BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
FANNIE MAY HERRSCHER)

Appearances:

For Appellant: Orvile R. Vaughn, her Attorney

For Respondent: James J. Arditto, Franchise Tax Counsel.

O P I N I O N

This appeal is taken pursuant to Section 19 of the Personal Income Tax Act (Chapter 329, Statutes of 1935, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of Fannie May Herrscher to his proposed assessment of an additional tax in the amount of $116.44 for the taxable year ended December 31, 1936.

The facts as agreed upon by both Appellant and Respondent are set forth in Respondent's brief as follows:

"In filing her return for the taxable year 1936, the taxpayer omitted from taxable income the sum of $4,331.28 interest received upon bonds of the Federal Farm Mortgage Corporations. In his Notice of Additional Personal Income Tax Proposed to be Assessed, the Commissioner included in taxable income the amount of said interest and allowed a loss on worthless stock of $3,000, which was not claimed by the taxpayer on her original return. Against the additional tax determined to be due, the Commissioner allowed a credit of 1% of the said amount of $4,331.28 interest, or $43.31, which resulted in an additional tax of $116.44. Taxpayer, on the other hand, contends that none of said bond interest is subject to tax and that by reason of the allowance of the loss on worthless stock mentioned above, she is entitled to a refund of $360.00"

Congress, by Act of February 26, 1934, (48 Stat. 360, 12 U. S. C. A. Sec. 1020-f), has provided that:

"(b) Mortgages executed to the Land Bank Commissioner and mortgages held b the corporation (i. e., the Federal Farm Mortgage Corporation3 and the credit instruments secured thereby, and bonds issued by the Corporation under the provisions of this subchapter should be deemed and held to be instrumentalities of the United States, and as such they and the income therefrom shall be exempt from Federal, State, Municipal and local taxation (except surtaxes, estate, inheritance and gift taxes)."

The Respondent contends "that the Personal Income Tax over and above the one per cent tax is a surtax within the meaning of that term as intended by Congress in the enactment of the Federal Farm Mortgage Act, and, accordingly, the Commissioner's action in including this interest in taxable income and allowing as a credit against the total tax one per cent of the amount of said interest is correct. (P. 2, Respondent's Brief)

Appellant, on the other hand, takes the position that *no* portion of the California Personal Income Tax is a surtax, regardless of the applicable rate as determined by the graduated scale (Section 5, Personal Income Tax Act of 1935) and that; therefore, the interest from the bonds in question is wholly exempt from tax.

In Opinion NS 1806, dated June 30, 1939, the California Attorney General concluded that the California Personal Income Tax is in part a "surtax" within the meaning of statutes similar to the one quoted above. His reasoning is set forth in the following quotation from the opinion:

> "In using this term (surtax) in the federal statute above referred to (48 Stats. 267, 12 U. S. C. A. Sec. 1138-c) I do not believe Congress intended to permit the taxation by the states of interest exempt from normal tax only where the state statutes in so many words provide for a 'surtax.' Rather, it seems to me, the intention was to permit such taxation after exempting the income from a normal tax equivalent to the normal tax under federal laws.
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> "Under this theory or understanding this type of income would be exempt from the one per cent tax under California law, but would be subject to tax at two per cent if the taxable income plus this income exceeded $5,000 and so on through the graduated tax scale. It seems unreasonable to say that such income is entirely exempt from taxation in California because our statute does not use the term 'surtax,' but that by amendment of the statute we could subject the income to tax by making use of the term 'surtax' in connection-with incomes over $5,000. Congress did not, in my opinion, have in mind forcing the states to adopt the federal surtax system, but means only to give this type of income an exemption to the extent of the federal normal tax.
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> "To hold otherwise would be to impute to Congress an intent to compel the states to adopt the federal surtax plan, even though under a graduated tax system, such as California has provided for, the same result is arrived at without being in name a surtax. The surtax is there under both systems, and I am unable to conclude that in order for California to reach income of the type herein considered it must label its exaction a 'surtax' instead of reaching the same result under a 'graduated' tax. In my opinion, Congress intended to allow taxation of this income by the states under their own statutes to the extent that such statutes do not offend against the established 'surtax' principle of the Federal statute."

The Commissioner, in his brief, rests his case upon this opinion. The Appellant disputes the conclusion reached by the Attorney General, -contending that under the federal system of income taxation there are two taxes, a normal tax and a surtax, computed on different bases and amounts, whereas in California there is but one tax, at graduated rates.

We agree, however, with the Attorney General that it is not reasonable to suppose that Congress intended that the exclusion of "surtaxes" from the exemption should be limited to those taxes specifically designated as "surtaxes" in the taxing statute, or that Congress intended to compel the states to adopt the federal surtax plan, even though under a graduated scale such as California's the same result is reached. As stated in Cooley on Taxation, fourth edition, volume one, page 146,

> "In determining what kind of a tax a particular tax really is, the name given the tax by the statute imposing it is not controlling."

As stated in Paul and Mertens, Law of Federal Income Taxation (1939 Cumulative Supplement, p. 18, Sec. 2.04),

> "The underlying theory of the surtax is that it places the burden of the tax in accordance with ability to pay."

Undoubtedly the underlying theory of the graduated scale of the California Personal Income Tax is to place the burden of the tax in accordance with ability to pay. It should perhaps be mentioned that by an amendment effective July 19, 1941 (Chapter 1226, Statutes of 1941), Section 14 of the Personal Income Tax Act now reads in part, "The tax imposed under this act is not a surtax." We do not, however, regard this amendment as requiring a different conclusion on our part with respect to the taxable year 1936, involved in this appeal. We are, accordingly, of the opinion that the action of the Commissioner in overruling the Appellant's protest against the proposed assessment of additional tax in the amount of $116.44 for the year ended December 31, 1936, should be sustained.

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 Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of Fannie May Herrscher to a proposed assessment of an additional tax in the amount of $116.44 for the year ended December 31, 1936, pursuant to Chapter 329, Statutes of 1935, as amended, be and the same is hereby sustained.

Done at Sacramento, California, this 15th day of July 1943, by the State Board of Equalization.

R. E. Collins, Chairman
J. H. Quinn, Member
Geo. R. Reilly, Member

ATTEST: Dixwell L. Pierce, Secretary