The Character of Income

Art. 1, section 2, cl. 3 of the United States Constitution requires that Congress apportion all direct taxes among the States. In *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, aff. reh., 158 U.S. 601 (1895), the Supreme Court held as unconstitutional the income tax part of the Tariff Act of 1894, 28 Stat. 509, 553, ch. 349, and determined that it constituted an unapportioned direct tax. This decision necessitated the adoption of the Sixteenth Amendment to the United States Constitution, after which Congress enacted in October, 1913, the Tariff Act of 1913, which imposed at Section II another income tax. 38 Stat. 114, 166, ch. 16. In consequence of the decision in *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1 (1916), Congress repealed the 1913 income tax and enacted another one in 1916. 39 Stat. 756, ch. 463. Virtually every two years thereafter, Congress amended that act, eventually enacting in 1939 the Internal Revenue Code of 1939. 53 Stat. Part 1. In August, 1954, Congress re-arranged the provisions of the 1939 Code by means of the Internal Revenue Code of 1954, 68 A Stat. The current 1986 tax code is simply the renamed 1954 Internal Revenue Code. Pub. L. 99–514, 100 Stat. 2085, 2095 (section 2).

The Supreme Court has repeatedly observed that, through these income tax acts, Congress reached the full extent of the taxing power authorized by the Sixteenth Amendment. See *Eisner v. Macomber*, 252 U.S. 189, 203 (1920)("we are unable to see how it can be brought within the meaning of 'incomes' in the Sixteenth Amendment, it being very clear that Congress intended in that act to exert its power to the extent permitted by the amendment.");[1] *Irwin v. Gavit*, 268 U. S. 161, 166 (1925)("Congress intended to use its power to the full extent."); *Douglas v. Willcuts*, 296 U. S. 1, 9 (1935)("We think that the definitions of gross income * * * are broad enough to cover income of that description. They are to be considered in the light of the evident intent of the Congress 'to use its power to the full extent.'"); *Helvering v. Clifford*, 309 U. S. 331, 334 (1940)("The broad sweep of this language indicates the purpose of Congress to use the full measure of its taxing power within those definable categories."); and *Commissioner v. Kowalski*, 434 U.S. 77, 82 (1977)("The starting point in the determination of the scope of 'gross income' is the cardinal principle that Congress in creating the income tax intended 'to use the full measure of its taxing power.'").

But, what constitutes the full reach of the federal income tax as authorized by the Sixteenth Amendment? To what extent are "salaries" and "wages" within the scope

[1] In this case, the Supreme Court also defined income as a "a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital, however invested or employed, and coming in, being 'derived'– that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal– that is income derived from property." 252 U.S. at 207.

of this amendment and the federal income tax laws? Do prior income tax acts and applicable regulations assist in answering this question?

A fundamental rule of statutory construction is that acts in *pari materia* are to be read and construed together. "[A]ll acts in *pari materia* are to be taken together, as if they were one law." *United States v. Stewart*, 311 U.S. 60, 64 (1940). See also *Sanford's Estate v. Commissioner*, 308 U.S. 39, 44 (1939); and *Harrington v. United States,* 78 U.S. 356, 365 (1877). This is particularly true regarding the federal tax laws. While there are many such acts, all of them are regarded as parts of one system of taxation, and construction of any one act may be assisted by review of other acts in this same "system." See *United States v. Collier*, Fed.Cas. No. 14,833 (Cir. Ct. S.D.N.Y. 1855). A prior tax act, even one which has been repealed, still is to be considered as explanatory of later acts. See *Southern Ry. Co. v. McNeill*, 155 F. 756, 769 (Cir. Ct. E.D.N.C. 1907).

The 1894 federal income tax act which was a part of the Tariff Act of 1894 imposed the tax on the "gains, profits, or income * * * derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation carried on in the United States or elsewhere." 28 Stat. 553. In the Tariff Act of 1913, the section imposing the tax was worded slightly different:

> "[T]he net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent". 38 Stat. 167.

