The Sixteenth Amendment
100 Years of the Federal Income Tax

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"The hardest thing in the world to understand is the income tax." ~ Albert Einstein

Americans have now been grappling with the income tax for 100 years. Since the 16th Amendment was ratified by Congress in 1913, U.S. citizens have been attempting to accurately complete Form 1040. While the annual income tax exercise is fresh in our minds, we thought it would be informative and somewhat gratifying to look back at the process that brought us here, and the tax rates that confronted tax payers on this anniversary in prior years.

History of the Sixteenth Amendment

Prior to 1913, the main source of revenue for the federal government was tariffs. Tariffs, it was argued, disproportionately affected the poor and were unpredictable. It was felt by many that the solution was a federal income tax. The resolution proposing the Sixteenth Amendment was passed by Congress on July 12, 1909 and ratified in 1913. The Amendment stated "Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

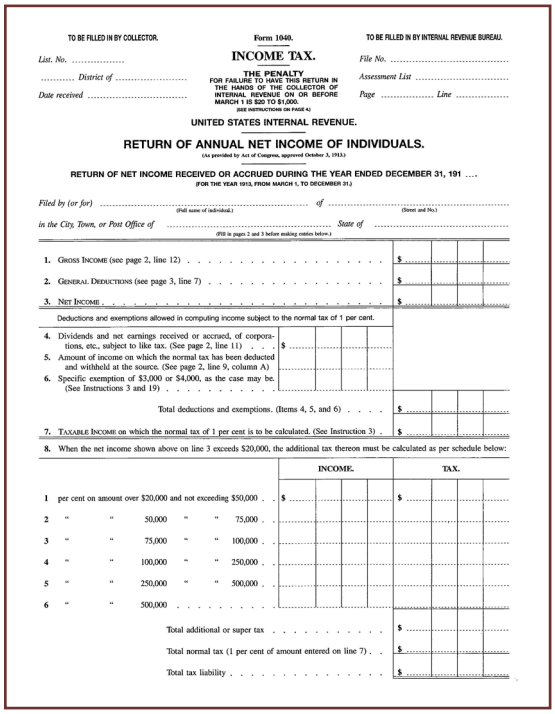
What followed was The Revenue Act of 1913, also called the Tariff Act, since its purpose was to lower basic tariff rates and compensate for lost revenues by imposing a federal income tax.

The first tax filing in 1914

The federal income tax started at 1% on personal income of more than $3,000 (over $71,000 in today's dollars[1]) for single filers or $4,000 for couples, with a surtax of 6% on incomes over $500,000. The first Form 1040 included three pages of calculations and one page of instruction. Taxpayers were to complete the new form and return it to the local tax collector who would check it for accuracy and send it on to the Bureau of Internal Revenue headquarters (predecessor to the IRS) in Washington for a second review. The total tax due was to be presented to the taxpayer by June 1, 1914 with a final tax payment received by June 30, 1914.

The procedure was complicated which prompted the LA Times to comment "The present income tax law is so confusing to the ordinary taxpayer that assistance in the preparation of the income statement is almost necessary"[2].

Tax revenues for 1914 were a disappointing $28 million, however, it took only a few years for the federal income tax to produce revenues far exceeding the tariff revenues and it became the main source of income for the government. Interestingly, less than 1% of the population paid federal income tax in 1914.



TO BE FILLED IN BY COLLECTOR.

List. No. .....

..... *District of* .....

Date received .....

Form 1040.

INCOME TAX.

THE PENALTY
FOR FAILURE TO HAVE THIS RETURN IN THE HANDS OF THE COLLECTOR OF INTERNAL REVENUE ON OR BEFORE MARCH 1 IS $20 TO $1,000.
(SEE INSTRUCTIONS ON PAGE 4.)

TO BE FILLED IN BY INTERNAL REVENUE BUREAU.

File No. .....

Assessment List .....

Page ..... *Line* .....

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL NET INCOME OF INDIVIDUALS.
(As provided by Act of Congress, approved October 3, 1913.)

RETURN OF NET INCOME RECEIVED OR ACCRUED DURING THE YEAR ENDED DECEMBER 31, 191 ....
(FOR THE YEAR 1913, FROM MARCH 1, TO DECEMBER 31.)

Filed by (or for) ..... (Full name of individual.) *of* ..... (Street and No.)

in the City, Town, or Post Office of ..... *State of* .....
(Fill in pages 2 and 3 before making entries below.)

1. GROSS INCOME (see page 2, line 12) . . . . . $
2. GENERAL DEDUCTIONS (see page 3, line 7) . . . . . $
3. NET INCOME . . . . . $

Deductions and exemptions allowed in computing income subject to the normal tax of 1 per cent.

4. Dividends and net earnings received or accrued, of corporations, etc., subject to like tax. (See page 2, line 11) . . . $
5. Amount of income on which the normal tax has been deducted and withheld at the source. (See page 2, line 9, column A) .
6. Specific exemption of $3,000 or $4,000, as the case may be. (See Instructions 3 and 19) . . . . . .

