

From
Cracking the Code
The Fascinating Truth About Taxation In America

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Part One

(The Nature Of The Law)

"Come, we shall have some fun now!" thought Alice. "I'm glad they've begun asking riddles-- I believe I can guess that," she added aloud.

"Do you mean that you think you can find out the answer to it?" said the March Hare.

"Exactly so," said Alice.

"Then you should say what you mean," the March Hare went on.

"I do," Alice hastily replied; "at least-- at least I mean what I say-- that's the same thing, you know."

"Not the same thing a bit!" said the Hatter. "Why, you might just as well say that 'I see what I eat' is the same thing as 'I eat what I see'!"
"You might just as well say," added the March Hare, "that 'I like what I get' is the same thing as 'I get what I like'!"

"You might just as well say," added the Dormouse, which seemed to be talking in its sleep, "that 'I breathe when I sleep' is the same thing as 'I sleep when I breathe'!"

About Taxes- Direct v. Indirect



United States Constitution, Article 1, Section 9: *"No capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."*

Before we delve into the history and evolution of the "income" tax, which is the focus of this first part of 'Cracking the Code', it is worthwhile to discuss the general nature of direct taxes and excises. Understanding the principles of the two different classes of taxes, and the jurisdictional issues with which they are connected, is not critical to understanding the tax laws-- the words with which those laws are written clearly express their meanings and limitations. Nonetheless, I believe a comprehension of why those laws are written as they are will be beneficial to the reader. Furthermore, while this book addresses only a few particular areas of the law in detail, the basic principles which will be discussed in this section apply much more broadly, and should serve the interests of the reader accordingly.

All Constitutionally valid federal taxes must be either direct or indirect. Any tax laid on property or people, and thus unavoidable, is a direct tax. Under the Constitution, federal direct taxes must be apportioned. Apportionment means the division of the total cost of a tax (such as a \$10 per house tax X 100 houses = \$1000) among the states (and DC) proportionate to their percentage of the total national population, with the resulting amount being due from the state or district. The state or district is free to collect the money however it wishes.

Because of this Constitutional requirement, once someone has come into ownership of money or other property, by fulfilling the terms of a contract, through inheritance, by way of a dividend distribution or however it has been done, that property can only be taxed by means of an apportioned tax. Capitulations, or taxes on people-- either simply for being there, or on their unprivileged activities, must also be apportioned.

CAPITATION: A poll tax; an imposition which is yearly laid on each person according to his estate and ability.

Bouvier's Law Dictionary, 6th Edition

"The taxes which, it is intended, should fall indifferently upon every different species of revenue, are capitation taxes,"... "Capitation taxes, if it is attempted to proportion them to the fortune or revenue of each contributor, become altogether arbitrary. The state of a man's fortune varies from day to day, and without an inquisition more intolerable than any tax, and renewed at least once every year, can only be guessed at."... "Capitation taxes, so far as they are levied upon the lower ranks of people, are direct taxes upon the wages of labour, and are attended with all the inconveniences of such taxes."... "In the capitation which has been levied in France without any interruption since the beginning of the present century, the highest orders of

people are rated according to their rank by an invariable tariff; the lower orders of people, according to what is supposed to be their fortune, by an assessment which varies from year to year."

This is how Adam Smith, the Father of Economics, defines and describes "capitations" in Book V, CH. II, Art. IV of his seminal treatise on economics and taxation, 'The Wealth of Nations'. This book, published in 1776, instantly rocketed to the heights as the absolute authority on these subjects throughout the Western World. It remains the single most comprehensive resource on the meaning of the Constitutional term "capitation".

Smith deplores capitations as inequitable, inflationary, counterproductive, and destructive of liberty. Importantly, he makes clear that any tax levied upon and/or measured by the exercise of a basic right-- such as the right to life, liberty, the ownership of property, working, or engaging in trade-- is a capitation. Indeed, capitations are alternately known as (and get their name from) "head taxes", because they fall directly upon the head of the citizen. They must be paid by the citizen, and out of his own funds-- simply because he is there, maintaining and exercising his natural powers.

