
Cordell Hull Writes the Income Tax

It was March of 1913. The Sixteenth Amendment – the Income Tax Amendment – had been ratified the previous month. Pro-income tax Democrats were in control of both the House and the Senate, and the newly elected Democratic president, Woodrow Wilson, also favored an income tax. There was no doubt there would be a federal income tax, and very soon. It was equally clear, however, that any federal income tax enacted in 1913 would be of only limited revenue significance; the exemption level would be high enough to exclude the vast majority of the population from the coverage of the tax, and even the top rates of the tax were likely to be in the single digits.

Although it was clear enough that Congress would enact an income tax, and that the tax would raise a limited amount of revenue from a small number of taxpayers, the details of the income tax were very much up for grabs. Would taxpayers be required to write checks to the government to pay their tax, or would much or all of the tax be collected by withholding at the source? Would there be a single (“flat”) rate of tax, or would the income tax feature a graduated rate structure? Would investment gains from stock and real estate be treated as taxable income, or as nontaxable additions to capital? And what about investment losses? Would they be deductible, or would the income tax simply ignore them? Would payments of federal income tax be deductible in determining one’s taxable income (resulting in a tax-exclusive tax base), or nondeductible (resulting in a tax-inclusive tax base)? Would the taxable unit be the individual in all cases, or would married couples or entire households be treated as taxable units? How would the income tax deal with appreciation in property transferred by gift or bequest? Would the appreciation be taxed to the transferor at the time of the transfer, to the transferee at the time of a later sale, or never? Would the tax base include the rental value of owner-occupied housing?

Would labor income be taxed at lower rates, higher rates, or the same rates as investment income?

Designing an income tax required answering these and dozens – perhaps even hundreds – of similar questions. In the years before 1913, when the political question had been whether there was to be a federal income tax at all, details of income-tax design had received almost no political attention. Now that there was going to be an income tax, however, Congress needed to grapple with these structural issues. As with all federal tax legislation, the task of producing the first draft of an income-tax bill fell to the Ways and Means Committee of the House of Representatives. And on the Committee sat Cordell Hull, a young Democratic Congressman from Tennessee, who for years had been a fervent advocate of a federal income tax, and who by self-directed study had become the undisputed expert in Congress on the intricacies of the taxation of income. Hull was not just willing, but eager, to single-handedly produce the first draft of the income-tax bill, and Committee Chairman Oscar W. Underwood (D., Ala.) was more than happy to let him do so.

Although the income-tax provisions of the tariff bill endured some modifications as they worked their way through Congress, the income tax that became law in October of 1913 very closely resembled, in its technical aspects, the first draft Hull had produced earlier in the year. How good a job did Hull do? The answer depends, of course, on one's expectations. From one perspective, Hull did well enough that, just a few years later, the new income tax could be pressed into service as the most important tax for financing the nation's participation in World War I; well enough that decades later the tax could be converted from a class tax to a mass tax for the financing of World War II; and well enough that more than a century later the income tax, although always under attack, seems firmly ensconced as the most important source of financing for the federal government. From another perspective, however, he did as unsatisfactory a job as one might expect of someone who – despite being very intelligent and remarkably hard working – attempted to do by himself and without formal training a task that would have daunted a host of experts. It took Congress and the Treasury Department decades to correct some of the mistakes and oversights of Hull and the 1913 Congress. And some of the shortcomings of the early modern income tax have resisted all attempts at correction for more than a century.

This book offers a collection of case histories in the technical development of the income tax – the gradual and only partially successful “figuring out” of the income tax by Congress and Treasury. The focus is

not on big-picture issues such as whether there should be an income tax at all, whether an income tax should be a class tax or a mass tax, whether rates should be high or low, and how progressive (if at all) the rate structure should be. Those topics have been ably covered in other studies.¹ The focus is also not on aspects of the development of the federal income tax where landmark Supreme Court cases have played leading roles. Perhaps because of the enduring influence of C. C. Langdell's introduction of the case method of law school instruction in the late nineteenth century,² the stories of the leading Supreme Court federal income-tax cases have been ably told, and are well known to tax practitioners and scholars.³

With a handful of notable exceptions, however, little has been written about the early technical development of the income tax by Congress and the Executive Branch in areas where the Supreme Court did not play a leading role. In two excellent articles, Marjorie Kornhauser has excavated the early histories of the taxation of capital gains and of the nonrecognition of gain on like-kind exchanges.⁴ And Steven A. Bank's monograph on the transformation of the corporate tax covers its technical development as well as the big-picture political debates.⁵ However, there is little else in this vein.