After this Court's decision in *Brushaber*, *supra*, Congress repealed the 1913 income tax act and enacted a new one. The Revenue Act of 1916, 39 Stat. 756, 757, ch. 463, followed its predecessors and defined the subject of the tax, "income", as follows:

> "INCOME DEFINED.
> "SEC. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent,

> dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever".

A year later, Congress amended the 1916 act by means of the Revenue Act of 1917, 40 Stat. 300, 329, ch. 63. Again, the phrase, "gains, profits, and income," appeared in this act in a section amending the section of the 1916's act defining "income":

> "SEC. 1200. That subdivision (a) of section two of such Act of September eighth, nineteen hundred and sixteen, is hereby amended to read as follows:
> "(a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income, derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

The Revenue Act of 1918, 40 Stat. 1057, 1065, ch. 18, contained this "gains, profits, and income" phrase in its section defining "gross income":

> "GROSS INCOME DEFINED.
> "SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term 'gross income'—
> "(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

This same language was used to define "gross income" in sections 213 of the Revenue Act of 1921 (42 Stat. 227, 237-38, ch. 136); the Revenue Act of 1924 (43 Stat.

253, 267, ch. 234); and the Revenue Act of 1926 (44 Stat. 9, 23-24, ch. 27).

The Revenue Act of 1928, 45 Stat. 791, 797, ch. 852, established a different format and section numbering for this income tax act, and section 22 thus became the section defining "gross income":

> "SEC. 22. GROSS INCOME.
> "(a) General definition.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

The subsequent income tax acts also defined gross income in this same manner. Section 22 of the Revenue Act of 1932, 47 Stat. 169, 178, ch. 209, contained the phrase, "'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service," as did the same section in the Revenue Act of 1934, 48 Stat. 680, 686-87, ch. 277. Section 22 of the Revenue Act of 1936, 49 Stat. 1648, 1657, ch. 690, and the same section in the Revenue Act of 1938, 52 Stat. 447, 457, ch. 289 also contained this phrase, "'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service."

The 1939 Internal Revenue Code, 53 Stat. Part 1, codified all of the various then effective tax laws of the United States into one act. Virtually every section of the income tax provisions in the Revenue Act of 1938 were incorporated into this Code. Section 22 thereof thus provided as follows:

> "(a) GENERAL DEFINITION.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever." 53 Stat. Part 1 at 9.

In August, 1954, Congress essentially rearranged the provisions of the Internal Revenue Code of 1939 to create the Internal Revenue Code of 1954, 68A Stat. The relevant Congressional committees published reports clearly stating that section 61 of the Internal Revenue Code of 1954 was based upon section 22 of the 1939 Internal

Revenue Code:

> "§ 61. Gross income defined.
> 'This section corresponds to section 22(a) of the 1939 Code. While the language in existing section 22(a) has been simplified, the all-inclusive nature of statutory gross income has not been affected thereby. Section 61 (a) is as broad in scope as section 22(a).
> "Section 61 (a) provides that gross income includes 'all income from whatever source derived.' This definition is based upon the 16th Amendment and the word 'income' is used in its constitutional sense. Therefore, although the section 22(a) phrase 'in whatever form paid' has been eliminated, statutory gross income will continue to include income realized in any form."[2]

Thus, section 61 of the 1954 Internal Revenue Code has the same meaning, reach and scope as section 22 of the 1939 Code. Determining the meaning of the phrase, "gains, profits, and income derived from salaries, wages, or compensation for personal service," is thus important, even today. But, what does this phrase mean, especially since it expresses the full reach and scope of the Sixteenth Amendment?

Canons of statutory construction dictate that all words in a statute are to be assigned meaning, and that nothing therein is to be construed as surplusage. Similarly, words in a statute cannot be defined so as to render other provisions of the same statute inconsistent, meaningless or superfluous. See *United States v. Menasche*, 348 U.S. 528, 538-39 (1955); *United States v. Lexington Mill & Elevator Co.*, 232 U.S. 399, 410 (1914); and *Montclair v. Ramsdell*, 107 U. S. 147, 152 (1883).

The common perception of a "salary" is that it is payment for work based on a weekly, monthly or annual basis. Similarly, a "wage" is generally understood as payment for work on an hourly basis. And these words have a meaning different from "compensation for personal service", both in common parlance and the federal income tax laws.

