Vanderbilt Law Review

Volume 22
Issue 6 *Issue 6 - November 1969*

Article 4

11-1969

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Recommended Citation

Joe G. Davis, Jr. and Arthur J. Ranson, III, An Evaluation of Municipal Income Taxation, 22 *Vanderbilt Law Review* 1313 (1969)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol22/iss6/4

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NOTES

An Evaluation of Municipal Income Taxation

I. INTRODUCTION

In recent years a series of tumultuous events have confronted local governments across the nation. Our cities have been racked with civil disorders and face seemingly insurmountable fiscal problems. Furthermore, traditional sources of revenue have proven insufficient to meet the economic needs of local governments whose annual expenditures have grown from an estimated nine billion dollars in 1946 to more than 50 billion in 1965, and currently approach 100 billion dollars.[1] In an effort to solve the problem of burgeoning expenses, several central cities have turned to the municipal income tax, which broadens the tax base to include "daylight residents" who benefit from central-city services during the day but return, tax-free, to their suburban communities in the evening.

A growing number of cities, beginning with Philadelphia in 1938,[2] have imposed personal and corporate income taxes. The list of major cities presently imposing the tax includes New York, Pittsburgh, Baltimore, Cleveland, Cincinnati, St. Louis, Kansas City, Louisville, Detroit, and Grand Rapids. One characteristic common to all cities which have enacted the tax is an urgent need for new sources of revenue. Philadelphia, for example, was faced with bankruptcy; Detroit and Cincinnati were plagued by huge budget deficits. A recent survey indicated that approximately 1,750 taxing jurisdictions, ranging from large cities to small townships, imposed some form of income tax.[3] In the past two years, the number of persons paying city income taxes has

1. FORTUNE, March 1965, at 106-07. In New York City, expenses have doubled since the mid-fifties, while available revenue has increased by less than 75%. U.S. NEWS & WORLD REPORT, March 21, 1966, at 82.

2. Charleston, South Carolina, adopted the first municipal income tax in the early 1800's; however, it was abandoned due to administrative difficulties.

3. N.Y. Times, Dec. 5, 1965, § 4 (Editorial), at 4, col. 1 (late city ed.). Eighty-five percent of all cities currently imposing income taxes are located in Ohio and Pennsylvania, which do not have statewide income taxes.

doubled to more than eighteen million. The prospects are great that this trend will continue.[4]

In order to delineate the perspective of this Note, two observations must be made. First, the term "municipal income tax" encompasses many variations from city to city in the legal nomenclature used to identify the tax. For example, "wage taxes," "payroll taxes," "earnings taxes," and "occupational license taxes" are widely used terms which simply disguise the presence of a municipal income tax.[5] Secondly, in relation to the traditional municipal property and sales taxes, the municipal income tax is normally supplemental rather than substitutional. An increased utilization of the municipal income tax, however, should partially relieve the burden now imposed on these traditional revenue sources.[6] Although the proportion of municipal revenue raised by the municipal income tax remains relatively low,[7] the Philadelphia experience[8] has demonstrated that the difference between the revenues received from the property and income taxes narrows considerably after the income tax has been in effect for a short time.

II. THE PERSONAL INCOME TAX STRUCTURE

A. *Historical Background*

Philadelphia, in 1938, became the first city to adopt the municipal income tax. This ordinance was passed under the authority of the Sterling Act,[9] which was adopted by the Pennsylvania Legislature in

4. *See* H.R. REP. No. 1480, 88th Cong., 2d Sess. 477 (1964).

5. R. SIGAFOOS, THE MUNICIPAL INCOME TAX: ITS HISTORY AND PROBLEMS 12 (1955).

6. In 1966, out of a total local revenue yield of approximately 27 billion dollars, only 472 million came from income taxation, while over 2 billion resulted from sales taxes and 23 billion from property taxes. U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES, no. 581, at 408 (89th ed. 1968).

7. In 1966 municipal income taxation accounted for 5.6% of all taxes collected by major cities. Christian Science Monitor, April 13, 1968, at 1, col. 4 (midwest ed.). The New York City personal income tax in the 1966-67 fiscal year yielded 122.1 million dollars from residents and 14 million dollars from commuters. In 1967-68 it was expected to yield 141.5 million dollars from residents and 15.5 million from commuters. N.Y. Times, Feb. 4, 1968, at 42, col. 1 (late city ed.).

8. The Philadelphia income tax, which has increased from 16 million dollars in 1940 to 91 million dollars in 1966, yielded 42% of the total local tax revenues in 1966 as compared with 46% for property taxes. *See* Christian Science Monitor, *supra* note 7, at 3, col. 3.

9. PA. STAT. ANN. tit. 53, § 15971 (Supp. 1969). From 1947 until 1966, Philadelphia's taxing authority was derived from "The Home Rule Tax Act of 1947." PA. STAT. ANN. tit. 53, § 6851 (1957). In 1965, "The Local Tax Enabling Act," PA. STAT. ANN. tit. 53, §§ 6901-24 (Supp. 1969), was enacted for cities of the second and third class, boroughs, townships, and school districts. The Act of 1947 was repealed and the Sterling Act, as amended, now covers cities of the first class. PA. STAT. ANN. tit. 53, § 1 5971 (Supp. 1969).

1932 and authorized the City of Philadelphia to tax any non-property sources not already taxed by the State. During its first year of existence, the Philadelphia ordinance was partially invalidated by the Pennsylvania Supreme Court, which held that the exemption of the first 1,000 dollars of income for each taxpayer was in violation of the State constitution's uniformity requirement.[10] In 1939, Philadelphia enacted a new tax ordinance which has served as a model for many cities since that time. This tax was imposed as a payroll tax which applied to all earnings in the form of wages, salaries, commissions, and other forms of compensation for personal services earned within the city. No exemptions or deductions were allowed. Although partnerships and unincorporated business associations were subject to the tax, corporations were excluded, since they were taxed by the state and were beyond the power of city taxation under the Sterling Act.

Following World War II, a large number of municipalities instituted the income tax as an additional source of urgently needed revenue. In 1946, Toledo, Ohio, imposed an income tax on individuals, corporations, and unincorporated business associations. Since that date, Toledo and numerous other Ohio cities have enacted the income tax under the home rule provisions of the Ohio Constitution.[11] Municipal income taxes next appeared in Kentucky, where Paducah in 1947, and Louisville in 1948, adopted an occupational license tax, which was measured on the basis of net income.[12] In 1948 St. Louis became the first city in Missouri to enact an earnings tax based on income.[13] Kansas City adopted the tax in 1964 under specific legislative

10. Butcher v. City of Philadelphia, 333 Pa. 497, 6 A.2d 298 (1938). For a discussion of the Philadelphia experience, see Phillips, *Philadelphia's Income Tax After Twenty Years*, 11 NAT'L TAX J. 241 (1958).