This book offers a selective – very far from comprehensive – description of the early technical development of the federal income tax. Three criteria guided the selection of the topics covered in the book – that the topic is important to a basic understanding of today's federal income tax, that a historical perspective on the topic deepens understanding of the policy stakes, and that there is an interesting and little-known story to be told.

¹ On the big-picture political development of the income tax over many decades, see John F. Witte, *The Politics and Development of the Income Tax* (1985) and W. Elliott Brownlee, *Federal Taxation in America: A Short History* (1996). For excellent political (rather than technical) studies of aspects of the federal income tax, see Steven A. Bank, Kirk J. Stark, and Joseph J. Thorndike, *War and Taxes* (2008); Joseph J. Thorndike, *Their Fair Share: Taxing the Rich in the Age of FDR* (2013); and Ajay K. Mehrotra, *Making the Modern American Fiscal State: Law, Politics, and the Rise of Progressive Taxation, 1877–1929* (2014).

² See generally Bruce A. Kimball, *The Inception of Modern Professional Education: C. C. Langdell, 1826–1906* (2009).

³ Conveniently, the stories of ten leading Supreme Court income tax cases, told by ten different scholars, are available in a single volume. See generally *Tax Stories: An In-Depth Look at Ten Leading Federal Income Tax Cases* (Paul L. Caron, ed., 2003).

⁴ See generally Marjorie E. Kornhauser, *The Origins of Capital Gains Taxation: What's Law Got to Do with It?*, 39 *Sw. L. J.* 869 (1985); Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 *S. Cal. L. Rev.* 397 (1987).

⁵ See generally Steven A. Bank, *From Sword to Shield: The Transformation of the Corporate Income Tax, 1861 to Present* (2010).

Considered together, the stories told here suggest some insights into how tax laws – and perhaps laws more generally – evolve over time, and into the circumstances which determine whether Congress corrects early mistakes or allows those mistakes to persist.

After this opening chapter on Cordell Hull and the 1913 income tax, Chapters 2 through 9 focus on the technical development of various aspects of the income tax. The primary focus is on the first decade or so of the development of the federal income tax – from 1913 to the mid-1920s. However, of the eight stories told, only two (the conversion of the income tax to a tax-inclusive base, and the nontaxation of homeowners' imputed rental income) reach definitive conclusions in the first decade of the tax; the telling of the other stories requires attention to later decades as well.

Chapters 2 and 3 describe how the revenue needs of World War I, arising just four years after the introduction of the income tax, necessitated the correction of mistakes in the design of the 1913 tax – mistakes which Congress might have left unresolved for decades if income-tax rates had remained in the single digits. Chapter 2 recounts how Congress adopted an elaborate withholding mechanism under the 1913 income tax, comprehensively rejected withholding just four years later during World War I, and then – ironically enough – returned to income-tax withholding during World War II. Chapter 3 involves a much shorter time span. It describes how Congress enacted a tax-exclusive income-tax base in 1913 (by allowing a deduction for federal income taxes paid), only to decide four years later that it had made a mistake. The story ends in 1917; once Congress had converted the income tax to a tax-inclusive base, it never revisited the issue.

Chapters 4 and 5 tell the parallel stories of two early conceptual errors which have persisted in the income tax to this day – the tax-free step-up in the basis of appreciated assets transferred at death, and the deduction for unrealized appreciation in property donated to charity. Chapter 4 explains how the twin errors arose in the early years of the income tax from legislative inattention to detail and administrative unfamiliarity with principles of income-tax design. Chapter 5 describes how those taxpayer-favorable errors developed powerful constituencies able to defeat concerted reform efforts in the 1970s, 1980s, and early 1990s.

Chapters 6 and 7 offer two examples of Congress muddling through for decades – experimenting with almost every conceivable tax treatment of a topic, before finally settling (more or less) on a particular approach. The convoluted development of the income-tax treatment of capital losses is the subject of Chapter 6. During the first three decades of the income tax,

Congress at one time or another enacted virtually every possible treatment of capital losses. Chapter 7 recounts the early controversies concerning marriage penalties and bonuses in the personal exemptions of the income tax, and concerning the relative income-tax burdens imposed on single and married taxpayers. As with capital losses, in the first thirty years of the income tax Congress was unable to settle for long on any one approach to these issues.

