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# Practicability and Constitutionality of an Income Tax

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T H E S I S

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T I O N A L I T Y   O F   A N   I N C O M E   T A X .

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by

Charles M. Smalley.

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Cornell University.

1895.

T A B L E O F C O N T E N T S.

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PRACTICABILITY AND CONSTITUTIONALITY OF AN INCOME TAX.

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INTRODUCTION

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This subject is one which naturally divides itself into two parts ; first, the practicability of an income tax ; second, the Constitutionality of an income tax.

In dealing with the first part of the subject it has been the endeavor of the writer to consult the works of well known economists and writers on economics. The material being gathered in part from standard works on taxation and in part from the literature of the day on the justness and practicability of an income tax. In dealing with the first part of this subject it is my purpose to consider the chief objections which have been raised to an income tax and as far as possible to answer those objections.

In dealing with the second part of the subject it is not my purpose to attempt a defense of the Constitutionality of the recent income tax in all its aspects as I believe in some respects it is unconstitutional especially in taxing the incomes of state officials. As a whole it is my purpose to show that an income tax is Constitutional.

PART I.

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Let us consider for a few moments just what we mean by an income tax. All taxes must be derived from income, if they were not the people upon whom they were assessed would be unable to pay taxes. If a government in the exercise of its power of taxation should levy taxes to such an extent that the capital of its citizens had to be taken in paying the tax the citizens would cease to contribute to the support of their government for the self evident reason that they have nothing to contribute. Such a system of taxation would be killing the geese that laid the golden eggs.

What then is meant by an income tax? A tax levied upon the income of a person is an income tax. In levying this tax the income of the individual is taken as the index of the ability to pay taxes and made the basis of assessment.

Let us turn now to the main considerations in this subject and consider some of the objections which have been raised either to the justness or practicability of introducing into our already complicated system of taxation the feature of a tax upon incomes.

In discussing these objections some, if not a majority, of the writers on the subject of taxation make a fatal blun-

der at the beginning of their discussions and arguments against a system of income taxation by assuming that because an income tax is not a perfect tax it is not a juster and equitable tax than other forms of taxation. It is not a question of establishing a perfect system of taxation. Such a thing is impossible for the human mind to formulate. It is a question of what method of levying taxes is relatively the best. Not what method is perfect.

The first and greatest of the practical objections to an income tax it is proposed to consider, is that the tax can't be collected justly. It is claimed that an income tax is a tax on honesty. That the honest will pay their share of the burden while <sup>th</sup>~~the~~ dishonest will evade the tax if by no other method they will perjure themselves for the sake of retaining a few dollars.

In an article on the income tax, in a journal devoted somewhat to the discussion of economic questions, the writer says :-" For a man who has once got over his dislike for telling lies it is quite as easy to defraud the government of what you ought to pay as to let them defraud you of what you ought not to pay. The practical result of the whole institution is that probably at least ninety-nine percent of the persons who annually pay income tax deliberately cheat." (1)

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 (1) The Saturday Review. Vol. 69. p. 68.

If this be true it is certainly a startling fact to learn that the self-respect and patriotism of a people are not as great as their love of money. This seems to be a very strong argument against the people if not against the adoption of an income tax. What of other systems of taxation? Will there be no dishonest people under these? In arriving at any conclusion as to whether an income tax will be evaded more than any other tax there are scarcely any statistics to guide one.

Perhaps it would be well to quote another writer on economics, Professor Edwin R. A. Seligman, who, in writing on the evasion of income taxes, says :- "I have undertaken to make some comparison and venture to say that the history of the federal income tax during the Civil War shows that, notwithstanding all its imperfections, crudities, and ensuing frauds, it was nevertheless more successful than the general property tax".(1)

A tax never has and it is quite safe to say never will be devised by the mind of man that can be justly collected. It is merely a question of degree. If an income tax is evaded to such an extent as some people think it would be, why has it been so successful in the countries

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(1) "The American Income Tax." The Economic Journal Dec. 1894, p. 639.

where it has become a part of their system of taxation? Do we hear anything about the evasion of income taxes in England or in the Cantons of the Swiss Republic? If an income tax is evaded so extensively and is so injurious to the honesty and patriotism of the subjects of a government would these countries continue such a system of taxation? Truly the answer to this question must be in the negative.

