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Taxation of State Agencies and Instrumentalities

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RECENT CASE NOTES

TAXATION OF STATE AGENCIES AND INSTRUMENTALITIES.—For many years New York City has operated municipal waterworks, supplying water for public and private purposes. The inhabitants are charged for the water they use; but the City does not make a profit. Petitioner holds the office of chief engineer of the water system by statutory authority, with a fixed salary of $14,000 a year. He supervises and exercises control over the operation of the system. The Commissioner of Internal Revenue assessed an income tax against him in respect to his salary; and he seeks to have the assessment set aside. Held, the supplying of water by a city to its inhabitants is a governmental function, and a person regularly employed therein is a state agency exempt from federal income tax.[1]

In the classic case of McCulloch v. Maryland,[2] Chief Justice Marshall decided that the States could not tax the agencies and instrumentalities of the Federal Government, because "the power to tax involves the power to destroy." From that time on both the Federal Government and the States, including their political subdivisions, have been considered free from any burden of taxation attempted to be imposed by the other. Following Marshall's reasoning, the Supreme Court in Collector v. Day[3] definitely established the converse of McCulloch v. Maryland, i. e., that state instrumentalities are exempt from federal taxation, including income taxes. The Sixteenth Amendment[4] did not affect this holding, for the Court has decided that the Amendment was not intended to extend the taxing power to new or excepted subjects, but merely to remove the requirement of apportionment.[5]

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[1] Brush v. Commissioner of Internal Revenue (1937), 57 S. Ct. 495. Mr. Justice Roberts and Mr. Justice Brandeis dissented. Mr. Justice Stone and Mr. Justice Cardozo concurred with the majority upon the ground that petitioner brought himself within the terms of the exemption prescribed by Treasury Regulation 74, Article 643, the validity of which was not challenged by counsel for the Government. Compare this with Helvering v. Powers (1934), 293 U. S. 214, 55 S. Ct. 171, where the Court, in dealing with the same treasury regulation, said, "But the Treasury Department could not by its regulation either limit the provisions of the statute or define the boundaries of their constitutional application."

[2] (1819), 4 Wheat. 316.

[3] (1871), 11 Wall. 113, 20 L. Ed. 122. Here Day, a state judge, was held to be exempt from the federal Civil War income taxes.

[4] The Sixteenth Amendment to the United States Constitution provides, "The 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."

[5] Brushaber v. Union Pacific R. R. Co. (1916), 240 U. S. 1, 36 S. Ct. 236, 60 L. Ed. 493; Stanton v. Baltic Mining Co. (1916), 240 U. S. 103, 36 S. Ct. 278, 60 L. Ed. 546; William E. Peck & Co. v. Lowe (1918), 247 U. S. 165, 38 S. Ct. 432, 63 L. Ed. 1049; Eisner v. Macomber (1920), 252 U. S. 189, 40 S. Ct. 189, 64 L. Ed. 521; Evans v. Gore (1920), 253 U. S. 245, 40 S. Ct. 550.

However, the principle that a state agency or instrumentality is not subject to federal taxation was greatly restricted by South Carolina v. United States.[6] That case involved the ability of the Federal Government to impose license taxes on dealers selling liquor in dispensaries run by the State for profit. In upholding the tax, the Court laid down a proposition that the exemption of state agencies and instrumentalities from national taxation is limited to those which are of a strictly governmental character, and does not extend to those which are used by the State in carrying on an ordinary private business. The difficulty lies in distinguishing between a proprietary and a governmental function. Some writers have suggested that immunity from taxation be granted only to those activities which are historically governmental;[7] and the cases up to now have generally indicated that such was the test.[8] The instant case expressly disregards that view. Another possible test is the tort distinction between governmental and proprietary activities, which was referred to in South Carolina v. United States. This distinction seems to be indefinite and unsettled[9] and, on the whole, inapplicable to the field of taxation;[10] therefore, the Court was probably justified here in disregarding the decisions in tort actions. The Court expressly refuses to formulate a general test, but in effect does that by inquiring whether the activity in question constitutes an essential governmental function. From various analogies, it concludes that supplying water is such a function.

It is interesting to compare the instant case with *Metcalf & Eddy v. Mitchell*,[11] which involved a similar factual situation. That case dealt chiefly with the taxability of income received for services rendered to States and their subdivisions under contracts. Exactly the same problem as we have here was also involved but was not pressed by the Government. In sustaining the tax there, the Court placed another important limitation on tax exemptions: Not only must the income be derived from the State and the State be engaged in a governmental activity, but also the individual must be a state employee or hold a regular official position; a private contractor cannot claim exemption. Although the present revenue acts do not specifically exempt state officers and employees, as the former acts did,[12] the present case indicates that such persons are still exempt.