11. Article XVIII, § 3 of the Ohio constitution gives municipalites the authority to exercise all powers of local self-government and to adopt and enforce other regulations "not in conflict with general laws." This section has been interpreted to allow municipal occupational taxes as long as they are not pre-empted by the State. Marion Foundry Co. v. Landes, 112 Ohio St. 166, 147 N.E. 302 (1925). Article XVIII, § 13 grants the State the authority to limit municipal taxing powers. Angell v. Toledo, 153 Ohio St. 179, 91 N.E.2d 250 (1950). The taxing power of Ohio cities is limited to a 1% rate unless approved by 55% of the voters at a general election or 60% at a special election. "Municipal Income Tax Act," OHIO REV. CODE ANN. § 718.01 (Baldwin 1964).

12. The Kentucky cities have imposed the municipal income tax under the guise of an occupational license tax as authorized by the Kentucky Constitution which allows the General Assembly to delegate to municipal corporations the power "to impose and collect license fees on . . . franchises, trades, occupations and professions." KY. CONST., § 181. *See* City of Louisville v. Sebree, 308 Ky. 420, 214 S.W.2d 248 (1948). Kentucky cities have direct authority to tax the income from corporations. *See* KY. REV. STAT. ANN. §§ 68.180, 91.200, 91.280 (1969).

13. The St. Louis income tax, termed an earnings tax, is authorized under a state statute

authority[14] and remains the only other Missouri city to impose the income tax. Subsequently, Gadsden, Alabama, imposed a license tax[15] that determined liability by measuring earnings within the city.

The eleven Michigan cities which impose the income tax are fairly recent additions to the list. Detroit and Hamtramck first adopted the tax in 1962 under the home rule provisions of the Michigan statutes.[16] In 1964, the Michigan Legislature passed the City Income Tax Act[17] which now serves as a uniform ordinance for all Michigan cities. In 1966, New York City, under specific legislative authority,[18] enacted a comprehensive income tax covering residents, non-residents, unincorporated associations, and corporations. New York's tax is the most detailed and complete tax passed to date. In the same year, Baltimore imposed a tax under legislation authorizing each Maryland county and the City of Baltimore to adopt an income tax as a 20 to 50 percent surtax upon the state income tax liability.[19] The Baltimore tax which was recently raised to 50 percent of the state income tax, is unique since it is collected by the state and remitted to the city.[20]

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empowering cities of more than 700,000 population to enact a tax on salaries, wages, commissions, and other compensations earned by residents and non-residents for work performed in the city. The city is also authorized to tax net profits of corporations earned from activities within the city and net profits of unincorporated business associations. MO. STAT. ANN. § 92.110 (Supp. 1968).

14. Kansas City's earnings tax is authorized under MO. STAT. ANN. § 92.210 (Supp. 1968).

15. The Gadsden tax was levied as a license fee for the privilege of engaging in a trade, occupation, or profession within the city and was imposed at a rate of 1% on all wages, salaries and other compensation for personal services. The tax was upheld under ALA. CODE ANN. tit. 37, §§ 733, 735 (1960), which authorizes municipal corporations to license businesses, trades, and professions. Estes v. City of Gadsden, 266 Ala. 166, 94 So. 2d 744 (1957). Gadsden remains the only Alabama city to impose an income tax.

16. Home rule cities are authorized to provide for "laying and collecting rents, tolls and excises." MICH. STAT. ANN. § 5.2082 (1949). *See* Dooley v. City of Detroit, 370 Mich. 194, 121 N.W.2d 724 (1963).

17. MICH. STAT. ANN. § 5.3194 (Supp. 1969). Individual and corporate income taxes are now imposed under this ordinance in the following cities: Battle Creek, Detroit, Flint, Grand Rapids, Hamtramck, Highland Park, Lansing, Lapeer, Pontiac, Port Huron, and Saginaw.

18. "City Corporate Business and City Unincorporated Business Income Tax," N.Y. SESS. LAWS ch. 772 (McKinney 1966) (codified at N.Y. GEN. CITY APP. §§ 1-149 (McKinney 1968)); "City Personal Income Tax on Residents," N.Y. SESS. LAWS ch. 773 (MCKINNEY 1966) (codified at N.Y. GEN. CITY §§ 25-a to -c (McKinney 1968)); "City Earnings Tax on Non-Residents," N.Y. SESS. LAWS ch. 774 (McKinney 1966) (codified at N.Y. GEN. CITY §§ 25-m to -0 (McKinney 1968)).

19. MD. ANN. CODE art. 81, § 283(d) (Supp. 1968). Another statute now requires all counties and the City of Baltimore to enact an income tax of at least 20% of the state income tax liability. MD. ANN. CODE art. 81, § 323 (Supp. 1968).

20. Michigan recently enacted a statute allowing the state to collect and administer the city income taxes and remit the proceeds less 2% for administration costs. MICH. STAT. ANN. § 53194(8) (Supp. 1969).

Two other cities which recently imposed the income tax are experiencing legal difficulties. The Colorado Supreme Court held a Denver tax invalid under the state constitution.[21] Likewise, San Francisco's levy of a one percent tax on non-resident earnings withir the City has been held invalid by a county superior court in California.[22]

B. General Provisions

Because of the need for a large source of revenue, and because of limited administrative facilities, most cities have imposed an income tax at a flat rate on a simply computed tax base. Although non-residents are taxed in all cities but Baltimore and a few small towns in Pennsylvania, the tax base for non-residents is always limited to salaries and other compensation earned within the taxing municipality's jurisdiction. Most cities limit the tax base to "earned" income, but a minority includes interest, capital gains, dividends, and rental income. Generally, cities do not allow personal exemptions or deductions.[23] All cities, except those in Michigan and the two Kentucky cities of Mayfield and Middlesboro, impose an income tax on unincorporated business associations.[24] Most cities tax the proprietor of a wholly owned business as an individual, rather than the firm, on income earned within the city.[25]

Prior to examining the details of the existing ordinances in particular cities, the different forms in which the tax may be imposed should be noted: (1) a flat rate imposed on earned income without allowances for exemptions or deductions;[26] (2) a progressive rate imposed on earned income without allowances for exemptions or

21. The Denver earnings tax was held to be in violation of Art. X, § 17 of the Colorado constitution which gives the state the exclusive power to impose income taxes. City and County of Denver v. Duffey Storage & Moving Co., 450 P.2d 339 (Colo. 1969).

22. County of Alameda v. City of San Francisco (Sonoma Co. Super. Ct. Nov. 7, 1968).

23. All state and local income taxes, however, are allowed as deductions from the adjusted gross income under the federal income tax. INT. REV. CODE of 1954, § 164.

24. TAX FOUNDATION, INC., CITY INCOME TAXES 13 (1967).

25. *Id.* at 21.

26. This structure offers a maximum amount of revenue with low administrative costs, since a large percentage of the tax is withheld by employers. The main drawback of this tax is its regressiveness due to the disallowance of personal exemptions, the flat rate, and the exclusion of unearned income. With maximum rates usually limited to 2%, however, there is little tax inequity, even as to low-income groups. This tax is used by the Kentucky, Missouri, Alabama, Ohio, and Pennsylvania cities.

deductions;[27] (3) a flat rate imposed on all types of income without allowances for exemptions or deductions;[28] (4) a progressive rate imposed on all income without allowances for exemptions or deductions;[29] (5) a flat rate imposed on all income with allowances for exemptions and deductions;[30] (6) a progressive rate imposed on all income with allowances for exemptions and deductions;[31] and (7) a combination of several structures.[32]

C. Rate

Eighty percent of the cities imposing an income tax have flat rates which apply to residents and non-residents. Although in some cities the rates are less for non-residents, the majority imposes the same rates on residents and non-residents.[33] Most Ohio cities apply a one percent rate

27. The progressive rate increases administrative costs because refunds or assessments for additional liability are often required; however, the employers still carry the great bulk of administration since the tax is largely paid through the withholding process. There are no cities that use this tax structure.