Chapters 8 and 9 involve two areas where Congress went its own way in the early years of the income tax, disregarding both precedent from the income taxes of other jurisdictions and the advice of income-tax experts. Chapter 8 describes how the 1913 legislation failed to specify whether the imputed rental value of owner-occupied housing was included in the base of the income tax, and how Treasury wrestled with the interpretive question before deciding that imputed rents were not taxable. The issue was settled in the first year or so of the income tax, and neither Congress nor Treasury has since revisited it. Chapter 9 tells a story with a similar beginning, but a very different ending – how Congress in 1913 ignored both precedent from other jurisdictions and expert advice in not taxing labor income more lightly than investment income, and how in later decades Congress experimented with several methods of tax favoritism for earned income.

Chapter 10 departs from a focus on particular aspects of the law to describe a long-running question-and-answer column in the *Wall Street Journal* during the first decade-plus of the life of the income tax, “Answers to Inquirers.” The column provides a fascinating portrait of a nation of affluent taxpayers coming to grips with the complexities of the new income tax.

Chapter 11 concludes by pondering what lessons might be drawn from the histories related in the preceding chapters. It suggests several lessons, the most important of which concerns the circumstances under which Congress did or did not correct its early mistakes. Although the stories in this book involve a number of policy judgments about which reasonable persons could differ, and also some situations where a tax rule that was appropriate under one set of economic or social conditions became inappropriate when conditions changed, there are also a number of instances in which early income-tax design choices were simply wrong. There is an internal logic to the taxation of income, and several of the early design choices described in the following chapters were adopted because the legislators and administrators working on the tax did not fully understand that logic. Such choices can fairly be described not as debatable policy choices, but simply as mistakes.

Running through the stories of those mistakes is the question of what determines when or whether the errors are corrected. If an error works to the benefit of taxpayers (as is true of most of the errors considered in this book), the error will fairly quickly develop both an expert consensus that it should be corrected and a constituency of taxpayers opposed to its correction. The opponents of reform tend to prevail when the revenue cost of keeping the error is moderate – in other words, if the federal government can afford to leave the error in the Internal Revenue Code. The survival of the tax-free basis step-up at death and of the charitable deduction for unrealized appreciation are examples of this phenomenon. Reformers, on the other hand, succeed when retention of the error poses an existential threat to the revenue-raising capacity of the income tax. Congress has been able to correct mistakes fairly promptly once it becomes clear that a failure to do so would have devastating consequences for federal revenues. When the high tax rates necessitated by World War I exposed the revenue-raising inadequacy of a tax-exclusive base, Congress quickly shifted to a tax-inclusive base and has never looked back. Similarly, Congress abandoned the unlimited deductibility of capital losses against ordinary income once it became clear that the continuation of unlimited deductibility would have been devastating to the fisc.

1.1 Cordell Hull

Because everything described in this book is an outgrowth of the 1913 income tax, and because the 1913 income tax in its technical aspects was to a remarkable extent the work of a single person, one way to begin the story of the income tax is with that person. Cordell Hull was born on October 2, 1871, in a farmhouse in the foothills of the Cumberland Mountains, near the town of Byrdstown, Tennessee.⁶ He was the third of five children – all boys – of William and Elizabeth Hull. William Hull's hundred-acre farm was sufficiently profitable for him to afford to hire a teacher for Cordell, his brothers, and several neighbor children; Cordell's first schooling was in a schoolroom in the Hull home. Based on interviews with people who knew Cordell as a child, Hull's biographer Harold B. Hinton wrote that young Cordell was "an introspective, bookish boy who took little or no part in the fishing and swimming expeditions of others. His outlook on life was

⁶ Information on the childhood and early career of Cordell Hull is drawn from Harold B. Hinton, *Cordell Hull: A Biography* (1942).

serious, and he preferred reading to idling away the days as did most of the boys his age.⁷

When Cordell was sixteen, his father sent him – along with his two older brothers – to boarding school at the Montvale Academy in Celina, the county seat. His teacher there, Joseph Simon McMillin, was the younger brother of Tennessee Democratic politician Benton McMillin, who later served as Governor of Tennessee, and who still later represented Tennessee in the House of Representatives. Simon brought his promising young student to Benton's attention, and Benton was to become an important mentor for Cordell in the early years of Cordell's political career.