The framers of the Constitution were avid and serious students of Smith's enormously popular work. (During the turmoil of the revolutionary war years alone, Americans bought the equivalent of more than 233,000 copies if proportioned to today's population. This is a solid testament to the esteem in which this substantial and serious work-- 976 pages of densely-packed small type in my copy-- was held.) Agreeing wholeheartedly with Smith's recognition of the evils of unchecked capitations, the framers specifically prohibited such practices in Article 1 of the Constitution.

Any tax which is not apportioned must have the limiting characteristics of indirect taxes, which is to say, it can only be laid upon a wholly optional activity. Indirect taxes, which are

denominated as imposts, duties, and excises, are also generally funded by someone other than the remitter (the liable party who sends in the money). Indirect taxes generally take the form of a return to the state of a portion of the benefit conveyed by a special privilege, such as the revenue from trade across the national borders, the salary or other revenue from a public office, or gains of, or from investment in, government corporations and instrumentalities. Indirect taxes can also be attendant upon the purchase of a taxed, optional article, by which transaction the vendor becomes liable for a tax paid with the consumer's money. All federal taxes must be either direct or indirect-- therefore they must all be either apportioned or optional.

Applying these principles, we can see that while a tax on shopping in general would be a capitation, or direct tax, a tax laid upon some particular thing for which one might or might not shop at one's discretion would be indirect, and thus not a capitation. Similarly, a tax upon being a postal inspector, for instance, to which no one has a right, is an indirect tax, while a tax upon being a graphic artist, to which anyone has a right, would be a capitation. A tax accompanying each transaction involving a taxable article that takes place in your store is an indirect tax, while a tax on simply having your store open for business-- even if you might be able to recover it from customers-- would be a capitation. Black's Law Dictionary, 5th edition, puts the distinction succinctly:

"[A direct tax is one] which is demanded from the very persons who it is intended or desired should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he should indemnify himself at the expense of another".

The term "excise" is particularly illustrative of the nature of indirect taxes as specifically on activities. "Excise" means "a

piece of the action". Excise taxes particularly tax activities associated with the receipt or transfer of property, and the exercise of profitable privilege. In the case of an "income" tax, for instance, it is the activity which produces the property we commonly call 'income' which is being taxed. The income enters into the picture only as a means of measuring the amount (or value) of the taxable activity:

"The income tax is, therefore, not a tax on income as such. It is an excise tax with respect to certain activities and privileges which is measured by reference to the income which they produce. The income is not the subject of the tax: it is the basis for determining the amount of tax." F. Morse Hubbard, Treasury Department legislative draftsman. House Congressional Record March 27th 1943, page 2580

"When a court refers to an income tax as being in the nature of an excise, it is merely stating that the tax is not on the property itself, but rather it is a fee for the privilege of receiving gain from the property. The tax is based upon the amount of the gain, not the value of the property." John R. Luckey, Legislative Attorney with the Library of Congress, "Frequently Asked Questions Concerning The Federal Income Tax" (C.R.S. Report for Congress 92-303A (1992)).

In addition to prescriptions as to how taxes are laid, there are also jurisdictional issues involved in taxation. A government cannot tax-- directly or indirectly-- any thing or any activity outside either its legal or its geographical jurisdiction.

The Constitution establishes a particular geographical area of jurisdiction for the federal government, which includes

the District of Columbia, such places as may be formally ceded to that government by the several States for forts, magazines and other needful buildings, and the various territories and possessions:

"The Congress shall have Power To exercise exclusive Legislation in all Cases whatsoever, over such District (not exceeding ten Miles square) as may, by Cession of particular States, and the Acceptance of Congress, become the Seat of the Government of the United States, and to exercise like Authority over all Places purchased by the Consent of the Legislature of the State in which the Same shall be, for the Erection of Forts, Magazines, Arsenals, dock-Yards, and other needful Buildings." U.S. Constitution Article 1, Section 8, Clause 17.