When the Revenue Act of 1918 was enacted, the Commissioner of Internal Revenue was required to determine what its various terms meant and inform employees of the Bureau of Internal Revenue of the uniform construction to be given to the various provisions of that law. The first attempt to define the meaning of the phrase, "compensation for personal service", was made by the Commissioner of Internal Revenue on April 16, 1919 by means of Regulations 45 for the Revenue Act

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[2] House Report 1337, 83rd Congress, 2nd Session, at A18-19. See also Senate Report 1622, 83rd Congress, 2nd Session, at 168.

of 1918.[3] This set of regulations for that income tax act defined this phrase as follows:

> "ART. 32. Compensation for personal services. – Where no determination of compensation is had until the completion of the services, the amount received is income for the taxable year of its determination, if the return is rendered on the accrual basis; or, for the taxable year in which received, if the return is rendered on a receipts and disbursements basis. Commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, retired pay of Federal and other officers, and pensions or retiring allowances paid by the United States or private persons, are income to the recipients; as are also marriage fees, baptismal offerings, sums paid for saying masses for the dead, and other contributions received by a clergyman, evangelist, or religious worker for services rendered. However, so-called pensions awarded by one to whom no services have been rendered are mere gifts or gratuities and are not taxable. The salaries of Federal officers and employees are subject to tax, except that, in view of the provisions of the Constitution of the United States as construed by the Supreme Court, the salaries of the President of the United States and Federal judges are not subject to the tax if elected or appointed to office prior to the passage of the taxing statute. But see article 86. See further articles 85 and 105-108."

The Commissioner defined "compensation for personal service" identically in Art. 32, Regulations 62 for the Revenue Act of 1921,[4] and Art. 32, Regulations 65 for the Revenue Act of 1924.[5] Clearly, "compensation for personal service" is entirely different from "salaries" and "wages".

Black's Law Dictionary, Fifth Edition (1979), defines the word "derive" as "[t]o receive from a specified source or origin," and the same dictionary defines "derived" as "[r]eceived from a specified source." The above phrase, "gains, profits, and income derived from salaries, wages, or compensation for personal service," indicates that "income" is **derived from** the "sources" of "salaries, wages, or compensation for personal service." Neither "salaries" nor "wages" means "income." Instead, "income" is derived from salaries, wages and compensation for personal service.

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[3] Treasury Decision 2831, 21 Treasury Decisions Under Internal Revenue Laws 170.

[4] Treasury Decision 3295, 24 Treasury Decisions Under Internal Revenue Laws 207.

[5] Treasury Decision 3640, 26 Treasury Decisions Under Internal Revenue Laws 745.

One of the first tax regulations adopted by the Commissioner of Internal Revenue in an effort to define wages and salaries was by means of Regulations 115, authorized by section 2 of the Current Tax Payment Act of 1943, 57 Stat. 126, ch. 120.[6] In section 404.101 of these Regulations 115, 8 F.R. 12262 (Sept. 7, 1943), wages included such items as "pensions and retired pay", "traveling and other expenses", "vacation allowances", and "dismissal payments", among other minor items. Clearly, vacation allowances, sick pay, dismissal payments and retirement benefits are items of "income" **derived from** wages (as well as salaries). See also 26 C.F.R. section 31.3401(a)-1.

In summary, the phrase, "gains, profits, and income **derived from** salaries, wages, or compensation for personal service," clearly expresses a limit to the reach and scope of the federal income tax laws. This phrase appeared in those income tax laws from 1894 through the summer of 1954, when it was replaced by means of the amended language in section 61 of the 1954 Code. But, the two sections, section 22 of the 1939 Code and section 61 of the 1954 Code, mean the same thing. Based on this phrase as well as clearly established rules of statutory construction, "income" has a different meaning from "salaries", "wages", and "compensation for personal service".[7]

[6] Current wage withholding pursuant to 26 U.S.C. section 3401, et seq., is based on the Current Tax Payment Act, as amended.

[7] Compensation for labor is different from compensation for personal service.