Total deductions and exemptions. (Items 4, 5, and 6) . . . . $

7. TAXABLE INCOME on which the normal tax of 1 per cent is to be calculated. (See Instruction 3) . $
8. When the net income shown above on line 3 exceeds $20,000, the additional tax thereon must be calculated as per schedule below:

	INCOME.	TAX.
1 per cent on amount over $20,000 and not exceeding $50,000 .	$	$
2 " " 50,000 " " 75,000 .		
3 " " 75,000 " " 100,000 .		
4 " " 100,000 " " 250,000 .		
5 " " 250,000 " " 500,000 .		
6 " " 500,000		
Total additional or super tax		$
Total normal tax (1 per cent of amount entered on line 7) . .		$
Total tax liability		$

Page 1 of the first Form 1040 issued in 1913, which covered the tax period March 1 through December 31, 1913

The Sixteenth Amendment was not the first attempt to tax income

The Internal Revenue Service was created in 1862 as the Bureau of Internal Revenue. President Lincoln signed into law the nation's first income tax to help pay for the Civil War. As a progressive tax, it was a forerunner of our existing income tax. It started at 3% and increased if a person made more than $10,000. This tax was repealed in 1872 as Congress concentrated once again on tobacco and distilled spirit tariffs to bring in revenues.

There was another attempt at an income tax in 1894 with the Wilson-Gorman Tariff Act. This Act, also known as The Revenue Act, established for a five-year period, any "gains, profits and incomes" in excess of $4,000 ($109,000 in 2013 dollars[1]) would be taxed at 2%. It was the first peacetime income tax, but was very short lived. The Supreme Court ruled against it a year later. They determined that certain taxes levied by the Act were direct taxes that were not allocated among the states and therefore, did not conform to Constitutional requirements.

[1]Bureau of Labor Statistics (BLS) CPI Inflation Calculator
[2] "File Statement in Twelve Days", Los Angeles Times, Feb. 16, 1914

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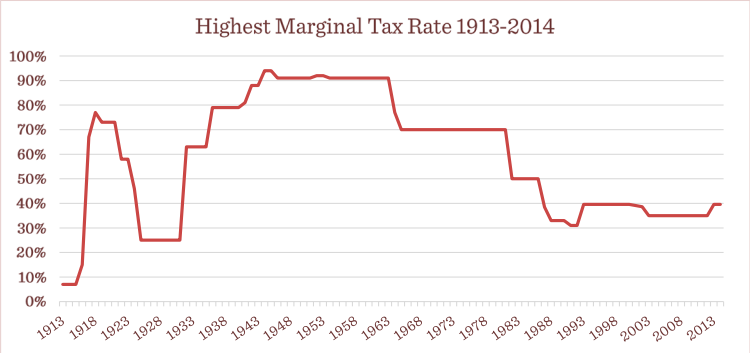
The Supreme Court ruling was corrected by the Sixteenth Amendment. It made income taxes exempt from the constitutional requirements regarding direct taxes which allowed Congress to levy an income tax without apportioning it among the states or basing it on the US Census.

A look at where income tax rates have been in the last 100 years

The maximum federal income tax rate has been up and down throughout the last 100 years starting at 7% (the initial 1% rate plus the 6% surtax) and rising to a high of 94% during the war years, 1944-45. It stayed over 90% until 1964, when, under President Johnson, it was reduced to 77%. It was reduced again in 1965 to 70% where it stayed until 1981. In that year, Congress enacted the largest cut in tax rates in US history by dropping the highest marginal rate to 50% under The Economic Recovery Tax Act of 1981, which also indexed tax rates to inflation. The trend continued downward until the maximum income tax rate hit 31% in 1991 and 1992, the lowest point since 1931 when rates were 25%.



Source: Tax Foundation, www.taxfoundation.org

It is probably safe to say that our current rates which start at 10% and go to a marginal rate of 39.6% will undergo future changes. As recently as 2013, we saw the addition of the Net Investment Income Tax of 3.8% on high income taxpayers, and changes to the capital gains rate. There may be more changes to come.

What Can be Done?

Investors at all income levels may be able to take advantage of the tax-exempt income provided by municipal bonds. When investing in municipal bonds issued in the investor's state of residence, the income earned is generally exempt from state income tax as well. While you're grappling with the income tax, take time to consider an investment that could provide tax-exempt income.

Aquila Group of Funds

The Aquila Group of Funds offers seven state-specific municipal bond funds which invest in municipal obligations of investment-grade quality, seeking to provide a high level of current income exempt from state and regular federal income taxes, while preserving capital. For more information on the Aquila Group of Funds, visit www.aquilafunds.com.

Mutual fund investing involves risk; loss of principal is possible. Investments in bonds may decline in value due to rising interest rates, a real or perceived decline in credit quality of the issuer, borrower, counterparty, or collateral, adverse tax or legislative changes, court decisions, market or economic conditions. Fund performance could be more volatile than that of funds with greater geographic diversification.

For certain investors, some dividends may be subject to federal and state taxes, including the Alternative Minimum Tax. Consult your professional tax advisor.

The Net Investment Income Tax (NIIT) is a 3.8% tax established by the Patient Protection and Affordable Care Act (PPACA) that applies to the lesser of (1) net investment income or (2) the excess of a taxpayer's modified adjusted gross income (MAGI) in excess of an applicable threshold amount. For more information, please consult your professional tax advisor.

Before investing in a fund, carefully read about and consider the investment objectives, risks, charges, expenses, and other information found in the fund prospectus. The prospectus is available from your financial advisor, when you call 800-437-1020, or visit www.aquilafunds.com.