30-SBE-017

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
VORTOX MANUFACTURING COMPANY)

Appearances:

For Appellant: Nichols, Cooper and Hickson

For Respondent: Reynold E. Blight, Franchise Tax Commissio

O P I N I O N

This is an appeal under Section 25 of the Bank and Corporation Franchise Tax Act (Chap. 13, Stats. 1929) from the actio of the Franchise Tax Commissioner in overruling the protest of Vortox Manufacturing Company against a propose.3 assessment of an additional tax of $4,110.54, with interest.

The sole point involved in this appeal is whether amou ts received as royalties for the use cf patent rights issued by the United States Government are subject to inclusion in the tax base under this statute. The Commissioner has proceed d in reliance upon language of the Act which apparently authorizes him to include such income, while the taxpayer protests that this procedure is violative of the Constitution of the United States. The question is of paramount importance and presents itself in many similar appeals. Consequently, we have deferred our decision until now so that we might be afforded opportunity for mature deliberati-on on the problem.

Section 4 of the Act specifies. that certain classes of corporation, in which Appellant is apparently included, must pay annually to the State a tax "according to or measured by" their net income, less certain offsets for property taxes paid locally. "Net income" is defined in Section 7 of the Act as the "gross income", less allowable deductions. "Gross income" is defined in Section 6 of the Act as follows:

"The term 'gross income,' as herein used, includes gains, profits and income derived from the business, of whatever kind and in whatever form paid; gains, profits or income from dealing in real or personal property; gains, profits or income received as compensation for services, as interest, rents, commissions, brokerage or other fees, or otherwise received in carrying on such business; all interest received from federal, state, municipal or other bonds, and, except as hereinafter otherwise provid all dividends received on stocks."

There is no provision in the Act for the deduction of incor from tax exempt sources. For this reason the Commissioner has insisted upon the inclusion of the royalties from patent rights,

although it is obvious that the patents themselves are not taxable. (Long v. Rockwood, 277 U. S. 142.) The appeal is based upon the proposition that inclusion of patent royalties in the tax base is, in effect, taxation of income from a federal instrumentality.

In support of this view the Appellant cites two recent, decisions of the-United States Supreme Court. One of these, Long v. Rockwood, 277 U. S, 142, holds that a state may not tax directly royalties from patents. The other, Macallen v. Massachusetts, 279 U. S. 620, holds that, under the guise of an excise tax measured by net income, a state may not tax income from exempt sources, such as federal and state bonds, thereby accomplishing by indirection what it is forbidden to do directly

Each of these cases involves taxing statutes of the Commonwealth of Massachusetts, and the Franchise Tax Commissioner seek to differentiate the "history" of the effort to reach tax exempt income by "excise" taxation there and in California, We do not find the "differences" urged particularly convincing. It is true that the taxation of income from exempt sources was sought to be accomplished in Massachusetts through amendment of an existing excise statute rather than through adoption of an entirely new law as in California. But to make this a vital point of difference would be virtually to hold that Massachusett may not take in two bites what California may have in one.

Analyzing the former tax on general corporate franchises assessed under Section 3664d of the Political Code, the Franchis Tax Commissioner has attempted to show that under it the tax exempt property of corporations was actually included in the value of the corporate franchises as ascertained by our Board. This reveals a lack of understanding of what constitutes the value of a corporate franchise, because the constitutional and statutory provisions under which we proceeded certainly did not contemplate that the franchise value of corporations would be increased through their ownership of exemptproperty. In arrivi at the worth of a corporate franchise we were required to ascertain the total worth of the corporation through the known value of its stocks and bonds, capitalization of its net earnings or some other accepted method. From this total corporate worth we deducted the intrinsic value of its assets, including tax exempt property, in order that we might arrive at the corporate "excess which had been established as the proper basis for franchise assessment. (Miller & Lux v. Richardson, 182 Cal. 115.) Certainly, this "corporate excess" or franchise value could not be said to include the value of tax exempt property.