28. This tax is more equitable than those which do not include unearned income, since a much larger percentage of total income for the higher income groups is unearned. This tax structure is not in use at the present time.

29. As in the third possibility, the greater degree of fairness offered to the low-income taxpayer would seem to offset the increased administrative costs.

30. This tax structure is actually progressive even with the flat rate because the allowance for exemptions and deductions decreases the taxpayers' effective rate of tax below the stated rate. Also, the high income groups are taxed on the basis of their ability to pay, since interest, capital gains, dividends, and rental income are included. This type of tax is used by the Michigan cities allowing a $600 exemption for the taxpayer, his spouse, and dependents; however, no personal deductions are allowed.

31. This method is used by New York City and Baltimore. It offers the greatest degree of progressivity combined with the highest cost of administration. One of the greatest drawbacks with this tax structure, which is styled after the federal income tax, is the reduction in revenue due to the allowance of exemptions, deductions, and low rates for low income groups. This factor would seem to be outweighed by the fairness of the system. Baltimore has minimized administrative costs by having the state collect the tax. For New York's proposal of a similar administration, see note 58 *infra*. Michigan allows its cities to contract for state collection. *See* note 20 *supra*.

32. This last alternative, which involves a combination of several possibilities, seems to have the highest prospects. *See* notes 230-245 *infra* and accompanying text. The local income tax can be coordinated with either the state or federal income tax, with collection and administration at either the local, state, or federal level. Under this structure, the taxpayer would compute his local tax liability as a percentage (surtax) of his tax liability to the higher level of government. Alternatively, the local rate could be applied to the taxable income as computed on the state or federal return. This sytem has two advantages: (1) administrative costs are reduced; and (2) the taxpayer computes his taxable income once for state, federal, and local purposes. Baltimore, which has adopted a state collection with liability imposed as a surtax upon the state tax, is the only city to use this alternative.

33. Only one city, Williamsport, Pennsylvania, taxes non-residents (1%) at a greater rate than residents (0.5%). TAX FOUNDATION, INC., *supra* note 24, at 13.

on all compensation earned by non-residents within the city. Residents are taxed on all compensation earned within or without the city, as well as commissions for personal service. The one percent rate also applies to all net profits of unincorporated businesses derived from activities within the city. Resident partners of unincorporated businesses, however, are liable for earnings outside the city.[34]

The Louisville occupational license tax is imposed at a rate of 1.25 percent on salaries, wages, and compensation for services performed within the city. The Louisville tax also includes net profits of all businesses, professions, and other activities conducted within the city.[35] The Michigan cities under the "City Income Tax Act" impose a rate of one percent on residents and five-tenths of one percent on nonresidents.[36] Detroit, by special legislative action imposes a rate of two percent on residents until December 31, 1970. Unlike the Ohio cities, Michigan residents must include dividends, interest, capital gains, and rental income in their tax base. The two Missouri cities imposing the tax, St. Louis and Kansas City, apply rates of one and one-half of one percent, respectively, to all earned income of residents and income earned within the city by non-residents. Resident partners are also taxed on all profits from unincorporated businesses. Furthermore, unincorporated associations are taxed on net profits earned within the city. Gadsden, Alabama, applies a two percent rate to all income earned within the city.

In Pennsylvania, there is some variance as to the rates applied. Philadelphia, under the Sterling Act, imposes a rate of two percent. Other cities, townships, boroughs, and school districts, however, impose a maximum rate of one percent, as required under "The Local Tax Enabling Act."[37] By limiting the tax base to earned income of individuals and unincorporated business associations, Pennsylvania cities do not tax interest, dividends, capital gains, or rental income.

The only cities to apply progressive rates are New York and Baltimore. The rates for New York residents vary from four-tenths of one percent on income less than 1,000 dollars to two percent on excess income over 30,000 dollars. The residents' tax base is their federal

34. CCH STATE TAX GUIDE ¶ 15-725 to -735, at 1597-1600 (1969) (citing municipal ordinances).

35. CCH STATE TAX GUIDE ¶ 15-463, at 1573 (1969).

36. MICH. STAT. ANN. § 5.3194(21) (Supp. 1969).

37. CCH STATE TAX GUIDE ¶ 15-780, at 1607-2 (1969); PA. STAT. ANN. tit. 53, § 6908 (Supp. 1969).

adjusted gross income with allowances for exemptions and deductions.[38] Commuters to New York City pay a flat one-quarter of one percent on wages and salaries earned within the city, and self-employed non-residents pay a flat three-eights of one percent on earnings within the city.[39] Non-residents are not allowed personal exemptions or deductions, but they may exclude from 1,000 to 3,000 dollars on incomes less than 30,000 dollars.[40] New York City also imposes an unincorporated business tax of four percent on the income of unincorporated associations. Allowances for deductions and exemptions are identical with the New York State income tax provisions; therefore, all businesses receive a 5,000 dollar exemption. If the tax liability of an unincorporated business is 100 dollars or less, it pays no tax. If the tax liability is greater than 100 dollars, the credit is the amount by which 200 dollars exceeds the tax owed (thus giving no credit for tax liability greater than 200 dollars).[41]

Baltimore residents pay a rate of 50 percent of their state income tax liability. The progressive state rate is as follows: two percent on the first 1,000 dollars; three percent on the second 1,000 dollars; four percent on the third 1,000 dollars; and five percent on all amounts in excess of 3,000 dollars. The state taxable income is computed from the federal adjusted income, thus including dividends, rents, interests, and capital gains.[42]

D. Tax Base

As previously noted, all cities include in the tax base of residents and non-residents salaries, wages, commissions, and compensation for personal services earned within the city. Residents in most cities must also include salaries and compensation for services earned outside the taxing jurisdiction, but are usually not required to include other forms of income. Baltimore, New York, and the Michigan cities are the only municipalities which include unearned income in the tax base of

38. N.Y. SESS. LAWS ch. 773, § 25-a(§ 3) (McKinney 1966); CCH STATE TAX GUIDE ¶ 15-691, at 1593-2 (1969).

39. The non-resident tax base also includes income from real or tangible personal property located within the city.

40. N.Y. SESS. LAWS ch. 774, § 25-m(§ 2) (McKinney 1966); CCH STATE TAX GUIDE ¶ 15-692, at 1593-3 (1969). Non-residents may deduct the New York City tax on their New York State and federal income tax returns, but residents may deduct city taxes only on their federal returns.

