Notre Dame Law Review

Volume 28 | Issue 1 Article 3

10-1-1952

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Recommended Citation

Robert L. Berry & John M. Sullivan, *Taxation -- The Constitutionality of Federal Taxation as an Exercise of Federal Police Power*, 28 Notre Dame L. Rev. 127 (1952).
Available at: http://scholarship.law.nd.edu/ndlr/vol28/iss1/3

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NOTES

Taxation

THE CONSTITUTIONALITY OF FEDERAL TAXATION AS AN EXERCISE OF FEDERAL POLICE POWER

Enforcement of tax collection against sporadic wrongdoers, contended Justice Black speaking for the minority in a recent case,[1] will place the revenue service in the field of imposing sanctions for the commission of purely local crimes. He further argued that neither the tax burden of honest citizens will be lightened, as more than likely the cost of such litigation will far exceed the yield, nor was it believable that Congress intended to treat occasional ill-gotten gains as belonging to the wrongdoer so as to be taxable under a colorable claim of right theory.

The whole of his argument might well be dismissed under a "chamber of horrors" label, yet its cogency in a narrow area of public policy is well worth more than passing attention. The opinion emphasized the need for maintaining the efficiency of the tax system and for protecting the local enforcement of criminal law, and commented critically on the encroachment of federal law in the field of local criminal law. Almost scornfully, it was said:[2]

> The Government's brief is suggestive of the only other reason that occurs to me — to give Washington more and more power to punish purely local crimes such as embezzlement and extortion. Today's decision illustrates an expansion of federal criminal jurisdiction into fields of law enforcement heretofore wholly left to states and local communities. I doubt if this expansion is wise from the standpoint of the United States or the states.

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[1] Rutkin v. United States, 343 U.S. 130, 72 S.Ct. 571, 96 L.Ed. 833 (1952). Rutkin was an ex-bootlegger of Prohibition days who managed to extract a large sum of money from a former associate. The extraction occurred over a number of years and culminated in 1943 when he was paid $250,000. The petitioner omitted the latter sum from his income on the basis that it was in payment for an alleged interest in a post-Prohibition liquor business. The government charged that the money was extorted and was receipt of a gain covered under INT. REV. CODE §22(a). The minority opinion noted that of 900 pages of oral testimony during the trial thirteen pages were devoted to matters arising out of the tax question and the balance was given over to the record of the rascality of the appellant. The conviction on charge of tax evasion was affirmed 5-4. Commissioner v. Wilcox, 327 U.S. 404, 66 S.Ct. 546, 90 L.Ed. 752 (1946), was distinguished and limited to its facts. The minority opinion was written by Justice Black, and concurred in by Justices Reed, Frankfurter and Douglas.

[2] Rutkin v. United States, 343 U.S. 130, 141, 72 S.Ct. 571, 96 L.Ed. 833 (1952).

An exhausive exploration of the areas in which federal taxation has exerted influence, coerced action, or imposed punishment is beyond the scope of this endeavor. It is possible, however, to sketch briefly the main fields in which taxation has acted, albeit secondarily, to sanction some line of conduct considered undesirable.

I.

The first such area is that in which Congress has attempted by the imposition of a tax, subsequently found wanting in constitutionality, to control, eliminate, or punish the participation in a given activity.

Under the National Prohibition Act[3] it was provided that, upon a finding that there was an illegal sale or manufacture of liquor in violation of the statute, a tax was to be assessed and collected from the person committing the violation double the amount provided by the existing revenue act.[4] In addition, the violator was subject to a penalty imposed upon him as a retailer or manufacturer. Needless to say, the excise stamp required could not be issued prior to engaging in the forbidden activity. It was the opinion of the Court that evidence of a crime was prerequisite to the assessment of the tax, and that Congress could not have "intended that penalties for crime should be enforced through the secret findings and summary action of executive officers,"[5] even if carried out as revenue measures.

After the repeal of the Eighteenth Amendment, a restaurant operator in Birmingham, Alabama was tried for failure to purchase the excise stamp required of retail liquor dealers operating in states which still prohibited the liquor trade.[6] The Court found that the imposition of the tax arose out of the commission of a crime and that the amount of the tax was indicative of a penal and prohibitory measure rather than one designed for revenue. "[T]he statute," said the Court, "is a clear invasion of the police power, inherent in the States, reserved from the grant of powers to the federal government by the Constitution."[7]

Another act to which the term "tax" was applied did not become a constitutional measure even though the aim of Congress was to promote the highest good. The purpose was to eliminate the use of

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[3] 41 STAT. 305, 317, 318 (1919).