Another of the objections to the tax is that it is inquisitorial. This objection is true. But we must not forget, as many people seem to do, that all methods of taxation are inquisitorial. An income tax cannot be said to be any more inquisitorial than a tax levied in the form of custom duties where goods are subject to the most rigid inspection by a herd of inspectors.

An income tax is said to be un-American and un-democratic. During the debates in Congress over the adoption of the income tax feature of the Wilson Bill a prominent senator made the startling assertion that an income tax was unknown in democratic communities. This is obviously an erroneous view. If we regard England as a wide-bound mediæval country, which is certainly contrary to the facts of English progress along the lines of democratic institutions, what can be said of the colonies of Australia and the cantons of the Swiss Republic where a system of income taxation

constitutes the chief source of revenue ?

" It is a well established fact," says Professor R. A. Seligman, " that the income tax has been most fully developed precisely in the most democratic communities; and that the whole tendency toward democracy, even in non-republican states has gone hand in hand with the extension of direct taxation, and more especially of the income tax." (1)

Turning aside from the objections to the practical working of an income tax to a consideration of the justness and equitability of the measure what is there to be said in favor or against an income tax as embodying these qualities. It may be well said that the first and greatest criterion of any tax is justice. What is meant by justice in a tax cannot be better described than in the words used by Adam Smith in the first of his already classical canons of taxation. " The subjects of every state ought to contribute to the support of the government, as nearly as possible in proportion to their respective abilities : that is, in proportion to the revenue which they respectfully enjoy under the protection of the state."(2)

It is claimed that an income tax is a retrogressive tax; that it is a tax upon thrift and industry and a premium

(1) The Economic Journal. Dec. 1894, p. 639.

(2) Adam Smith's " Wealth of Nations", Book V. Chap. II.

on indolence and laziness therefore it is not a just tax. This reasoning is based on the fact that under an income tax the burden of taxation will fall upon those who have incomes.

This it seems is the only reason why an income tax is just because it falls on those who have the ability to pay taxes and not upon those who are able to earn scarcely the necessities of life. "Taxation," says Freud, "is equitable, when each member is taxed in proportion to his means of paying the tax; it is inequitable, when each member is not taxed in proportion to his means of paying the tax." (1) Under no other tax can the citizens of a state be made to contribute to the support of their government in proportion to their means of contributing as uniformly and equitably as under an income tax.

Under the system of general property taxation a person may own a large amount of property and yet obtain a comparatively small income from the capital invested. Under the general property tax such a person is not taxed according to income, the true test of his ability to pay, but according to the assessed valuation of his property which is obviously not the test of ability but rather the test of disability.

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(1) Freud, "Principles of Taxation," p.33.

"Property taken by itself," says Mr. Collouch, " is no accurate test of the capacity to bear taxes : that depends quite as much on income as on property ; and to leave the former out of view in ascertaining taxes would be like leaving the influence of currents or contrary winds out of view in estimating the course of a ship. If there is a tax on property taxes must be paid even there is no benefit derived from the property . In the case of an income tax there must be an income derived from the property in order to levy the tax. Under the former it would be paying taxes according to disability in stead of ability." (1)

Several of the writers on taxation object to an income tax as being unjust because under it incomes derived from permanent property and incomes derived from professional industry are taxed without any discrimination being made in favor of the latter. They claim that it is unjust to tax an income which depends upon the health and business ability of a professional man at the same rate as an income obtained from an estate which may have descended from one generation to the next, of the same family for hundreds of years.

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(1) McCollouch on Taxation, Chap. IV. p. 113.

The owner of such an estate may have done nothing to improve it, while the income of the professional man depends altogether on his individual activity.

The writers who raise this objection do not seem to recognize the fact that a tax on a professional income only continues during the life of the income while an income tax on incomes derived from property of a permanent nature continues while the property lasts. In other words when the ability to pay the tax continues the tax itself continues, but when the ability ceases the tax also does. This would seem to be a reason for the justness of an income tax rather than against it.