From an early age, Cordell was determined to become a lawyer. In the spring of 1891, at the age of nineteen, he completed the one-year law course at Cumberland University in Lebanon, Tennessee, and was admitted to the Tennessee bar. Backed financially by his father, who by then had become a very successful local businessman, Cordell hung out his law office shingle in Celina. He soon decided to run for the state legislature as a Democrat, and was elected in the autumn of 1892, shortly after his twenty-first birthday. After serving two two-year terms he did not run for reelection, and resumed devoting all his time to the practice of law. In 1898, at the outbreak of the Spanish-American War, Hull was commissioned as a captain in the Fourth Tennessee Volunteers. The Fourth Tennessee was organized too late to take part in the brief hostilities, but Hull and his regiment were sent to Cuba for the postwar occupation.

In 1901, Hull moved his law practice to Gainsboro, Tennessee, where he formed a partnership with a young Republican lawyer by the name of John J. Gore (a distant relative of the famous Gore political family of Tennessee). Less than two years later, Governor James B. Frazier appointed Hull to a judgeship in Tennessee's Fifth Judicial District. Hull served as a circuit-riding trial judge, spending only about one month of each year at home.

After three years on the bench, Hull decided to run for Congress in 1906. He was elected as a Democrat representing Tennessee's Fourth District, occupying the seat that until six years before had been held by his early mentor Benton McMillin. Hull served eleven terms in the House of Representatives (1907–21 and 1923–31), before being elected to the Senate in 1930. Franklin Delano Roosevelt appointed him Secretary of State in 1933. Hull became the longest-serving Secretary of State in American history before resigning for health reasons in November of 1944.

⁷ *Id.*, 25.

Hull worked tirelessly during World War II toward the creation of the United Nations. In poor health in 1943, he flew to Moscow to work out the Declaration of Moscow, committing the United States, Great Britain, the Soviet Union, and China to supporting the establishment of an international organization dedicated to the maintenance of international peace and security.⁸ In his 1944 letter accepting Hull's resignation as Secretary of State, Roosevelt called Hull "the father of the United Nations" and "the one person in all the world who has done the most to make this great plan for peace an effective fact."⁹ Largely – although not exclusively – on account of Hull's efforts on behalf of the United Nations, he was awarded the Nobel Peace Prize in 1945.¹⁰ Although the fact does not loom large in the public consciousness today, Hull has – remarkably enough – strong claims to being the father of both the federal income tax and the United Nations. There would be, of course, considerable disagreement as to the honor attached to those two titles.

In his memoirs (published in 1948) Hull recounted that, when he arrived in Washington as a freshman congressman in December of 1907, he was already "vitally interested in the income tax, having studied it for nearly fifteen years."¹¹ He had "examined income-tax law from the Civil War period on," he "had closely followed the great debates of 1893 and 1894" preceding the enactment of the 1894 income tax, and he had "deeply pondered" the 1895 decision of the Supreme Court in the *Pollock* case¹² invalidating the 1894 income tax on constitutional grounds.¹³ Hull had a particularly keen interest in the income tax because Benton McMillin had drafted the 1894 income-tax legislation as a member of the House Ways and Means Committee.¹⁴ Hull the memoirist recalled that he had been "keenly impressed with the income-tax doctrine in the light of our lopsided tax conditions in 1907, in which wealth was shirking its share of the tax burdens."¹⁵ He had hoped that, if he and like-minded colleagues could persuade Congress to enact another federal income tax, the Supreme Court might reject its *Pollock* precedent and uphold the new tax.¹⁶

⁸ Hull Wins Nobel Peace Prize; Red Cross Gets 1944 Award, *N.Y. Times*, November 13, 1945, 1.

⁹ *Id.*

¹⁰ *Id.*

¹¹ Cordell Hull, *The Memoirs of Cordell Hull* 48 (1948).

¹² *Pollock v. Farmers' Loan & Tr. Co.*, 157 U.S. 429 (1895), *aff'd on reh'g*, 158 U.S. 601 (1895).

¹³ Hull, *supra* note 11, 48.

¹⁴ *See id.*

¹⁵ *Id.*, 49.