41. CCH STATE TAX GUIDE ¶ 15-693, at 1593-5 (1969).

42. MD. ANN. CODE art. 81, § 288 (Supp. 1968).

residents. By limiting the tax to earned income and excluding interest, dividends, capital gains, or rental income, taxpayers in the higher tax brackets pay proportionately less than the lower income groups, who derive a large percentage of income from salaries.

In recent years, interest and dividends have amounted to merely three percent of the federal adjusted gross income, while capital gains and rent have been less, averaging under two and one percent, respectively.[43] By excluding these sources from the tax base, cities have exempted a relatively small source of revenue and have avoided many costly administrative problems. When the tax is viewed from the standpoint of seeking the most equitable tax structure, however, these results strongly favor the inclusion of this revenue source in the tax base. For taxpayers with a federal adjusted gross income of 10,000 to 15,000 dollars, dividends, interest, and capital gains amount to one and seven-tenths and one and three-tenths percent respectively. Above the 15,000 dollar adjusted gross income level, these sources of income become increasingly important. For taxpayers in the 15,000 to 20,000 dollar bracket, dividends are five and one-fifth percent, interest four and one-tenth percent, and capital gains three and three-tenths percent. For those with 20,000 to 50,000 dollars adjusted gross income, dividends amount to seventeen and seven-tenths percent, interest eight and one-tenth percent, and capital gains ten and two-fifths percent.[44] Even though the inclusion of these sources of income which cannot be withheld requires procedures for discovering, checking, and verifying the taxpayers' returns, they should be included to increase the fairness and equity of the municipal income tax system. As can be seen from the tax base, the tax becomes much less regressive when these sources are included. When exemptions and deductions are allowed, the tax becomes progressive, even with a flat rate.

E. Deductions and Exemptions

The problem of defining the tax base in connection with exemptions and deductions is subject to great variance among municipalities. The use of liberal exemptions and deductions, even when combined with a flat rate, can make the tax progressive and adjust the burden of tax liability according to the amount of income and the size of the taxpayer's family. In order to accomplish this objective, municipalities must allow liberal exemptions and deductions to various

43. TAX FOUNDATION, INC., *supra* note 24, at 17-18.
44. *Id.*

classes of individuals and for certain types of income. It is estimated, however, that allowance of federal-type deductions and exemptions would decrease the local income tax revenues by as much as 50 percent unless the rates were increased to offset the decreased tax base.[45]

All cities have exempted certain types of income from the tax base. Those cities following federal-type provisions for adjusted gross income, such as New York and Baltimore, permit the same exemptions allowed under the *Internal Revenue Code of 1954* which include the following: interest on those United States obligations and bonds which are considered exempt from state tax;[46] workmen's compensation benefits for injuries or sickness; pensions for injury or service in United States armed forces; and certain accident and health benefits.[47] Those cities not using federal-type provisions for adjusted gross ineome as the tax base are fairly uniform in the type of income excluded. For example, the Michigan cities exempt the following sources of income: gifts and bequests; interest from federal or state obligations; proceeds from insurance, annuities, pensions, and retirement benefits; military pay; welfare relief, unemployment, and workmen's compensation benefits.[48]

The major problem with allowance of either personal exemptions or deductions, beside the loss of revenue, is the increase in administrative costs. In 1966, Detroit, which includes unearned income but allows personal exemptions and itemized business expense deductions, was forced to remit tax refunds to 48 percent of its taxpayers. In large part, this additional expense ean be attributed to

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45. R. SIGAFOOS, *supra* note 5, at 109.

46. INT. REV. CODE of 1954, § 103. New York requires that interest on obligations of states other than New York be added to the federal adjusted gross income which excludes such obligations. Also federal income taxes are not deductible under the New York City income taxes. N.Y. SESS. LAWS ch. 773, § 25-a(§ 12) (McKinney 1966); CCH STATE TAX GUIDE ¶ 15-682, at 1584-5 (1969).

47. INT. REV. CODE of 1954, §§ 104, 105.

48. MICH. STAT. ANN. § 5.3194(42) (Supp. 1969); CCH STATE TAX GUIDE ¶ 15-543, at 1581 (1969). Cleveland's exemptions include: military pay; income from tax exempt property or activities of religious, charitable, and educational institutions; poor relief; unemployment insurance benefits, pensions, annuities, and gratuities; alimony; personal earnings of persons under 18 years of age; compensation for personal injuries or property damage; and interest, dividends, and other income from intangibles. *Id.* ¶ 15-726a, at 1597-3 (citing Codified Ord. of City of Cleveland, Ord. No. 256-68 § 115.0501). Ohio cities are required by statute to include and exclude certain types of income. For example, compensation for personal services for individuals over 18 and net profit from businesses and professions must be included in the income tax base. No city is allowed to tax military pay, pensions, or allowances, and income from religious, scientific, educational, fraternal, literary, and charitable institutions is generally exempt. OHIO REV. CODE ANN. § 718.01 (Baldwin 1964).

the exemptions and deductions.[49] One procedure which decreases administrative expense is the allowance of a flat exclusion. For example, under the New York City commuter tax, commuters exclude 1,000 to 3,000 dollars on incomes up to 30,000 dollars.

Most cities allowing exemptions, however, utilize a specific exemption for the taxpayer, his spouse, and his dependents. Michigan cities, as well as New York, allow 600 dollar exemptions; Baltimore allows 800 dollar exemptions. Personal exemptions are not permitted in Kentucky, Missouri, Alabama, Ohio, and Pennsylvania cities.

New York and Baltimore are the only cities which allow personal deductions. New York residents may take the federal itemized deductions as adjusted for the State income tax, or a standard deduction of ten percent of their adjusted gross income or 1,000 dollars, whichever is less.[50] The Maryland state income tax, which is used by Baltimore, allows itemized federal deductions, less income taxes imposed by any other state or city. In lieu of itemized deductions, residents of Maryland may take a ten percent standard deduction or 500 dollars, whichever is less.[51]

F. Double Taxation and Reciprocity

Taxpayers who live in one jurisdiction and work in another face the problem of tax liability in both jurisdictions. Where both jurisdictions impose income taxes, there have been problems in adjusting the liability between the two cities, since both provide services and need revenue. The answer in most areas has been the allowance of tax credits for amounts paid to other jurisdictions. One of the greatest drawbacks to any system of tax credits is the increased administrative burden, requiring a more complicated tax form and often necessitating refunds. Employers have increased difficulty in large, fragmentized, urban areas because they must determine the credits applicable to each employee.

Urban areas may treat taxes paid in different jurisdictions by one of four procedures.[52] First, the right to tax may be given to either the city of residence or the city of employment, but not both. States which permit only certain cities to impose the tax and allow no credits use a

49. Warren, *Detroit's Experience*, 28 ACAD. POL. SCI. PROC. 452, 454 (1968).

50. N.Y. SESS. LAWS ch. 773, § 25-a(§§ 13-15) (McKinney 1966); CCH STATE TAX GUIDE ¶ 15-691, at 1593-2 (1969).

51. MD. CODE ANN. art. 81, §§ 281-82 (Supp. 1968); CCH STATE TAX GUIDE ¶ 15-505, at 1577-3 (1969).

52. Taylor, *Local Income Taxes After Twenty-one Years*, 15 NAT'L TAX J. 113, 122 (1962).

variation of this first form. New York, Baltimore, St. Louis, Kansas City, and several Ohio cities allow no credits, thus giving priority to the place of employment (residents having no problems of double taxation). By statute, Philadelphia is the only Pennsylvania city which does not give credits for taxes paid in the place of residence.[53] Secondly, the city of residence is allowed to tax all earned income except that which is taxed at the place of employment. In this situation, the city of residence allows a credit for all taxes paid to the city of employment. The Michigan cities[54] and those whose residents work in Philadelphia employ this type of credit.