PART II.

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CONSTITUTIONALITY OF AN INCOME TAX .

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Against the constitutionality of an income tax <sup>to</sup> main lines of argument have been advanced the first one of which we may call the direct tax argument ; the second the uniform tax argument.

The Constitution provides that, " Direct taxes shall be apportioned among the several States which may be included within this Union, according to their respective numbers, which shall be determined by adding to the whole number of free persons, including those bound to service for a term of years, and excluding Indians not taxed, three fifths of all other persons". "No capitation or other direct tax shall be laid, unless in proportion to the census herein before directed to be taken."(1) In other words direct taxes, according to the constitutional requirement , must be apportioned among the States according to the population.

As to what taxes are included in the term direct taxes the Constitution is silent. If an income tax is a

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(1) Article I. Sect. II.and IX.

direct tax within the meaning of the Constitution it is clearly unconstitutional. The question therefore resolves itself into this; is an income tax a direct tax within the meaning of the Constitution ?

" A direct tax," says Mill, "is one which is demanded from the very person who, it is intended or desired, should pay it." (1) Mill includes within his category of direct taxes all taxes on expenditure which are imposed immediately on the consumer and taxes on incomes. McCollough, at the beginning of his work on taxation, says taxes are of two classes direct and indirect. He defines a direct tax to be one which is taken immediately from property or labor. (2) Besides the authors quoted all the other writers on taxation and economics since the time of Adam Smith have regarded a tax on incomes as a direct tax. They have with a remarkable degree of uniformity held a view which, if adopted in the solution of the Constitutional question involved, would clearly and logically compellus to hold an income tax to be a direct tax and therefore unconstitutional, as it cannot be laid in proportion to the population. How then can the

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(1) Mill, Principles of Pol. Econ., Book V. Chap. III. p. 367.

(2) McCollough on Taxation p. 1.

constitutionality of this tax be established? Clearly if it is done we must hold an income tax to be a direct tax for the purpose of economic discussion and some other form of taxation in order to comply with the constitutional mandate.

Assuming that such a distinction exists, how are we to ascertain what forms of taxation are included within the term of direct taxes as it is used in the Constitution? On this question the Constitution itself is silent therefore we must obtain our information from other sources.

In the Articles of Confederation of 1777, the mode of supplying the common treasury with funds was provided for by a system of requisition upon the several States. No distinction, however, was made between direct and indirect taxes. The lack of coercive power to enforce the collection of the taxes under the Confederation was one of the reasons for the adoption of the present Constitution. But in the journal of the proceedings of the constitutional convention of 1787 nothing of much value is recorded in regard to the subject of taxation. On July 12, 1787, Gouverneur Morris, of New York, submitted a proposition, "that taxation shall be in proportion to representation." It is also recorded in this day's proceedings that Morris having changed his proposition by inserting the word, "direct", it passed as follows :- "Provided always that direct taxes ought to be proportional

to representation." (1) On the twentyfourth of July of the same year, Mr. Morris said, "that he hoped that the committee would strike out the whole clause. He had meant it as a bridge to assist us over a gulf ; having passed the gulf, the bridge may be removed. He thought the principle laid down with so much strictness liable to strong objections."(2) But the bridge remained, however much the builder may have desired to remove it ; and the provision in question was silently incorporated into the draft of the Constitution as that instrument was adopted without the attempt being made on the part of any one to define the exact meaning of the language employed.

In the reports of the debates, in the several state conventions, on the adoption of the Constitution, we find that the subject of taxation was discussed with ability and at great length in some of the state conventions. From the reports of these debates it is learned that there were different views as to the advisability of conferring upon the national government the power to lay direct taxes. Some of the members of these conventions were in favor of an unlimited power of taxation, others favored a restricted power.

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(1) Madison Papers, by Gilpin, p.p. 1079 -81

(2) 2 Madison Papers, by Gilpin, p. 1197.

