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NEW DECISIONS ON TAXATION IN INTER- GOVERNMENTAL RELATIONS

The problem of the adjustment of the mutual powers and duties of the national government and of the states is an ever-present one in our legal system, and in no subject is this problem more difficult or more pressing than that of taxation. With all the numerous decisions of the Supreme Court on this subject (or perhaps because these decisions are so numerous) the matter is still doubtful and confused. Two recent decisions of the court have, however, cast some light upon this darkness. These cases are *Willcuts v. Bunn*¹ and *Educational Films Corporation of America v. Ward*.²

The first of these decisions is to the effect that profit realized on the sale of state and municipal securities is taxable as income by the Federal government. The latter case sustains a New York franchise tax based upon corporate income, as applied to a domestic corporation, a large part of whose income was realized from copyrights granted by the Federal government. The cases are, therefore, alike in that intergovernmental relations are concerned and that in both instances a tax was sustained notwithstanding a claim that the tax burdened some function of the other government.

It is well understood, of course, that the states may not by taxation or otherwise substantially burden the functions of the Federal government, and that the Federal government is similarly required not to burden the functions of the state.³ It is the problem of drawing the line between permitted and forbidden taxes, which causes the trouble.

While the states are forbidden to impose an undue burden upon interstate commerce⁴ yet considerable leeway is given, and state taxes which actually burden such commerce may yet be sustained if the burden is not regarded as unreasonable.⁵ Thus a

¹ 51 Sup. Ct. 125 (Jan. 5, 1931).

² 51 Sup. Ct. 170 (Jan. 12, 1931).

³ *McCulloch v. Maryland*, 4 Wheat. (U. S.) 316 (1819).

⁴ *Western Union Telegraph Co. v. Kansas*, 216 U. S. 1 (1910).

⁵ *Maine v. Grand Trunk Ry. Co.*, 142 U. S. 217 (1891). But see *Galveston etc. Ry. Co. v. Texas*, 210 U. S. 217 (1908).

state may impose a tax upon the net income of a corporation even though such a corporation secures substantially all its income from interstate commerce.⁶ But these interstate commerce problems are not applicable with respect to intergovernmental relations, since interstate commerce is not a function of the Federal government but is merely under its protection.⁷

Accordingly, where a function of the Federal government is burdened by a state tax, or a state government is burdened by a Federal tax, the courts may be, and in fact are, more rigid in their requirements. Thus state taxes which in any way burden the Indians, whom the Federal government has the duty to protect, are regarded with much hostility by the Supreme Court.⁸ It is also well settled that neither government may tax the officers or employees of the other with respect to their emoluments of office.⁹ And quite naturally, the borrowing power—that *sine qua non* of any government—is protected most carefully as against a state tax burdening the securities of the Federal government, or vice versa.¹⁰ Other necessary governmental functions are similarly protected even against non-discriminatory taxes.¹¹ For example, the Supreme Court has held that a state may not impose an excise tax upon gasoline sold to the United States for use by the Coast Guard, even though this tax was collected from all other users of gasoline.¹² So far has this protection been carried that it is held that a deduction permitted in computing the tax may not be diminished in any way by reason of income from the securities issued by the other government, and thus not directly taxable, upon the ground that this results in a tax burden upon such securities.¹³

⁶ *U. S. Glue Co. v. Oak Creek*, 247 U. S. 321 (1918). See also *Peck & Co. v. Lowe*, 247 U. S. 165 (1918).

⁷ *Gillespie v. Oklahoma*, 257 U. S. 501 (1922).

⁸ See *Brown, The Taxation of Indian Property*, 15 Minn. L. R. 182 (1931).

⁹ *Collector v. Day*, 11 Wall. (U. S.) 113 (1871); *Dobbins v. Erie County*, 16 Pet. (U. S.) 435 (1842).

¹⁰ *Weston v. Charleston*, 2 Pet. (U. S.) 449 (1829); *Bank of Commerce v. New York*, 2 Black (U. S.) 620 (1862); *Bank Tax Case*, 2 Wall. (U. S.) 200 (1864); *United States v. Railroad Co.*, 17 Wall. (U. S.) 322 (1872).