Within this geographical jurisdiction, the United States Congress is permitted to exercise legislative authority of the same general character as that enjoyed by the union States.

All other areas within the union are under the exclusive jurisdiction of one of the several States, and are thus insulated from federal authority except in regard to certain enumerated powers, and federal governmental property and contract rights. As was declared by counsel for the United States before the Supreme Court in *United States v. Bevans*, 16 U.S. 336 (1818):

"The exclusive jurisdiction which the United States have in forts and dock-yards ceded to them, is derived from the express assent of the states by whom the cessions are made. It could be derived in no other manner; because without it, the authority of the state would be supreme and exclusive therein,"

with the court, in its ruling agreeing:

"What, then, is the extent of jurisdiction which a state possesses? We answer, without hesitation, the jurisdiction of a state is co-extensive with its territory;"

In *New Orleans v. United States*, 35 U.S. (10 Pet.) 662, 737 (1836), the court reiterates this principle:

"Special provision is made in the Constitution for the cession of jurisdiction from the States over places where the federal government shall establish forts or other military works. And it is only in these places, or in the territories of the United States, where it can exercise a general jurisdiction."

In 1956, the Eisenhower administration commissioned the Interdepartmental Committee for the Study of Jurisdiction Over Federal Areas within the States. The pertinent portion of its report points out that,

"It scarcely needs to be said that unless there has been a transfer of jurisdiction (1) pursuant to clause 17 by a Federal acquisition of land with State consent, or (2) by cession from the State to the Federal government, or unless the Federal Government has reserved jurisdiction upon the admission of the State, the Federal Government possess no legislative jurisdiction over any area within a State, such jurisdiction being for exercise entirely by the States, subject to non-interference by the State with Federal functions, and subject to the free exercise by the Federal Government of rights with respect to the use, protection, and disposition of its property".

Non-geographical jurisdiction, simply stated, involves a government's authority over itself and its own creations. A thorough discussion of this type of jurisdiction could easily fill a book of its own; it is sufficient for the present to observe that such jurisdiction *does not* involve (or establish) coercive

authority to burden-- by taxation or otherwise-- any natural person in the exercise of his or her Rights.

"It could hardly be denied that a tax laid specifically on the exercise of those freedoms would be unconstitutional." United States Supreme Court, *Murdock v. Pennsylvania* 319 U.S. 105 480-487, (1943)

Because the Rights retained by the people are many and (mostly) undefined, the practical effect of this limitation is to confine the lawful application of excises to the benefits of privilege granted or facilitated by the government; in other words, gains arising from the exercise of federal power either by, or for the special benefit of, the recipient of the gains.

"The terms 'excise tax' and 'privilege tax' are synonymous. The two are often used interchangeably." American Airways v. Wallace 57 F.2d 877 (1932)

"Excises are taxes laid upon the manufacture, sale or consumption of commodities within the country, upon licenses to pursue certain occupations and upon corporate privileges." "...the requirement to pay such taxes involves the exercise of privilege..." U. S. Supreme Court, *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911).

"A tax upon the privilege of selling property at the exchange... ...differs radically from a tax upon every sale made in any place." "A sale at an exchange differs from a sale made at a man's private office or on his farm, or by a partnership, because, although the subject- matter of the sale may be the same in each case, there are at an exchange certain advantages, in the way of finding a market, obtaining a price, the saving of time, and in the security of payment, and

other matters, which are more easily obtained there than at an office or a farm." U. S. Supreme Court, Nicol v. Ames, 173 U.S. 509 (1899)