Our forms for report, prepared under the provisions of Section 3667 of the Political Code, called explicitly for "the market or actual value of non-assessable real and personal property owned by the company" on the assessment date. They als called for the income received from this type of property. These factors were required for the express object of assuring that we should be in a position to make due allowance for the ownership of such property and the income derived therefrom when valuing

corporate franchises. There is no basis for the assertion that our Board taxed as a part of the value of general Corporate franchises property exempted from taxation under the laws of this State or of the United States.

So far as the policy of the state with reference to taxaction of banks is concerned, any inference to the effect that exempt property was taxed under subdivision (c) of Section 14 of Article XIII of the Constitution or Section 3664c of the Political Code is drawn in apparent disregard of the fact that these provisions, called for a tax on bank shares and not on banks themselves. It is a fundamental conception of the law that a tax on the stock of a corporation is not rendered unconstitutional because the corporation owns securities which are exempt from taxation, while a tax on those same securities, or on the income therefrom, would be invalid. (Bank of California v. Roberts, 248 U. S. 476, 492.) It has been held that a tax upon bank stock is not a tax on exempt securities, even though the value of the stock may be influenced through the ownership of such securities by the bank. (Des Moines National Bank v. Fairweather, 263 U.S. 103.) Therefore, we find nothing in the "history" of California taxation which justifies the conclusion that we have taxed in the past, either corporations generally or banks particularly, on account of their ownership of tax exempt property.

Concerning the auspices under which the present tax on banks and corporations "according to or measured by" their net income was introduced, only brief comment need be made. In its report recommending the plan to the Legislature the Special Tax Commission created under Chapter 455, Statutes of 1927, discussed its reasons for proposing the adoption of the measure. It said that the share tax method then employed with reference to banks was probably invalid, citing the case of Merchants National Bank of Richmond v. Richmond, 256 U. S. 635. It discussed the four alternatives allowable under Section 5219, U. S. Revised Statutes relating to state taxation of national banks, and concluded that "the only practicable method of securing a substantial revenue from the banks is to proceed under the fourth method permitted by the federal statutes, and tax banks 'according to or measured by net income.'" (Final Report of the California Tax Commission (March 5, 1929), p. 247.)

Discussing the origin of this method, the Commission said:

"The original proposal for this amendment was prepared and submitted to the congress as a result of the joint activities of a committee of the American Bankers Association and a committee of the National Tax Association. The known purpose of these committees was to modify the 1923 amendment so as to permit a law such as the franchise tax on income of corporations in force in New York state to be applied to national banks., This intention is also plainly stated in the report of the House Committee on Banking and Currency." (Final Report of the California Tax Commission (March 5, 1929), p. 259.)

Rejecting as undesirable the taxation of banks and corporations directly on their net income under the third alternative

provided by Section 5219 of the U. S. Revised Statutes, the Commission assigned its reasons as follows:

"The third method may be discarded in favor of the fourth, because under the fourth everything can be accomplished which may be gained by proceeding under the third, and presumably more besides, viz., the inclusion, if desired, of tax-exempt interest in the base." (Final Report of the California Tax Commission (March 5, 1929), p. 264.)

Continuing its discussion of the problems involved the Commission said:

"As has been pointed out, the 1926 amendment to Section 5219 was drafted with the avowed object of permitting the inclusion in the tax base of such income as the interest from tax-exempt bonds. The point, however, has not been adjudicated and a suit (The Macallen Company v. Commonwealth of Massachusetts) has already been filed in Massachusetts questioning the right of a state to include such interest,

"In the case of corporations other than banks, the point is not of vital importance, But the banks hold such large quantities of these tax-exempt bonds that the effect of a decision holding that the state may not include them in the base would be very serious indeed. An analysis of the replies of the banks to the Commission's questionnaire indicates that the non-inclusion of federal bond. interest would reduce the tax base of the banks approximately one-fourth and the non-inclusion of all interest exempt from the federal income tax would reduce that base by more than one-half." (Final Report of the California Tax Commission (March 5, 1929),p.276.)