In all the records and reports of these debates, so far as it has been possible for me to ascertain, there was no explanation of what was included within the term, direct taxes. To this general statement there is one exception. In the debates in the Virginia State Convention, John Marshall, in speaking upon the subject of taxation said :- "The objects of direct taxes are well understood : they are but few : what are they ? Lands, slaves, stock of all kinds, and a few other articles of domestic kind of property." (1) In the convention, Mr. Mason speaks of land and poll taxes but does not make it clear as to whether he regards these as the only forms of direct taxation or not.

Alexander Hamilton, speaking of taxes generally, said :- " Those of the direct kind, which principally relate to lands and buildings, may admit of a rule of apportionment. Either the value of the land or the number of the people may serve as a standard." (2) This writing bears the date of December 12, 1787. On January 8, 1788, the same author in speaking of internal taxes said :- "The taxes intended to be comprised under the general denomination of internal taxes, may be subdivided into those of the direct and those

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(1) Elliot's Debates, Vol. III. p. 229.

(2) The Federalist, No. XXI. p. 183, J. C. Hamilton's Ed.

of the indirect kind." (1) In this connection Hamilton discusses land taxes and poll taxes but he does not give nor attempt to give any definition or explanation of the phrase "direct tax."

In a speech delivered on May 8, 1794, by Mr. Sedgwick, a member of the House of Representatives, he said :- "According to these opinions, a capitation tax, and taxes on land, and on property and income generally, were a direct charge, as well in the immediate as ultimate source of contribution. He had considered these, and those only, as direct taxes in their operation and effects." (2) On June 5, 1794, Congress passed an act to lay duties upon carriages for the conveyance of persons. One Daniel L. Hylton, of Virginia, who was the owner of several carriages objected to this tax as being unconstitutional because it was a direct tax and not laid according to the population. Hylton brought suit in the United States District Court of Virginia to test the constitutionality of this tax. The court decided in favor of the constitutionality of the tax. Hylton appealed to the Supreme Court of the United States where the Decision of the lower court was affirmed. In his opinion, Mr. Justice Chase said :- "I am

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(1) The Federalist, No. XXXVI. p. 275, J. C. Hamiltons Ed.

(2) Elliots Debates, Vol. IV. p. 433.

inclined to think that a tax on carriages is not a direct tax, within the letter or meaning of the Constitution." (1) In speaking of direct taxes, in the same opinion, he said :- " I am inclined to think, but of this I do not give as a judicial opinion, that the direct taxes contemplated by the Constitution, are only two to wit, a capitation or poll tax, simply without regard to property, profession, or other circumstances ; and a tax on land."

The decision of this case did not decide what taxes are included within the term "direct taxes" as used in the Constitution but merely decided that this particular tax was not a direct tax. In the dictum of Justice Chase we find the first attempt to explain the meaning of the phrase "direct taxes".

Among the writings of Hamilton are a series of legal briefs one of which is entitled, "Carriage Tax". In this brief which was evidently prepared with a view to the Iylton case, as he appeared as one of the counsel for the United States, Hamilton said :- "What is the distinction between direct and indirect taxes ? It is a matter of regret that terms so uncertain and vague in so important a point are to be found in the Constitution. We shall be as much at a loss to find any

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(1) Iylton v. The United States, 3 Dallas's Rpts. 150.

disposition of either which can satisfactorily determine the point. We shall seek in vain for any antecedent settled legal meaning to the respective terms, there is none." (1) In the same brief Hamilton suggests that the distinction between direct and indirect taxes be settled by a "species of arbitration" and that under the head of direct taxes be included only "caption or poll taxes, and taxes on lands and buildings, and general assessments, whether on the whole property of individuals or on their whole real or personal estate. All else must of necessity be considered as indirect taxes."

Chancellor Kent in commenting on the Hylton case said:- "The better opinion seems to be, that the direct taxes contemplated by the Constitution were only two, viz. a caption or poll tax, and a tax on land." (2)

Sargent, in his work on the Constitution, in speaking of the subject of taxation says :- "Direct taxes are stated to be only two, namely, a caption, or poll tax, and a land tax; whether others are comprehended in these words appears doubtful." (3)

Turning aside from the decisions of the courts and

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(1) Hamilton's Works, Vol. VII. p. 848.