¹⁶ *See id.*

The income tax featured prominently in Hull's maiden speech before the House in March of 1908. Hull juxtaposed his own support of the income tax – and according to Hull, the support of 90 percent of Democrats in 1908 – with the Republican party platform of 1894, which had declared that “an income tax of any sort is odious and will bring odium upon any party blind enough to support it,” and which had predicted “the funeral of the political party which imposes such a burden.”¹⁷ Hull also talked about the income tax “to any Member of either House of Congress who was willing to listen” to him.¹⁸ He was so persistent that even some supporters of income taxation reached the point where they “would turn and walk in another direction” when they saw Hull approaching.¹⁹

Although by his own admission Hull “got nowhere with income tax in the Sixtieth Congress,”²⁰ he persevered in his efforts. He “began to acquaint [himself] with income-tax questions and conditions in foreign countries.”²¹ He asked the State Department to collect for him information on foreign income taxes, and he inserted into the *Congressional Record* much of what the Department sent him, “hoping that other Members would read it.”²² In March of 1909, Hull delivered on the floor of the House a lengthy speech devoted entirely to the income tax. Decrying the existing protective tariff as imposing “the chief burdens of government on those least able to bear them,”²³ and as permeated by “the spirit of greed and avarice,”²⁴ Hull called for “a gradual reduction of the tariff to a revenue basis,” with the revenue lost from the tariff reduction replaced by the introduction of “the best, the fairest, the most equitable system of taxation that has yet been devised – the taxation of incomes.”²⁵ Despite Hull's rhetorical fervor, his actual proposal was far from radical (at least viewed with the benefit of more than a century's-worth of hindsight): an income tax imposed on incomes above \$4,000 (an exemption level high enough to free well over 90 percent of the population from tax) at a flat rate of 2 percent.²⁶

Acknowledging the existence of the *Pollock* decision, and believing a constitutional amendment overruling *Pollock* to be “impractical, if not

¹⁷ 42 Cong. Rec. 3520 (March 18, 1908).

¹⁸ Hull, *supra* note 11, 49.

¹⁹ *Id.*, 49–50.

²⁰ *Id.*, 49.

²¹ *Id.*, 50.

²² *Id.*

²³ 44 Cong. Rec. 533 (March 29, 1909).

²⁴ *Id.*, 532.

²⁵ *Id.*, 533.

²⁶ *See id.*

entirely impossible,” Hull urged Congress to force the Supreme Court to reconsider *Pollock* by enacting a new income tax.²⁷ “It is entirely proper,” he asserted, “that Congress should pass another income-tax act, again raising the important questions deemed to have been erroneously decided by the Supreme Court heretofore, and by this course secure a rehearing upon these controverted questions.”²⁸

With great prescience, Hull argued that it was “exceedingly important” that an income tax be enacted and upheld before the next “war with a great naval power,” because in the event of such a war, “our foreign commerce would be reduced to a minimum and little revenue would be derived from imports,” making “indispensable” the revenue from the proposed income tax.²⁹ The most remarkable passage in the speech, however, was Hull’s response to the objection that an income tax would “make liars of the rich”:

The astonishing objection to this tax is sometimes offered ... that rather than contribute a small portion of their colossal incomes to the Government that protects them in their life, liberty, and property they would unhesitatingly commit perjury. I believe this is a slander upon even the idle holders of idle wealth and the possessors of colossal incomes, but if this shameful defense is true, then I say that every tax dodger should be rigorously subjected to the thumbscrews of the law.³⁰

1.2 The 1913 Income Tax in the House of Representatives

Although Congress did not enact an individual income tax in 1909, Hull’s 1909 championing of an income tax paved the way for the income tax of 1913. In a chance meeting on a train in 1909, Hull found a receptive audience for his income-tax advocacy in Senator Joseph W. Bailey (D., Tex.). “Becoming more and more interested” in an income tax as he listened to Hull, Bailey promised Hull to do everything he could to promote an income tax when the pending tariff bill reached the Senate.³¹ As Hull told the story in his memoirs, the “Old Guard crowd” in the Senate, led by Nelson W. Aldrich (R., R.I.), fearing that Bailey’s income-tax proposal might become law, decided to head it off by proposing instead a constitutional amendment overruling *Pollock* – an amendment the Old Guard was confident (again, according to Hull) would never be ratified by the requisite three-quarters of the states.³²

²⁷ *Id.*, 534.

²⁸ *Id.*, 535.

²⁹ *Id.*

³⁰ *Id.*, 536.

³¹ Hull, *supra* note 11, 60.

³² *Id.*