Thirdly, priority is given to the city of residence. Under this method, which is used in the Pennsylvania cities other than Philadelphia, the city of employment taxes the non-resident to the extent that he is not taxed by the city of residence. This structure has caused a proliferation of income taxes in the smaller communities surrounding the central cities, resulting in sizeable decrease in the central city's revenue from the tax. Presently, voluntary reciprocal tax agreements may be negotiated in each large urban area.[55] The Cleveland area provides a good example of this arrangement. The city of Cleveland grants a credit to non-residents who live in Cuyahoga or an adjoining county in the amount of 25 percent of the Cleveland tax or 25 percent of the other city's tax, whichever is less. This credit to non-residents is given only where the other city grants a similar credit to Cleveland residents. Cleveland residents, who are subject to the tax in the city where they are employed, may claim a 75 percent credit against the Cleveland tax if the city of employment grants a similar credit to its residents who are subject to the Cleveland tax.[56] Under this system, the place of employment taxes 75 percent of the earnings while the place of residence taxes 25 percent, thus avoiding double taxation.

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53. For the Pennsylvania tax credits provision, see PA. STAT. ANN. tit. 53, § 6914 (Supp. 1969).

54. Under the Michigan uniform ordinance, the credit allowed by the city of residence for taxes paid at the place of employment cannot exceed that amount of tax which the city of residence would have assessed if the taxpayer had been a non-resident. MICH. STAT. ANN. § 5.3194(75) (Supp. 1969); CCH STATE TAX GUIDE ¶ 15-543, at 1580 (1969).

55. This method is used by Ohio cities. For a good discussion of the Ohio situation, see S. SACKS & W. HELLMUTH, FINANCING GOVERNMENT IN A METROPOLITAN AREA 245 (1961).

56. CCH STATE TAX GUIDE ¶ 15-726a, at 1597-3 (1969) (citing Codified Ord. of City of Cleveland, Ord. No. 256-68, §§ 115.1901-02). Toledo has an arrangement similar to Cleveland's, except that Toledo allows non-residents to credit 50% of either tax, whichever is less. The Toledo credits are also limited to taxpayers in cities offering reciprocal credits. *Id.* ¶ 15-733, at 599 (citing Toledo Ordinance No. 597-58, § 15.).

The effective rate of tax is lowered by a tax credit arrangement. In such areas as Pennsylvania and Ohio, where a large number of jurisdictions impose income taxes, the problems arising from reciprocity and income allocation may become severe. In light of this, a municipal income tax which is collected and administered at either the state or federal level might provide a solution.

G. *Administration of the Personal Income Tax*

1. *General Scope.*—In assessing the value of any tax, the total revenue-producing capabilities must be compared with the costs and burdens of administration, since both affect the collecting agency and the taxpayer. Experience since 1939 has proven that the municipal income tax may be administered with reasonable efficiency and without unbearable costs of compliance to businesses and individuals. The greatest single factor contributing to the successful imposition and administration of the income tax is the withholding requirement, which is used by all cities and accounts for 70 to 80 percent of the total revenue.

Although it is difficult to compute and compare the actual costs of administration in the various cities, several generalizations can be made. The tax rate is inversely proportional to the cost of collection as a percentage of total collections. A tax levied at one or two percent can be collected as efficiently as a tax imposed at a five-tenths of one percent rate. Likewise, the complexity of the tax base is directly proportional to the costs of administration.[57] Municipalities which include all sources of income within the residents' tax base necessarily face higher administrative costs due to the added enforcement measures required: *e.g.*, discovering, checking, and verifying the amounts reported. The allowance of deductions, exemptions, and tax credits for payments to other jurisdictions increases administrative burdens. The jurisdictions allowing these items are often required to give tax refunds to a substantial number of taxpayers.

One factor which directly affects the administration of the tax is the economic complexity of the community and the location of the

57. Mayor Lindsay of New York City recently asked the state legislature to approve a plan to excuse from filing any resident earning $6,000 or less in wages and not more than $200 in other income per year. Lindsay stated that the amount already withheld from such persons by employers is so close to their final tax liability that the administrative effort to collect the difference is not justified. Approximately 1.5 million persons would fall into this "excused groups," resulting in an estimated savings to the city of $1.5 million. N.Y. Times, Jan. 15, 1967, at 1, col. 6.

large employers.[58] Since withholding is required of only those employers within the taxing jurisdiction, the costs of administration are increased if a large number of the city residents work outside the taxing jurisdiction.

2. *Actual Costs of Administration.*—The average cost—to—yield ratios vary from two to five percent, although it is much higher for various smaller jurisdictions.[59] A study made in 1961 indicated that collection costs for the Pennsylvania cities were below four percent in 53 percent of those jurisdictions collecting over 200,000 dollars. Costs for Pennsylvania cities collecting less than 200,000 dollars were less than four percent of total collections in only thirteen to twenty-eight percent of the jurisdictions. Costs for cities collecting over 200,000 dollars were four and four-tenths of one percent of total collections, but this decreased to three and nine-tenths of one percent when only the largest cities were tabulated.[60]

Several small municipalities in the area of Williamsport, Pennsylvania, pool administration costs through a central collection agency responsible for collection and distribution of the revenues.[61] Where several smaller taxing jurisdictions are within a larger taxing jurisdiction, the larger may collect the tax and distribute it to the smaller. Likewise, administrative costs may be decreased if the municipal tax is imposed as a surtax upon the state income tax with collection and distribution at the state level. This type of arrangement, which is used in Baltimore, has apparently been successful.[62]

III. MUNICIPAL CORPORATE INCOME TAXES

A. General Structure

Local corporate income taxes, which have become a significant source of local revenues, are imposed by all cities using the personal income tax, except those in Pennsylvania and the two Kentucky cities of Mayfield and Middlesboro. For example, New York City, which enacted the corporate income tax in 1966 to replace its gross receipts tax, realized 232 million dollars from the tax in 1967, as opposed to 163 million dollars from its personal income tax. The municipal

58. OHIO MUNICIPAL LEAGUE, STATISTICS ON MUNICIPAL INCOME TAXES IN OHIO (1967).

59. For example, in 1954, Maumee, Ohio, with a population of 5,500, had costs of 8.2% of the total collections. R. SIGAFOOS, *supra* note 5, at 60.