(2) Kent's Commentaries, Vol. I. p. 257. Twelfth Ed.

(3) Sargent on Constitutional Law, p. 305. Second Ed.

and the opinions of jurists, let us look at the enactment of the national legislature upon this subject of direct taxation. In 1798 a direct<sup>tax</sup> of two million dollars was laid by Congress, in 1813 one of three million dollars, and in 1815 one of six million dollars. In all three of these the tax was laid on lands, improvements thereon and dwelling houses, and slaves. Another direct<sup>tax</sup> was laid in 1861 of twenty million dollars, which was laid on lands, improvements and dwelling houses. Thus it will be seen that Congress in exercising its power of taxation has only levied direct taxes in two forms, namely, capitation taxes and taxes on land and improvements thereon. If Congress had regarded other property as coming within the Constitutional meaning of direct taxes, they would undoubtedly have extended these acts to cover all property taxable in that way. On June 30, 1864, Congress, by an internal revenue act, laid a certain tax upon the amounts insured, renewed, or continued by insurance companies; upon the gross amount of premiums received and assessments by them; and a tax also upon dividends, undistributed sums, and income.

The Pacific Insurance Company, a corporation engaged in business of insurance in California made returns of the different sources of its income in compliance with the above act. The different sources of income thus returned had been re-

ceived by the company in coined money ( the currency of California), and the amounts as returned were the amounts in the form of that currency. The assessor ( against the protest of the insurance company) added to the amounts as returned, the difference in value between the legal tender currency and coined money during the time covered by the returns; thus increasing the aggregate amount of the tax \$ 1989.. The collector being about to sell the companies property, the company paid the increased amount of the tax, under protest, and brought suit against the collector to recover back the amount alleged to have been wrongly paid.

It was contended, on behalf of the company, that the tax was a direct tax and therefore unconstitutional as it was not laid according to the Constitutional requirement. In the opinion of the court, delivered by Mr. Justice Swayne, it was said: "If a tax upon carriages", referring to the Iylton case, "kept for his own use by the owner, is not a direct tax, we see no ground upon which a tax upon the business of an insurance company can be held to belong to that class of revenue charges. To the question under consideration it must be answered, that the tax to which it relates is not a direct tax, but a duty on excise." (1) Again the

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 (1) Pacific Insurance Company v. Saule. 7 Wallace 433.

court decided that the particular tax in question was not a direct tax, but it throws no light on the meaning of that dark phrase "direct taxes". In the opinion of the court it quotes the dictum of Justice Chase in the Hylton Case but does not attempt any explanation of the language there employed.

July 13, 1868, Congress passed an act, in regard to raising revenue, one clause of which enacts as follows : "That every National banking association, State bank, or State banking, shall pay a tax of ten per centum on the amount of notes of any person, State bank, or State banking association, used for circulation and paid out by them after the first day of August, 1868, and such tax shall be assessed and paid in such manner as shall be prescribed by the Commissioner of Internal Revenue."

Under this act the tax of ten per cent was assessed on the Veazie<sup>9</sup> Bank, a banking corporation chartered by the State of Maine, for its bank notes issued for circulation after the day named in the act. The bank, at first, declined to pay the tax alleging it to be unconstitutional. The collector of internal revenue, one Fenno, proceeded to collect the tax whereupon the bank paid it under protest. An unsuccessful claim having been made on the commissioner of internal revenue for reimbursement, the bank brought suit

against Fenno to recover back the amount of the tax which had been paid. The case was carried from the district court of Maine to the United States Supreme Court. The opinion of the court was delivered by Chief Justice Chase, who had previously delivered the opinion in the *Fylton Case* while acting as Associate Justice. In the opinion he spoke at length on the acts of Congress, which have previously been referred to, in regard to direct taxes. In the course of his opinion he says :- "It may be rightly affirmed, therefore, that in the practical construction of the Constitution by Congress, direct taxes have been limited to taxes on land and appurtenances, and taxes on polls, or capitation taxes." (1) The court held that the tax in question was not a direct tax and therefore not unconstitutional.

