1923). *Cf.* PROVISIONS OF FEDERAL LAW HELD UNCONSTITUTIONAL 115 *et. seq.* (Library of Congress publication 1936).

such a practise would not change the results under a statute such as that in issue in *Heiner v. Donnan*;[74] theoretically, such a statute should not be required in the first place. Practically, two presumptions — that of the statute itself and that in favor of the constitutionality of its application — might be more effective than one in eliminating the gap that Congress conceives to exist between its intent and judicial notions of its intent.

Conclusion

Section 130 is a foolish statute which should be retroactively repealed.

Under the due process clause of the Fifth Amendment, the Court can declare unconstitutional an arbitrary statute enacted under the Sixteenth Amendment.

Section 130 is unconstitutionally arbitrary in that it affects taxpayers who, in numbers and importance, stand solidly within the statute's reach although not within its object. In the absence of proof of these numbers and importance, the statute is nevertheless unconstitutional in its application to persons whose activities are not within its object. For justice requires the courts to give a rational explanation of the application of a statute to a particular citizen, or to declare that application of the statute to be unconstitutional.

Justice requires the courts to draw lines — even in the half-shadows.

*John G. McQuaid**

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[74] See notes 28, 30, *supra*, and accompanying text.

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