60. TAX FOUNDATION, INC., *supra* note 24, at 24.

61. R. SIGAFOOS, *supra* note 5, at 50-51; *see* notes 255-56 *infra* and accompanying text.

62. Governmental officials in New York City contend that state collection of the income tax could save the city $5 million without substantial increase in costs to the state. N.Y. Times, Oct. 8, 1967, at 66, col. 4.

corporate income tax was first adopted by Toledo, Ohio, in 1946.[63] St. Louis became the first Missouri city to adopt the tax in 1948, and was followed by Kansas City in 1964.[64] Louisville, in 1948, was the first of eight Kentucky cities to enact the corporate income tax.[65] The next state in which the tax appeared was Michigan, where it was adopted by Detroit and Hamtramck in 1962.[66] New York[67] and Baltimore[68] are the most recent cities to impose the corporate income tax and remain the only cities in their states with statutory authority to adopt the tax.

The corporate income tax is imposed by all cities at a flat rate upon net income, which is usually defined in terms of net corporate income under the *Internal Revenue Code* with some adjustments in each state. In contrast with the federal provisions loss carryovers, income from foreign securities, and income from certain types of government securities are frequently disallowed. Federal income tax paid is not a deduction except in New York.[69] In addition to the deductions allowed by the Internal Revenue Service, supplementary depreciation allowances, expenditures for air and water pollution prevention, and other specific expenditures encouraged to achieve certain municipal objectives are frequently permitted.[70]

The Ohio cities generally impose a one percent rate[71] on the adjusted federal tax base, which is substantially modified by adjustments.[72] Cities in Kentucky and Michigan use the federal tax base with minor modifications. Detroit, under specific legislative authority,

63. By 1964, 81 local governments in Ohio had adopted the corporate income tax. H.R. REP. No. 1480, *supra* note 4, at 446. The power to impose corporate income taxes in Ohio is based upon the constitutional grant to local governments empowering them to exercise all powers of local self-government not in conflict with State statutes. *See* note 11 *supra*.

64. St. Louis and Kansas City have direct authority to tax the net profits earned by all corporations as a result of work done, services performed or rendered, and business or other activities conducted in the city. MO. ANN. STAT. §§ 92.110, 210 (Supp. 1968).

65. The Kentucky statutes grant different taxing powers to different size cities. First class cities are authorized to impose "license fees" on businesses based upon net profits. KY. REV. STAT. ANN. § 91.200 (1969).

66. Michigan cities now impose the corporate income tax under "The City Income Tax Act," MICH. STAT. ANN. § 5.3194 (Supp. 1969).

67. *See* N.Y. SESS. LAWS ch. 772 (McKinney 1966).

68. *See* MD. ANN. CODE art. 81, § 283 (Supp. 1968).

69. CCH STATE TAX GUIDE ¶ 10-694, at 1101-02 (1969).

70. TAX FOUNDATION, INC., *supra* note 24, at 21.

71. The following Ohio cities with populations over 150,000 impose a 1% rate: Akron, Cincinnati, Cleveland, Columbus, and Dayton. Toledo and Youngstown have a 1-1/2% rate. CCH STATE TAX GUIDE ¶ 10-000, at 1032 (1969).

72. Most Ohio cities do not allow deductions for federal or local income taxes and limit deductions to ordinary and necessary business expenses. *Id.* ¶ 10-725, at 1106-11 (citing municipal ordinances). Ohio does not impose a tax on net incomes.

imposes a rate of two percent. All other Michigan cities under the uniform City Income Tax Act apply a rate of one percent.[73] The rate in Louisville and Jefferson County is one and three-quarters of one percent for resident corporations and one and one-quarter of one percent for non-resident corporations.[74] St. Louis and Kansas City impose rates of one percent and one-half of one percent, respectively; however, neither city uses the federal definitions of net corporate income.[75] The corporate income tax in New York City is the most detailed and comprehensive of any to date. The New York rate of five and one-half of one percent which is more than twice that of any other city, is imposed on the federal tax base as adjusted for the state corporate income tax.[76] New York also has special income tax ordinances covering financial corporations, insurance companies, and utility and transportation companies.[77]

B. *Allocation of Income and Municipal Nonenforcement*

One problem unique to the corporate side of municipal income taxes is the determination of income subject to the tax.[78] This problem arises when a multi-state or multi-municipality business is involved in sales, production, or other activities in several municipalities within the same or different states. The tax liability of such a corporation may be affected by three different sets of laws: (1) the federal constitution and federal statutory law; (2) relevant state law; and (3) the provisions of the municipal ordinances.

The United States Supreme Court has prohibited states and their political subdivisions from imposing a privilege or franchise type tax upon corporations exclusively engaged in interstate commerce.[79] Cities and states, however, are allowed to impose direct taxes upon corporate net income fairly allocable to the taxing jurisdiction.[80] In addition to

73. The Detroit tax is effective until December 31, 1970. MICH. STAT. ANN., § 5.3194(21) (Supp. 1969).

74. Louisville imposes a 1¼% license fee on net profits of corporations. CCH STATE TAX GUIDE ¶ 10-463, at 1079 (1969).

75. St. Louis imposes the tax on corporate income "remaining after deduction from the gross profits or earnings the necessary expenses of operation exclusive of payments of federal or state income taxes." ST. LOUIS, MO., REV. CODE OF ORDINANCES § 145.020 (1960).

76. The New York City tax is imposed under three alternative rates; the corporation being liable for that rate which produces the greatest amount of tax. N.Y. SESS. LAWS ch. 772, § 4 (McKinney 1966); CCH STATE TAX GUIDE ¶ 10-694, at 1101 (1969).

77. N.Y. SESS. LAWS ch. 772, §§ 11, 41, 61 (McKinney 1966).

78. For complete discussion, see H.R. REP. No. 1480, *supra* note 4, at 451-55.

79. Spector Motor Service, Inc. v. O'Connor, 340 U.S. 602 (1951).

80. Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959).

these requirements under the interstate commerce clause of the Constitution, in 1959 the Congress passed Public Law 86-272[81] which was designed to impose minimum standards for state and local imposition of income taxes. The statute prohibits states and their political subdivisions from imposing net income taxes on income derived within the state from interstate commerce where the only business activities conducted within the state by the business or its independent contractors are limited to the solicitation of orders for the sale of tangible personal property. If the corporation is subject to taxation by the state, then it will be subject to taxation by the city, even though its only contact with the city is the solicitation of orders.[82]

The state statutes and local tax enabling provisions seldom provide jurisdictional requirements as to the degree of business activity required before a corporation may be subjected to the municipal income tax.[83] For example, the Ohio cities impose the income tax under broad constitutional provisions which have no specific nexus requirements. The Michigan uniform ordinance contains specific requirements for allocation of income subject to the municipal tax, but does not provide jurisdictional guidelines for determing what income is subject to the tax.[84] The enabling statutes in Kentucky and Missouri grant general authority to tax net profits of business activities conducted within the city without jurisdictional limitations.[85]

The municipal ordinances, which are similar to the state statutes, have broad liability provisions that generally subject to tax liability all firms conducting any activity within the taxing jurisdiction. The Ohio municipal ordinances, however, determine tax liability according to the attribution of income rules.[86]

The inadequacy of state and local laws concerning taxing authority contributes to the confusion in determing the tax liability of

81. 15 U.S.C. §§ 381-84 (1964).