On June 30, 1864, Congress passed an act, for raising public revenue, among the provisions of which was one for the taxing of incomes. (2)

In June, 1866, the deputy assessor of internal revenue for the proper district in Illinois delivered to William W. Springer a notice requiring him to make out a list of his incomes for the year 1865, and to return the list within ten

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(1) *Veazie Bank v. Fenno*. 8 Wallace 533, at p.544.

(2) 13 U. S. Statutes At Large p. 218.

days. Springer returned the list within the time required, together with a written protest against the authority of the deputy to demand the statement, on the ground that the acts of Congress under which that officer acted were unconstitutional and void.

Upon the refusal of Springer to pay the tax the deputy advertised certain real estate belonging to Springer, situated in the city of Springfield, Illinois, for sale. On March 15, 1867, the property was sold for the amount of the tax, penalty, and costs, the United States becoming the purchaser. Springer still retained the possession of the property and on December 2, 1874, the United States brought action of ejectment against him in the Circuit Court of the United States for the Southern District of Illinois. The case was carried, by writ of error, to the Supreme Court of the United States where a decision was given which clearly seems to settle forever the constitutionality of an income tax, at least so far as its being a direct tax is concerned.

The main defense to the action of ejectment was that the tax was a direct tax and therefore unconstitutional. In passing upon this question the court, in an opinion by Mr. Justice Swayne, said:—"Our conclusions are, that direct taxes, within the meaning of the Constitution, are only cap-

itation taxes, as expressed in that instrument, and taxes on real estate; and that the tax of which the plaintiff in error complains is within the category of an excise or duty." (1)

The late Justice Miller, in his lectures on Constitutional Law, commenting on this case says :- "In regard to this it is sufficient to say that it is believed that no other than a capitation tax, of so much per head, and a land tax, is a direct tax within the meaning of the Constitution of the United States." (2)

We come now to a consideration of the second argument against the Constitutionality of an income tax; namely, the uniform tax argument. The Constitution provides that "All duties, imposts, and excise shall be uniform throughout the United States". (3) What is meant by the word "uniform"? Does it mean that all property that is taxed shall be at the same rate or ratio? Such would be perhaps the natural inference at first thought. The result of this view would be that, as under a tax upon incomes, where there are different rates of assessment, the tax would not be uniform and therefore unconstitutional. But is this the correct view? Does

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 (1) Springer v. United States, 102 U. S. 586 at p. 602.

(2) Miller on the Constitution of the U. S. Lecture V. p.

237. (3) Article I. Sect. VIII. U. S. Constitution.

the Constitution mean that taxes shall be uniform as between the different places where it is assessed? I reply this question can be easily answered. The very words of the Constitution contains the solution of this problem which a number of people seem to regard as very difficult. The Constitution provides that taxes shall be uniform throughout the United States. Justice Miller in speaking on the uniformity of taxation as effected by the Constitutional provision says:- "They are not required to be uniform as between the different articles that are taxed, but uniform as between the different places and different States." (1)

In November, 1884, a case arose in the United States Supreme Court involving an act of Congress which imposed a tax of fifty cents upon the owners of vessels for every passenger brought into this country by them who was not a citizen of the United States. This tax was contested upon the ground that it was not a uniform tax. The court in passing upon the question held that :- A tax is uniform when it operates with the same force and effect in every place where the subject of it is found, and is not wanting in such uniformity because the thing taxed is not equally distributed in all

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(1) Miller on the Constitution of the United States.

parts of the United States. (1) These authorities clearly disprove of this argument against the Constitutionality of a tax upon incomes.

In this brief <sup>al</sup>  
^ view of the authorities it has been my purpose to present the facts as they appear in the records and reports. From these authorities it is my conclusion that an income tax is, as a whole, Constitutional. If in the case now being argued before the Supreme Court the decision is contrary to this conclusion it will be in direct opposition to the opinions and decisions of that court for the past one hundred years.

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(1) Lead Money Cases, 112 U. S. 580 at p. 594.