[4] REV. STAT. § 3244 (1875).

[5] Lipke v. Lederer, 259 U.S. 557, 562, 42 S.Ct. 549, 66 L.Ed. 1061 (1922).

[6] United States v. Constantine, 296 U.S. 287, 56 S.Ct. 223, 80 L.Ed. 233 (1935).

[7] *Id.,* 296 U.S. at 295, 296.

child labor by imposing a tax on the profits of the products of such labor.[8] When this law was challenged, the Court declared that a heavy exaction for a knowing departure from a specific norm of business conduct amounting to ten per cent of the net profit of the business was a penalty and therefore invalid.[9]

An enactment, which sought to give purchasing power to farmers in parity with other economic classes, contained the proviso that it was to be financed by a processing tax the funds of which were to be allocated to the Secretary of Agriculture for the expansion of markets and removal of surplus agricultural products.[10] It, too, was struck down,[11] for the reason that the solitary aim of the statute was to regulate a matter wholly reserved to the states, and, further, that taxation is an exaction for the maintenance of the government and not of special groups. In the words of the Court:[12]

> The exaction cannot be wrested out of its setting, denominated an excise for raising revenue and legalized by ignoring its purpose as a mere instrumentality for bringing about a desired end.
>
> The amount offered [the farmer] is intended to be sufficient to exert pressure on him to agree to the proposed regulation. The power to confer or withhold unlimited benefits is the power to coerce or destroy.

The principle expounded, however, did not arise unanimously from the deliberative chambers of the Court. Justice Stone, speaking for the minority, propounded the thesis that:[13]

> . . . regulation, if any there be, is accomplished not by the tax but by the method by which its proceeds are expended, and would equally be accomplished by any like use of public funds, regardless of their source.

Yet, he further added:[14]

> The power to tax and spend is not without constitutional restraints. One restriction is that the purpose must be truly national. Another is that it may not be used to coerce action left to state control. Another is the conscience and patriotism of Congress and the Executive.

When an existing revenue act imposed a tax of two cents per $100 value of trade in futures transactions, and a subsequent enactment[15] imposed a tax of twenty cents per bushel, the latter was held to be

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[8] 40 Stat. 1138 (1919) (Child Labor Tax Law).
[9] Child Labor Tax Case, 259 U.S. 20, 42 S.Ct. 449, 66 L.Ed. 817 (1922).
[10] 48 Stat. 31 (1933), 7 U.S.C. §601 (1946).
[11] United States v. Butler, 297 U.S. 1, 56 S.Ct. 312, 80 L.Ed. 477 (1936).
[12] *Id.*, 297 U.S. at 61, 70-1.
[13] *Id.*, 297 U.S. at 80.
[14] *Id.*, 297 U.S. at 87. Is it out of place at this moment to ask for the judicial test that measures the validity of conscience and patriotism?
[15] 42 Stat. 187 (1921) (The Future Trading Act).

an unconstitutional exercise of the taxing power. It was inescapably convincing that its purpose was to compel compliance with regulations governing Boards of Trade and had no substantial relation to tax collection.[16]

Nor did Congress choose the proper means to regulate the production and distribution of coal by applying an excise tax of 15 per cent on the sale price of coal at the mine, even though it was tempered by a drawback allowance amounting to 13½ per cent.[17] The drawback was to be allowed on the condition that the producer agree to and comply with regulations of a commission also set up by the act. The Court found that the so-called tax clearly exacted a penalty to coerce compliance:[18]

> One who does a thing in order to avoid a monetary penalty does not agree; he yields to compulsion precisely the same as though he did so to avoid a term in jail.

Since "penalty" has been a measure of constitutionality, a definition in the words of the Court itself should be of assistance:[19]

> The term "penalty" involves the idea of punishment for the infraction of the law, and is commonly used as including any extraordinary liability to which the law subjects a wrongdoer in favor of the person wronged, not limited to the damages suffered.