¹¹ *Telegraph Co. v. Texas*, 105 U. S. 460 (1881); *Williams v. Talladega*, 206 U. S. 404 (1912); *Federal Land Bank v. Crosland*, 261 U. S. 374 (1923).

¹² *Panhandle Oil Co. v. Mississippi*, 277 U. S. 218 (1928).

¹³ *Miller v. Milwaukee*, 272 U. S. 713 (1927); *National Life Insurance Co. v. United States*, 277 U. S. 508 (1928); *Missouri v. Gehner*, 281 U. S. 313 (1930).

There is thus considerable authority that no tax burden may be imposed by the states upon Federal securities or other functions of the national government, and that state securities and functions are similarly immune from the burden of Federal taxation. In fact, however, the United States Supreme Court has not been able to adhere to this rigid rule. In several classes of cases a certain amount of encroachment by the one government upon the other, even in this field of intergovernmental relations, has been permitted.

Two conspicuous and undoubted examples of such permitted encroachments are the inheritance tax cases and the "stock of stockholders" cases. In the former class of cases it is held that the United States may tax a bequest to the state, or a state may tax one to the United States;¹⁴ furthermore that either government may impose an inheritance tax notwithstanding the fact that the estate consists wholly or in part of securities issued by the other government, which securities could not, of course, be taxed directly.¹⁵ The other class of cases mentioned above holds that in taxing corporate stock in the hands of the stockholders no allowance need be made for the fact that the corporation is the owner of securities which are directly non-taxable on the principles already discussed.¹⁶ However, if the tax is levied against the corporation rather than against its stockholders allowance must be made for the non-taxable securities, notwithstanding the fact that the ultimate economic burden is the same whether the corporation itself or the stockholders are taxed.¹⁷

A third example of such permitted encroachments is in connection with governmental agents. Even an undoubted agent of the United States may ordinarily be taxed by the state upon its property, notwithstanding that the property has been obtained from the United States.¹⁸ And it is now definitely laid down that an independent contractor with a state is not immune from Federal taxation on the amount received from the state, even

¹⁴ *United States v. Perkins*, 163 U. S. 625 (1896); *Snyder v. Bettman*, 190 U. S. 249 (1903).

¹⁵ *Plummer v. Coler*, 178 U. S. 115 (1900); *Greiner v. Lewellyn*, 258 U. S. 348 (1922); *Blodgett v. Silberman*, 277 U. S. 1 (1928).

¹⁶ *Van Allen v. Assessors*, 3 Wall. (U. S.) 573 (1865); *Des Moines Bank v. Fairweather*, 263 U. S. 103 (1923).

¹⁷ *Home Savings Bank v. Des Moines*, 205 U. S. 503 (1907).

¹⁸ *Railroad Co. v. Peniston*, 18 Wall. (U. S.) 5 (1873); *California v. Central Pacific Ry. Co.*, 127 U. S. 1 (1888); *Baltimore Co. v. Baltimore*, 195 U. S. 375 (1904).

though his services were performed in an essential governmental function of that state.¹⁹

The remaining class of cases is the most important but also the most dubious. This relates to state or national taxes upon the franchise of corporations which are the holders of securities issued by the other government. It is obvious that such a tax is, or may be, a burden upon the government which issued the securities; yet it has been held that such a tax may be computed upon the basis of the entire stock of a corporation a large proportion of whose capital is invested in United States bonds.²⁰ The same rule has been expressly laid down by the court in *Flint v. Stone Tracy Company*,²¹ with respect to a Federal tax upon corporations based upon their net income, which income included interest upon state and municipal bonds. The tax was sustained on the basis that it was levied upon the corporation, and the burden upon the state and municipal corporations was entirely fortuitous and incidental.