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[6] (1905), 199 U. S. 437, 26 S. Ct. 110, 50 L. Ed. 261.

[7] Taxation—Immunity of State Officers from Federal Income Tax (1935), 33 Michigan L. Rev. 1283 at 1284, Magill, Tax Exemption of State Employees (1926), 35 Yale L. J. 956 at 964.

[8] United States v. State of California (1936), 297 U. S. 175, 56 S. Ct. 421, Helvering v. Powers (1934), 293 U. S. 214, 55 S. Ct. 171. South Carolina v. United States (1905), 199 U. S. 437, 26 S. Ct. 110, holds that exemption of state agencies and instrumentalities from national taxation is limited to those which are of a strictly governmental character. Flint v. Stone Tracy Co. (1911), 220 U. S. 107, 31 S. Ct. 342, 55 L. Ed. 389, follows the same reasoning and holds that "it is no part of the essential governmental functions of a State to provide means of transportation, supply artificial light, water and the like." See also State of Ohio v. Helvering (1934), 292 U. S. 360, 54 S. Ct. 725.

[9] Borchard, Government Liability in Tort (1924-5), 34 Yale L. J. 1, 129, 229 at 129, "We find the utmost confusion among the courts in the attempt to classify particular acts of state agents as governmental or corporate."

[10] Magill, Tax Exemption of State Employees (1926), 35 Yale L. J. 956 at 964.

[11] (1926), 269 U. S. 514, 46 S. Ct. 172, 70 L. Ed. 384.

[12] State officers and employees were expressly exempted by the Revenue Act

The importance of the instant case lies in the fact that it extends the field of "governmental" activities to those which are by their nature essentially governmental, regardless of whether they are historically such or not. It logically follows that this same result will be obtained in the case of other state operated public utilities, because in the larger cities electricity, gas, and even transportation are almost as essential as water. From the standpoint of logic, the Court is justified in casting away the inelastic rule that the federal taxing power extends to all activities except those in which the States have traditionally engaged, but as a practical matter, it has exempted thousands of persons from the federal income tax. Of course, when some are exempt, the burden of other taxpayers is increased to that extent. That a man employed by a private company is subject to income tax, while another having an identical position with a municipal corporation is not, seems grossly unfair to the layman; and the inequality caused by the increasing number of persons who are exempt may eventually lead to the downfall of the present system of income taxation.

It is suggested that a great mistake was made in Collector v. Day, when the Court considered the source of a person's income in determining the applicability of the income tax. Perhaps a better test is that set forth here in Mr. Justice Roberts' dissenting opinion, namely, that exemption should be given if the tax "discriminates against state instrumentalities and in favor of private citizens or if the burden of the tax be palpable and direct rather than hypothetic and remote." A tax on income is not discriminatory, nor is it a direct burden on the States. One can hardly contend that the States would have to increase the salaries of their officers and employees if they were subjected to the federal income tax. Such persons are not exempt from other federal taxes, which, for the most part, are probably paid from income earned by state employment. After all, a state officer is a citizen of the United States; and "he should contribute to the support of the government under whose protection he lives and pursues his calling.[13]

W I. M.

ADVERSE POSSESSION—TITLE TO CAVERN CLAIMED AND HELD UNDER MISTAKE.—Appellee sued appellant to quiet title to certain land, part of a cavern held by appellant and located under land owned by appellee. In 1883 appellant's predecessor in title discovered on his own land the entrance to the cavern since known as Marengo Cave. The cave was explored, its existence widely publicized, and complete possession taken by the discoverer who exhibited it upon payment of an admission fee. Possession was taken of the entire cave under the mistaken belief that the entire cave was under land owned by the discoverer. Appellant, to whom the property was conveyed in 1900, continued to hold exclusive and notorious possession under the same mistake. Continuously from the time of discovery until this suit, appellant and his predecessor in title operated the cave, advertised it, and made various improvements. Appellee purchased the adjoining tract of land in 1908, but made no claim of title to any part of the cavern until 1929 when this controversy arose. A survey ordered by

of 1913, 38 Stat. at L. 168, the Revenue Act of 1916, 39 Stat. at L. 759, and the Revenue Act of 1917, 40 Stat. at L. 303.

[13] Dissenting opinion of Mr. Justice Roberts in the instant case, 57 S. Ct. at 502.