"The 'Government' is an abstraction, and its possession of property largely constructive. Actual possession and custody of Government property nearly always are in someone who is not himself the Government but acts in its behalf and for its purposes. He may be an officer, an agent, or a contractor. His personal advantages from the relationship by way of salary, profit, or beneficial personal use of the property may be taxed..." U. S. Supreme Court, United States v. County of Allegheny, 322 US 174 (1944)

The Supreme Court has expressed the character of this limitation several different ways, among them by unambiguously and repeatedly striking down as unconstitutional over the years a number of attempted tax structures the objects of which could not be proven related to any delegated power of congress. In its most explicit declaration in this regard, the court says:

"[A]ll that Congress would need to do, hereafter, in seeking to take over to its control any one of the great number of subjects of public interest, jurisdiction of which the states have never parted with, and which are reserved to them by the Tenth Amendment, would be to enact a detailed measure of complete regulation of the subject and enforce it by a so-called tax upon departures from it. To give such magic to the word 'tax' would be to break down all constitutional limitation of the powers of Congress and completely wipe out the sovereignty of the states". Bailey v. Drexel Furniture Co., 259 U.S. 20 (1922)

Such rulings illuminate and enforce the requirement upon Congress to confine its taxing efforts to activities associated

with the implementation of its delegated authority, such as the conduct of public offices.

We have the benefit of two recent (though indirect) examples of the effect and meaning of this judicial recognition of the jurisdictional limitations on federal taxes. In the cases of *United States v. Lopez* 514 U.S. 546 (1995) and *Jones v. United States*, 99-5739, (2000), the U.S. Supreme Court threw out federal laws restricting the possession of a gun within 1000 feet of a school; and punishing arson; respectively. The court observed that neither act was supported by any credible foundation in any enumerated power of congress within the Constitution. Did Congress come right back and impose a \$10,000,000 tax on possession of a gun near a school; or upon the act of pouring and lighting gasoline in a house, which would have effectively accomplished its purposes? It did not, because it cannot.

Focusing the principles of the lawful limitations upon federal taxation on the "income" tax which we are about to particularly explore, we can perceive that unprivileged, outside-of-federal-jurisdiction gains cannot be taxed indirectly by the federal government. As the U.S. Supreme Court says in *Butcher's Union Co. v. Crescent City Co.*, 111 U.S. 746 (1883) (concurring opinion):

"The right to follow any of the common occupations of life is an inalienable right,..."

and,

"It has been well said that 'the property which every man has in his own labor, as it is the original foundation of all other property, so it is the most sacred and inviolable. The patrimony of the poor man lies in the strength and dexterity of his own hands, and to hinder his employing this strength and dexterity in what manner he thinks proper, without injury to his neighbor,

is a plain violation of this most sacred property.' Smith, Wealth Nat. bk. 1, c. 10.;

and in *Coppage v. Kansas*, 236 U.S. 1 (1915):

"Included in the right of personal liberty and the right of private property- partaking of the nature of each- is the right to make contracts for the acquisition of property. Chief among such contracts is that of personal employment, by which labor and other services are exchanged for money or other forms of property."

Other courts have expressed this principle as well:

"Since the right to receive income or earnings is a right belonging to every person, this right cannot be taxed as privilege." *Jack Cole Company v. Alfred T. MacFarland*, Commissioner, 206 Tenn. 694, 337 S.W.2d 453 Supreme Court of Tennessee (1960)

"[Although the Legislature may declare as privileges and tax as such for State revenue purposes those pursuits and occupations that are not matters of common right], the Legislature has no power to declare as a privilege and tax for revenue purposes occupations that are of common right." *Sims v. Ahrens*, 167 Ark 557, 271 SW 720 (Ark. S. Ct. 1925)

The proceeds of such work can only be taxed, of course, with an apportioned direct tax. Widespread (and deliberately?) cultivated misunderstandings to the contrary notwithstanding, no attempt to violate these principles is found within the Internal Revenue Code, as will soon be made clear.

Now, on to the main story...