These cases were decided when the Supreme Court had the idea that a state had plenary power to admit or exclude corporations on any terms deemed desirable. With the abandonment of this idea in recent years there has come to be a change of view as to the propriety of such franchise taxes. This change shows clearly in *Indian Oil Co. v. Oklahoma*,²² where it was held that a state might not tax a Federal lease of Indian lands directly, or even indirectly by taxing the stock of the lessee corporation upon a valuation including the value of the lease. It became still more explicit in *Northwestern Insurance Co. v. Wisconsin*,²³ where the court unanimously held that a state tax upon insurance companies of three per cent of their gross income is invalid so far as such income is derived from United States bonds held by the corporation. And if after this decision the idea that a corporate franchise tax could be levied with reference to non-taxable securities still survived, the death blow to it would seem to have been given by *Macallen Company v. Massachusetts*.²⁴

¹⁹ *Metcalf & Eddy v. Mitchell*, 269 U. S. 514 (1926); *Wheeler Co. v. United States*, 281 U. S. 572 (1930).

²⁰ The leading case is *Home Insurance Co. v. New York*, 134 U. S. 594 (1889), but there are several earlier cases to the same effect.

²¹ 220 U. S. 107 (1911).

²² 240 U. S. 522 (1916).

²³ 275 U. S. 136 (1927).

²⁴ 279 U. S. 620 (1929). See Powell, *The Macallen Case—and Before*, 8 Nat. Income Tax Mag. 47 (1930); Powell, *The Macallen Case—and Be-*

The last case held unconstitutional a Massachusetts excise tax based on corporate income, insofar as such income was composed of interest from bonds of the United States or its governmental agencies. The court took the position that such an interest was a direct burden upon the United States bonds held by the tax-paying corporation even though the basis of the tax was the privilege of being a corporation—a privilege given and certainly within the taxing jurisdiction of Massachusetts. It was also suggested that the Massachusetts legislature had acted with the dishonest intent of taxing such securities, in view of the fact that the law as originally enacted did not include interest from Federal securities in the taxable income and had been amended so as to bring about such inclusion. This theory is apparently not to be taken seriously since it would result in the ridiculous situation that a state may tax Federal securities only if it does so without showing a definite intent to that effect; furthermore the power of each state to levy such a tax would be determined according to its own history and without regard to the situation of other states. It is clear, therefore, that the Macallen case is on any reasonable construction a direct authority that a state may not levy a corporate franchise tax burdening even indirectly any Federal securities. The power of making indirect encroachments, at least of this kind, was supposedly ended.

Even under these authorities the decision in *Willcuts v. Bunn*²⁵ presented no real difficulty, and the court was unanimous. It is, of course, entirely settled that profits on the sale of capital assets may be included in taxable income,²⁶ so that the only possible objection to the tax would be that it was an indirect burden upon the state securities.²⁷ Certainly there is no direct burden, and it is not clear that there is any indirect burden in view of the fact that this income does not come from the issuer of the bond as is the case with interest and, unlike the case of interest, both the income and the tax are non-recurrent. Furthermore it does not appear that such an immunity from Federal tax as claimed in this case would assist states and municipalities

yond, 8 Nat. Income Tax Mag. 91 (1930); Brown, *Restrictions on State Taxation Because of Interference with Federal Functions*, 17 Va. L. Rev. 325 (1931).

²⁵ *Supra*, note 1.

²⁶ *Merchants' Loan and Trust Co. v. Smietanka*, 255 U. S. 489 (1921).

²⁷ That the federal government cannot tax the income from state and municipal securities appears from *Pollock v. Farmers' Loan and Trust Co.*, 157 U. S. 429, 583-586; 158 U. S. 601, 618.

in marketing their bonds, since the immunity from tax on profits would logically and sensibly mean a denial of deductions for losses. Furthermore, as the court pointed out, the long continued practice has been to include such profits in taxable incomes, and this without protest from the states. Thus the court had no real difficulty and the result was obviously correct.