Into this general area may fall a very recent case involving the gambler's occupational tax imposed under the Revenue Act of 1951.[20] The court, in holding the tax unconstitutional, followed the general rule expounded in *United States v. Constantine*,[21] and quoted with approval the view of Justice Roberts to the effect that under the cloak of a taxing act the intent was to usurp the states' police power.[22] On the other hand, in another case involving the same tax, the opposite result was reached.[23] A scrutiny of the cases cited in support of this latter decision leads to the opinion that the court glossed over the obvious effort made to preserve the rule of *United States v. Constantine*[24] by the decision in *United States v.*

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[16] Hill v. Wallace, 259 U.S. 44, 42 S.Ct. 453, 66 L.Ed. 822 (1922).
[17] 49 STAT. 991 (1935).
[18] Carter v. Carter Coal Co., 298 U.S. 238, 289, 56 S.Ct. 855, 80 L.Ed. 1160 (1936).
[19] O'Sullivan v. Felix, 233 U.S. 318, 34 S.Ct. 596, 599, 58 L.Ed. 980 (1914).
[20] 65 STAT. 529 (1951), 26 U.S.C. §§3290-3291 (1952).
[21] 296 U.S. 287, 56 S.Ct. 223, 80 L.Ed. 233 (1935).
[22] United States v. Kahriger, 105 F.Supp. 322 (E.D. Pa. 1952).
[23] United States v. Smith, 106 F.Supp. 9 (S.D. Cal. 1952).
[24] 296 U.S. 287, 56 S.Ct. 223, 80 L.Ed. 233 (1935).

Sanchez,[25] and moreover bases its view of constitutionality, not directly on the taxing power, but on the power to regulate interstate commerce to which the taxing power is adjoined. The first decision is now pending before the Supreme Court; whether or not it will be upheld as a tax, and not classified as an unconstitutional sanction, remains to be seen.

II.

In spite of the conclusions which might be derived from the material above, if an overriding moral suasion or element of public policy be discerned in the imposition of "penalty" taxation, there will not necessarily be found a want of constitutionality. For instance, when Congress chose to control traffic in narcotics[26] by levying a tax under the authority of the Constitution,[27] it was possible to find that it was basically a revenue measure to be administered with the aim of enforcing the special tax.[28] It was even admitted that the object sought was to secure close supervision of dealings in drugs, and that it made use of a penalty in order to obtain documentary proof "as a means of taxing and *restraining* the traffic."[29] (Emphasis added.) Further, this tax has been sustained upon the principle that:[30]

> . . . from an early day the court has held that the fact that other motives may impel the exercise of federal taxing power does not authorize the courts to inquire into that subject.

Without much question the Court accomplished a noteworthy task in steering the Harrison Narcotic Law through judicial waters fraught with reefs. In doing so it found that " . . . the power to lay taxes on an article includes no right to make any specific use of such tax-paid article unlawful."[31]

While the Court has said that "the statute must be strictly con-

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[25] 340 U.S. 42, 71 S.Ct. 108, 95 L.Ed. 47 (1950).

[26] 38 STAT. 785 (1914), as amended, 26 U.S.C. § 2550 (1946) (Harrison Narcotic Law).

[27] U.S. CONST. Art. I, § 8.

[28] Linder v. United States, 268 U.S. 5, 45 S.Ct. 446, 69 L.Ed. 819 (1925).

[29] United States v. Balint, 258 U.S. 250, 254, 42 S.Ct. 301, 66 L.Ed. 604 (1922).

[30] United States v. Doremus, 249 U.S. 86, 39 S.Ct. 214, 216, 63 L.Ed. 493 (1919).

[31] Blunt v. United States, 255 Fed. 332, 336 (7th Cir. 1918), *cert. denied*, 249 U.S. 608, 39 S.Ct. 290, 63 L.Ed. 800 (1919).

strued and not extended beyond the proper limits of a revenue measure,"[32] on another occasion it added:[33]

> . . . we must assume that it is a taxing measure, for otherwise it would be no law at all. If it is a mere act for the purpose of regulating and restraining the purchase of the opiate and other drugs, it is beyond the power of Congress and must be regarded as invalid. . . .

Over a quarter century before it became necessary to wrestle with the problem of applying coercive taxation to narcotic drugs, Congress enacted a law imposing discriminatory taxation upon oleomargarine. It was stated that Congress, within its delegated power of taxation, had the right to choose the objects upon which to impose an excise.[34] And an enactment does not lack constitutionality merely because it accomplishes another purpose in addition to raising revenue.[35]

Though it was contended that a particular levy was a penalty the purpose of which was to suppress traffic in certain noxious types of firearms,[36] and correspondingly subject to regulation only by the powers reserved to the states, it was not so held. Rather it was decided that the deterrent effect arising out of a measure which on its face was merely a taxing measure was not beyond congressional power. The determinant propounded was that:[37]

> Every tax is in some measure regulatory. To some extent it interposes an economic impediment to the activity taxed as compared with others not taxed. But a tax is not any the less a tax because it has a regulatory effect. . . .