82. H.R. REP. No. 1480, *supra* note 4, at 454.

83. *Id.* at 451.

84. "The tax shall apply on the taxable net profits of a corporation doing business in the city, being levied on such part of the taxable net profits as is earned by the corporation as a result of work done, services rendered and other business activities conducted in the city, as determined in accordance with this ordinance." MICH. STAT. ANN. § 5.3194(24) (Supp. 1969). The Michigan uniform ordinance incorporates 15 U.S.C. 381 (1964). MICH. STAT. ANN. § 5.3194(15) (Supp. 1969).

85. KY. REV. STAT. ANN. § 91.200 (1963) authorizes first class cities to impose license fees on "the net profits of all businesses, professions or occupations from activities conducted in the city . . . ." MO. REV. STAT. ANN. § 92.110 (Supp. 1968) authorizes St. Louis to impose an earnings tax "on the net profits earned by all corporations as the result of work done or services performed or rendered and business or other activities conducted in the city."

86. H.R. REP. No. 1480, *supra* note 4, at 452.

multi-branch corporations. The result of broad assertions of liability is to impose municipal tax liability on every firm which merely solicits orders within the state boundaries. Therefore, when faced with unclear municipal income tax liability, the corporations have in numerous instances ignored the tax. The House Special Subcommittee on State Taxation of Interstate Commerce has concluded that "[t]he combination of sweeping assertions of jurisdiction and inadequate enforcement, which at the State level may produce taxpayer uncertainty, at the local level appears to produce only indifference."[87] Based upon a series of questionnaires sent to corporations and various city tax administrations, the House Subcommittee further concluded that:

> [M]ost corporations do not file income tax returns with any local jurisdictions. Among those which do file, most file in only one jurisdiction, with widespread filing extremely rare. The experience of the companies studied suggests that for almost all but the largest corporations, local income tax filing is limited to the location of a place of business. Filing by a small corporation in any other locality is very unusual.[88]

Once it is determined that a corporation is subject to the municipal income tax, the problem of allocation of income arises. Corporations which do all of their business within the taxing jurisdiction do not have the opportunity to allocate income. Where only the major portion of the income is earned within the jurisdiction, allocation or division of income may also be denied.[89] For example, the St. Louis ordinance allows allocation of income only when it is derived from "activities . . . conducted both within and . . . without the city."[90] Since no definition of "activity" is provided under this ordinance, there is some doubt as to how much or what proportion of activity must be carried on outside the city before allocation will be allowed.

The allowance of allocation or division of income is usually done by one of several methods. The first method is separate accounting which allows the business to segregate items of income and cost for activities within a particlar municipality. The tax is imposed only upon that amount of net profits shown to be derived within the city. At the present time, separate accounting is used or allowed to some extent in all jurisdictions except Louisville and Lexington, Kentucky, and Portland, Oregon.[91]

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87. *Id.* at 470.
88. *Id.* at 467.
89. *Id.* at 456.
90. ST. LOUIS, MO., REV. CODE OF ORDINANCES § 145.030 (1960).
91. H.R. REP. No. 1480, *supra* note 4, at 459.

If separate accounting is not used, some type of formula or ratio determines the amount of income earned within a particular city. The most widespread method, at both the state and local levels, is the "Massachusetts formula," which is based upon a simple average of the following three ratios: sales or gross receipts within the city as a percent of total sales; property within the city as a percent of total property of the corporation; and total wages, salaries, and compensations for personal services paid within the city as a percent of total compensation paid. The resulting average ratio or percent is then applied to the corporation's total net income to determine the amount of income subject to the municipal tax. While the Michigan, Ohio, and Missouri cities use the "Massachusetts formula,"[92] a few cities use the "Pennsylvania formula," which is based upon an average of three slightly different ratios: physical assets, gross receipts, and payrolls. The last type of allocation formula is a two-factor ratio composed of sales and payrolls. This ratio is used in all of the Kentucky cities.[93]

One of the major problems concerning the use of any formula is the city-to-city variation of the definitions of each factor within the formula. A corporation doing business in several cities may be subject to a variety of requirements for computing sales, including one or more of the following: origin of sales, destination, sales office where made, sales activity, or intra-city shipments.[94] Likewise, the property factor may be limited to real and tangible property owned by the corporation or include leased property. Variations in the use of different formulas and in the definitions of the various factors within the formulas could theoretically lead to a lesser or greater liability than is actually due, thereby subjecting corporations to double taxation.[95] Since a low number of multi-city or multi-state firms file municipal income tax returns, this problem does not appear to be troubling most corporations at the present time. In addition to its finding that "few of the taxpayers who are technically liable for . . . . [the corporate income tax] file returns," the House Special Subcommittee also found

92. *Id.*

93. *Id.*

94. TAX FOUNDATION, INC., *supra* note 24, at 21-22.

95. "Although the existing local income taxes thus provide theoretical possibilities for overtaxation and undertaxation, it seems improbable that serious inequities often result at the local level today. The relatively small number of municipalities imposing net-income taxes, and the relatively low rates at which these taxes are imposed, suggests that it would be a rare company for which such overtaxation or undertaxation involved a significant amount of tax liability." H.R. REP. No. 1480, *supra* note 4, at 473.

that "[f]or those that do file, the work involved is kept down by disregarding required adjustments which are not expected to have a significant effect on liability."[96]

IV. LEGAL PROBLEMS OF MUNICIPAL INCOME TAXATION

A. *Fundamental Restrictions on Local Power to Levy a Municipal Income Tax*

1. *Constitutional and Statutory Prohibitions.*—Although the power of local governmental units to levy a municipal income tax is hedged with several fundamental restrictions, the most formidable takes the form of a specific constitutional or statutory prohibitions against the imposition of a tax. If such prohibitions are present the levy of a municipal income tax is impossible without constitutional amendment or statutory reform. For example, both Florida and Tennessee have prohibited the levy of local income taxes by express constitutional amendment.[97] Express statutory prohibitions against the municipal income tax are found in six states: Alaska, Kansas, North Carolina, South Dakota, Virginia, and Wisconsin.[98]

By expressly denying municipalities the power to levy an income tax, these statutes give effect to a legislative determination that only the state government should have the power to collect an income tax. The State Legislature of Virginia, by the process of implication, has interpreted the state constitution as reserving the power to tax incomes to the state and not to municipalities. This interpretation has been codified even though the constitution itself does not exclude municipalities from taxing income. The Virginia legislature embodied its interpretation in the following statutory language: "Incomes having been segregated for state taxation only, no county, city, town or other political subdivision of this State shall impose any tax or levy upon incomes."[99] In its prohibition of the municipal income tax, the Kansas legislature has disregarded a broad grant of municipal taxing power in the state constitution. The Kansas constitution provides that cities may:

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96. *Id.* at 471.

97. *See* FLA. CONST. art. IX, § 11; TENN. CONST. art. XI, § 9. These appear to be the only two states presently prohibiting municipal income taxation by express constitutional prohibition.

98. U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS REPORT, STATE CONSTITUTIONAL AND STATUTORY RESTRICTIONS ON LOCAL TAXING POWERS 86 (1962). *See, e.g.*, ALASKA STAT. § 43.20.290 (1962); KAN. GEN. STAT. ANN. § 12-140 (1964); N.C. GEN. STAT. § 105-247 (1965); VA. CODE ANN. § 58-80 (1969).