Not so easy, however, was the task of the writer of the opinion in *Educational Film Corporation of America v. Ward*.²⁸ This writer was Mr. Justice Stone, one of the dissenters in *Macallen v. Massachusetts*,²⁹ whereas here the dissenting opinion was written by Mr. Justice Sutherland who wrote the opinion of the court in the *Macollen* case. But one hardly needs this information in order to realize that the *Macallen* case was the chief intellectual hurdle for the court.

The opinion concedes that copyrights are Federal instrumentalities,³⁰ and goes into a lengthy discussion of whether the New York tax was a franchise tax or an income tax. The dissenting opinion takes what seems to be the correct view, namely that it is a franchise tax measured by income.³¹ But, at any rate, the discussion is largely verbal fencing with shadows, since *Macallen Company v. Massachusetts*³² clearly holds that a franchise tax indirectly burdening the Federal borrowing power by using income from non-taxable securities as a measure of the tax, can not be sustained.³³ The court further takes great comfort in *Flint v. Stone Tracy Co.*,³⁴ but that case was certainly overruled on this point by the *Macallen* case, unless on the theory that the Federal government has greater rights to hamper the states than the states have to hamper the Federal government—a position which is perhaps not without some reasonable basis but which the Supreme Court has never avowedly taken. Funda-

²⁸ *Supra*, note 2.

²⁹ *Supra*, note 24.

³⁰ *Long v. Rockwood*, 277 U. S. 142 (1928).

³¹ Of course a corporate franchise tax may be sustained in some circumstances, even though it is not properly an income tax. *Anderson v. 42 Broadway Co.*, 239 U. S. 69 (1915). But the New York Court of Appeals has held that this tax is in essence an income tax. *People v. Knapp*, 230 N. Y. 48, 129 N. E. 202 (1920). See, however, *People v. State Tax Commission*, 232 N. Y. 42, 133 N. E. 122 (1921).

³² *Supra*, note 24.

³³ *People v. Law*, 237 N. Y. 142, 142 N. E. 446 (1923) holds that interest from United States bonds must be included in corporate income which is the basis of the New York tax. This seems directly contra to the holding of the *Macallen* case. See also *People v. Knight*, 174 N. Y. 475, 67 N. E. 65 (1903).

³⁴ *Supra*, note 21.

mentally, the court reaches its decision because it feels that this sort of tax creates such an indirect and slight burden upon copyrights that it can not properly be considered to be an unconstitutional burden upon the Federal government. This all seems sound and sensible; but how was the court to dispose of the *Macallen* case?

There was nothing simpler—in more than one sense of that word. We are calmly informed that the *Macallen* case did not overrule *Flint v. Stone Tracy Co.* and did not in any way affect the principle of that case and its predecessors,³⁵ that a non-discriminatory franchise tax may be levied even though it is measured in whole or in part by corporate assets which can not be directly taxed, under principles already stated. The reason for the decision in the *Macallen* case was, we are told, that the Massachusetts legislature was so wicked as to have and avow an intent to do what it might legally have done if it had only not said so!

It is not pleasant to see the court driven to such puerile reasoning. On the other hand, the actual result is worthy of all commendation. The court should never have stepped aside from the sensible principle in this whole matter; namely, that encroachments by the state taxing power upon the nation or by the national taxing power upon the states should both be permitted so long as there is no discrimination and so long as the burden is not unreasonable. To put it another way, taxation is a practical matter and should be decided from a practical and not a theoretical standpoint. Outside of the *Northwestern* and *Macallen* cases the court had usually reached results not dissimilar to the general rule here suggested; though it must be confessed that the court either did not realize that it was applying such a test or was not frank enough to say so. In the cases last mentioned the court deviated rather seriously from this path, and getting back to it is neither very easy nor dignified, as the court must know by this time to its cost. Nevertheless it is to be hoped that it perseveres, and that the *Educational Film Corporation* case³⁶ marks a definite return to a practical rather than a theoretical consideration of the legality of state and Federal taxes in this field. If so, the rather ill-starred decision of *Macallen Co. v. Massachusetts*, will have to be overruled or at least largely devitalized; but this is very far from a calamity.

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³⁵ See note 20, *supra*.

³⁶ *Supra*, note 2.