A progressive tax on theater tickets sold by brokers apart from box office sales seriously threatened, according to the claimant, to destroy such business. Yet, the Court of Claims, admitting that to be the apparent aim of Congress, found no ground sufficient to make the act unconstitutional.[38] Long before the Congress gave thought to theater tickets, it deliberately sought to drive out of existence the circulation of notes of private persons, state banks and state banking associations by the imposition of a tax.[39] It was decided that in the

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[32] Linder v. United States, 268 U.S. 5, 19, 45 S.Ct. 446, 69 L.Ed. 819 (1925).
[33] Nigro v. United States, 276 U.S. 332, 341, 48 S.Ct. 388, 72 L.Ed. 600 (1928).
[34] McCray v. United States, 195 U.S. 27, 24 S.Ct. 769, 49 L.Ed. 78 (1904).
[35] *In re* Kollock, 165 U.S. 526, 17 S.Ct. 444, 41 L.Ed. 813 (1897).
[36] 48 STAT. 1236 (1934) (National Firearm Act).
[37] Sonzinsky v. United States, 300 U.S. 506, 513, 57 S.Ct. 554, 81 L.Ed. 772 (1937).
[38] Couthoui v. United States, 54 F.(2d) 158 (Ct. Cl. 1931), *cert. denied,* 285 U.S. 548, 52 S.Ct. 396, 76 L.Ed. 939 (1939).
[39] Veazie Bank v. Fenno, 8 Wall. 533, 19 L.Ed. 482 (U.S. 1869).

exercise of an undisputed constitutional power to provide a nation-wide currency, Congress was fully within its power to restrain by taxation the circulation of any but its own currency.

One of the problems confronting Congress in its imposition of taxes arises when the revenue measure is coupled with the exercise of another power. If the exercise of the other power is constitutional, the Court tends to sustain the tax, as in *Veazie Bank v. Fenno.*[40] But if the other power fails, so may the taxation. Thus, in *Carter v. Carter Coal Co.,*[41] since the Bituminous Coal Conservation Act of 1935 was held to be an invalid exercise of the power to regulate interstate commerce, its accompanying tax was resultingly nullified. In the second Bituminous Coal Act,[42] however, Congress selected the proper means of regulating the sale of bituminous coal as it effected interstate commerce, and correspondingly, the tax, which in substance imposed one rate for members of the code complying with the regulations, and another rate for non-members, was deemed a valid excise. In these circumstances, the Court found:[43]

> Clearly this tax is not designed merely for revenue purposes. In purpose and effect it is primarily a sanction to enforce the regulatory provisions of the Act. . . . The power of taxation, granted to Congress by the Constitution, may be utilized as a sanction for the exercise of another power which is granted it.

In *United States v. Butler,*[44] the regulation of agriculture coupled with a tax also aimed at coercing compliance was extensively distinguished in the case testing the validity of Titles III and IX of the Social Security Act,[45] which imposed a tax upon employers of eight or more persons for unemployment compensation purposes. The objections in the *Butler* case were deemed not applicable according to the findings of the Court:[46]

> (a) The proceeds of the tax in controversy are not earmarked for a special group.
>
> (b) The unemployment compensation law which is a condition of the credit has had the approval of the state and could not be a law without it.
>
> (c) The condition is not linked to an irrevocable agreement, for the state at its pleasure may repeal its unemployment law . . . termin-

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[40] *Ibid.*

[41] 298 U.S. 238, 56 S.Ct. 855, 80 L.Ed. 1160 (1936).

[42] 50 STAT. 72 (1937).

[43] Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381, 393, 60 S.Ct. 907, 84 L.Ed. 1263 (1940).

[44] 297 U.S. 1, 56 S.Ct. 312, 80 L.Ed. 477 (1936).

[45] 49 STAT. 620 (1935), 42 U.S.C. §§ 301-1305 (1946).

[46] Steward Machine Co. v. Davis, 301 U.S. 548, 592-593, 57 S.Ct. 883, 81 L.Ed. 1279 (1937).

ate the credit, and place itself where it was before the credit was accepted.

(d) The condition is not directed to the attainment of an unlawful end, but to an end, the relief of unemployment, for which nation and state may lawfully cooperate.