Later, in explaining its opposition to a real estate offset in the new law, the Commission made it clear that the tax was essentially one on income as a substitute for personal property taxes, saying

"The Commission regards the privilege of offset, which has been granted to personal property, as a temporary adjustment, undesirable in itself, which should be eliminated at the earliest practical moment. * * * * * 4 * * The correct view to take of the situation is that the new franchise tax is essentially a tax in partial substitution for the present taxes on personal property, the local assessment of such property being temporarily continued, because it offers a convenient solution of the problem of allocating the proceeds of this tax." (Final Report of the California Tax Commission (March 5, 1929), p. 301, 302.)

This frank exposition of the motives underlying the adoption of the tax on banks and corporations "according to or measured by" their net income is closely reminiscent of the language employed by the Massachusetts Tax Commission and commented upon by the United States Supreme Court in its decision of the Macallen case (supra). Consequently, this part of the "history" of the California Act, to our discernment, does not differ vitally from what transpired in Massachusetts.

However, it is plain that our law contemplates the inclusion of income from exempt sources in the tax base. If we should rule that the Commissioner erred in making the additional assessment to accomplish such inclusion, we should have to do so upon the assumption that the Act is unconstitutional.

The power to declare a law unconstitutional is one of the highest attributes of judicial authority. Although we sit in these matters as a quasi-judicial body, and must decide questions of law as well as of fact, we should not lose sight of the ultimate fact that we are not a Court but merely an administrative Board. The right of a ministerial office to question the constitutionality of a statute is generally denied. (6 R. C. L. 92.)

It is true that we have occasionally asserted that right. But this has been only under circumstances wherein such action on our part was necessary in order to protect the revenues of the state and get the problem before the Courts, (Miller & Lux v. Richardson, 182 Cal. 115.) In the instant case, and in all others like it before us, the taxpayers will have the opportuni

of taking the question to the Courts for decision. (Stats. 1929, Chapter 13, Sec. 30.)

It might be argued that, if the law is plainly unconstitutional, why should taxpayers be put to that trouble and expense' However, there is diversity of opinion as to the constitutional of the Act, and it seems to us desirable that this controversy should be settled by the Courts, whose authority to hold acts of the Legislature invalid cannot be questioned.

Much reliance is placed by the Commissioner on the decision of the United States District Court for the Southern District of New York on June 6, 1930, in the case of Educational Films Corporation of America v. Ward, ___ Fed. (2d) _____, (reported in United States Daily in the issue of Friday, June 6, 1930, at page 9), declaring that a taxing statute of New York similar to ours does not violate the federal Constitution although it includes income derived from federal copyright: in the tax base. This ruling is being vigorously contested and will be carried to the higher courts.

On the other hand, the Supreme Court of Washington, in an opinion handed down June 12, 1930, in the case of Aberdeen Savings & Loan Assn. v. Chase, ___ Pac. _____, (reported in United States Daily in the issue of June 20, 1930, at page 9, et seq. and June 21, 1930, at page 9) held that an income tax measure of that state patterned after the California statute, save as to the classes of corporations included, is invalid as an attempt to tax income from exempt sources.

Expressing much the same view,-the Supreme Court of Tennessee in a decision rendered on June 28, 1930, in the case of Quicksafe Manufacturing Corporation v. Graham, ___ S. W. _____, (reported in United States Daily in the issue of July 23, 1930, at Page 6) held that a corporate excise tax, measured by net income, may not be based upon royalties from patents.

These decisions are indicative of the diversity of opinion to which we have already alluded. In view of all the surrounding circumstances, we do not feel warranted in deciding that, under the California Bank and Corporation Franchise Tax Act, income from exempt sources may not be included in the tax base.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT Is HEREBY ORDERED, ADJUDGED AND DECREED, that the action of Reynold E. Blight, Franchise Tax Commissioner, in overruling the protest of Vortox Manufacturing Company, a corporation, against a proposed assessment of an additional

tax of $4,110.54, with interest, under Chapter 13, Statutes of 1929, be and the same is hereby sustained.

Done at Sacramento, California, this 4th day of August, 1930, by the State Board of Equalization.

R. E. Collins, Chairman
H. G. Cattell, Member
Jno. C. Corbett, Member
Fred E. Stewart, Member

ATTEST: Dixwell L. Pierce, Secretary