The statute does not call for a surrender by the states of powers essential to their quasi-sovereign existence.

It may be noted under (a) that reference is made to earmarking funds for a special group, a serious objection in *United States v. Butler*.[47] Nevertheless, a processing tax[48] imposed on coconut oil derived from the Philippine Islands, to be held as a separate fund for the Treasury of the Philippines was declared a legal tax.[49] The Court reasoned that since it would be valid for a separate appropriation to be made out of the general funds of the United States Treasury, it was not invalid where the tax and the appropriation were bound to one another in the same legislative act.

III.

Thus far we have explored the areas in which taxation has been held either unconstitutional because it coerces or sanctions, or constitutional irrespective of its regulatory or prohibitive effect. There is also a never-never land in which a revenue measure may be called a "penalty" or described in terms implying punishment without the question of validity being decided.

The importation of wood pulp, declared for customs purposes at less than the taxable market value, was not only subject to the importation duty, but also to a further sum based on such undervaluation. The additional sum was found to be a penalty. It was not imposed, the Court said, for revenue purposes, but, rather, it was exacted in addition to the import duties and for the particular act, *i.e.*, the act of undervaluation. As a penalty it was found to be within the exclusive jurisdiction of the district courts for adjudication.[50]

The imposition of an additional sum, equal to fifty per cent of a tax deficiency, due to fraud with intent to evade the tax was not res

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[47] 297 U.S. 1, 56 S.Ct. 312, 80 L.Ed. 477 (1936).

[48] 48 STAT. 680, 763 (1934).

[49] Cincinnati Soap Co. v. United States, 301 U.S. 308, 57 S.Ct. 764, 81 L.Ed. 1122 (1937).

[50] Helwig v. United States, 188 U.S. 605, 23 S.Ct. 427, 47 L.Ed. 614 (1903).

judicata because the taxpayer previously had been acquitted on charges of criminal evasion of the income tax. Rather, the addition was regarded as a legitimate civil sanction aimed at the protection of the revenues.[51]

That a revenue measure may be used to ensnare a willful wrong-doer whose wiles and power seem to forestall bringing him to account on other grounds is well known. Recall the "sad" plight of gangsters and racketeers, immune so long from sanction for violation of local criminal statutes, who are eventually caught up in the meshes of tax evasion. This point was aptly covered in *Steinberg v. United States*:[52]

> . . . common knowledge of prosecuting methods, and the comment of the court in sentencing this man clearly show that Steinberg was indicted, not to enforce a revenue law, nor penalize him for failing to comply with one, but to punish severely for dealing *largely* in liquor . . . . wherefore, as Congress has furnished weapons appropriate for frontal attack only against small fry, endeavor is made to net the larger fish in the meshes of revenue, customs, and tax laws, with the ever-useful conspiracy statute in reserve for a plurality of wrongdoers. The question is not whether this is wise or politic, fair or in good taste, but whether it can legally be done. We think it can under the language of the statutes. . . .

IV.

At the outset reference was made to the extension of federal police power foreseen by Justice Black implicit in the application of federal taxation as punishment for purely local crimes. The question remains to be answered as to how far taxation may be extended for ulterior purposes before it will be found invalid.

The existence of an ulterior or collateral purpose in taxation is, in itself, not sufficient to establish invalidity. Nor is the fact that Congress absolutely forbids something a bar to taxing the very same thing, for as Justice Holmes said, "Of course Congress may tax what it also forbids."[53] And as the Court has reiterated time and time again, congressional motive underlying legislative enactment is not a proper subject for judicial inquiry,[54] except, of course, in those circumstances when inquiry is made.[55] Yet, even when the question of motive is raised, "Legislative draftsmen have learned to preserve

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[51] Helvering v. Mitchell, 303 U.S. 391, 58 S.Ct. 630, 82 L.Ed. 917 (1938).

[52] 14 F.(2d) 564, 566-7 (2d Cir. 1926).

[53] United States v. Stafoff, 260 U.S. 477, 480, 43 S.Ct. 197, 67 L.Ed. 358 (1923).

[54] United States v. Doremus, 249 U.S. 86, 39 S.Ct. 214, 63 L.Ed. 493 (1919); Veazie Bank v. Fenno, 8 Wall. 533, 19 L.Ed. 482 (U.S. 1869).

[55] United States v. Butler, 297 U.S. 1, 56 S.Ct. 312, 80 L.Ed. 477 (1936).