99. VA. CODE ANN. § 58-80 (1969).

> determine their local affairs and government including the levying of taxes, excises, fees, charges, and other exactions except when and as the levying of any tax, excise, fee, charge, other exaction is limited or prohibited by enactment of the legislature applicable uniformily to all cities of the same class.[100]

Apparently ignoring local revenue needs, the Kansas legislature has prohibited not only the municipal income tax, but all major municipal non-property taxes.[101]

Although express state interdiction is a formidable limitation on municipal income taxing powers,[102] the large majority of the states neither permit nor prohibit the levy of a municipal income tax by express constitutional or statutory provision.[103]

2. *Specific Statutory Limitation.*—A second restriction on local taxing power is a specific limitation concomitantly imposed by the state with the authorization of local non-property tax. In relation to the municipal income tax, this restriction manifests itself in the various provisions setting maximum rates or defining the scope of the tax base. All cities which tax income under express statutory authorization, as well as those which tax under a home rule power, are subject to this restriction.[104]

3. *The Application of Dillon's Rule.*—Dillon's Rule presents a different form of restriction on the general powers of municipal taxation. As a rule of construction, it may be of particular importance in those states in which there is no express statutory or constitutional authorization for a municipal levy on income. Dillon's Rule is basically a statement of the theory that state authorization is the source of all municipal power. The Rule is as follows: It is the general and undisputed proposition of law that a municipal corporation possesses, and can exercise, the following powers, and no others: First, those granted in *express words*; second, those *necessarily or fairly implied* in,

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100. KAN. CONST. art. XII, § 5(b).

101. U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS REPORT. *supra* note 98, at 87.

102. *See* notes 113-114 *infra* and accompanying text.

103. A survey of the states shows that the eight states mentioned in the above text have some express constitutional or statutory prohibition against the municipal income tax. Of the eight states where some form of municipal income taxation is now in force, only six of these have express constitutional or statutory provision allowing the tax. In the other two, the tax is allowed by judicial decision. *See* notes 9-19 *supra* and accompanying text.

104. As to cities taxing under express statutory authorization, note the restrictions in PA. STAT. ANN. tit. 53, § 6908 (Supp. 1969) which sets the municipal income tax at one percent and limits the over-all amount of revenue a city can raise. As to cities taxing under a home rule provision, note Ohio's restriction of the tax rate to no more than one percent. OHIO REV. CODE § 718.01 (1964). *See* notes 11 & 37 *supra* and accompanying text.

or *incident* to, the powers expressly granted; third, those *essential* to the declared objects and purposes of the corporation—not simply convenient but indispensable.[105]

Since the large majority of states have no express statutory authorization of the municipal income tax and virtually all state constitutions delegate to the legislative branches the power to regulate local taxation, Dillon's Rule would appear to preclude local governments from taxing income on their own initiative. One authority on municipal taxation has stated the effect of the combination of these two factors as follows:

> [L]ocal governments as creatures of the state, may tax that which constitutional provision and state legislation authorize them to tax. By implication, what is not authorized specifically is beyond their authority.[106]

Whether such specific authorization is indeed required seems to be an open question. The problem becomes how specific must such authorization be? For example, if a state constitution simply gives to cities the power to determine their local affairs and government and to exercise all powers appropriate thereto, and there is no statutory prohibition of such a tax, it appears that the second and/or third components of Dillion's Rule might be invoked to defend a municipal levy on income even in the absence of express statutory authority for the tax. This argument would appear to be particularly applicable to defend local income taxation by home rule cities.[107] Cities in Ohio and Michigan, however, have levied an income tax for some time on the theory that the power to make such a levy is implicit in general enabling acts or home rule provisions.[108] A consideration of the experiences of these cities, indicates that the requirements of the second component of Dillon's Rule may be fulfilled on the theory that the levy

105. The Rule was the product of Judge John F. Dillon, a prominent 19th Century authority on municipal corporations. *See* J. DILLON, MUNICIPAL CORPORATIONS § 55 (1st ed. 1872).

106. R. SIGAFOOS, *supra* note 5, at 9.

107. See E. STASON, MUNICIPAL CORPORATIONS 42-45 (3d ed. 1959), for an example of the broad grants of governmental power given to home rule cities.

108. A survey shows that over 60 Ohio cities have enacted a income tax under a home rule provision of the Ohio constitution. *See* OHIO CONST. art. XVIII, §§ 3, 13. These taxes, however, must be levied within certain statutory limits. The Ohio legislature has provided that such a tax cannot be levied unless 55% of a city's voters approve of the tax in a general election vote (60% are necessary in a special or primary vote). This act also limited the tax rate to no more than one percent. OHIO REV. CODE § 718.01 (1964). Acting under a statutory provision which grants to charter cities the power to levy "rents, tolls and excises," Detroit and Hamtramik, Michigan, levied a tax on the gross incomes of all individuals and the net profits of all businesses earning income in the cities. The tax applied to residents and non-residents alike. *See* MICH. STAT. ANN. § 5.5082 (1949). For present Michigan authority, see note 17 *supra*.

of a municipal income tax is impliedly authorized by home rule provisions which are sufficiently broad.[109]

Study reveals, however, that restrictive application of Dillon's Rule far exceed more liberal applications. The first component of the Rule has often been interpreted by courts to prohibit municipalities from levying the tax, in the absence of express authorization or very sound grounds for implication. Indeed, it appears that the slightest question as to the authority of a municipality to levy a particular tax will suffice to invalidate it. The following case contains typically illustrative language:

> The authority to tax is not only a delegated authority conferred by the State, but it is assumed that the State has given all it intended should be exercised, and the grant, like that of all special and limited grants is to be strictly construed. Where municipal authority to tax is doubtful, the doubt is to be resolved against the tax.[110]

B. The Pre-emption Doctrine and its Effect on Municipal Income Taxation

1. *A Statement of the Doctrine.*—Growing out of the concept of state sovereignty over all subordinate political units, the doctrine of pre-emption has long been a most formidable barrier to the evolution of adequate municipal fiscal policies. Whether court-created or legislatively inspired, the doctrine has had the same crippling effect. In its simplest form, the doctrine stands for the proposition that if a state

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109. *See* U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS REPORT. *supra* note 98, at 84. It is reported that there is widespread opinion in California that the tax authority language in the charters of many cities is sufficiently broad to permit the levying of a municipal income tax, though due to public disfavor cities have been reluctant to adopt the tax. *See* R. SIGAFOOS. *supra* note 5, at 9. San Francisco recently enacted an "earnings tax" on *non-residents* working in San Francisco city and county which was to become effective on January 1, 1969. The tax was levied on the gross receipts or compensation of each individual (with an exemption for persons whose annual income did not exceed $4,000). The tax was to be administered by an employer withholding scheme. Legal difficulties were encountered, however, and the tax was declared invalid. The grounds for invalidation are unknown since a published report on the case is not available at the time of this writing. The case is likely to be appealed. County of Alameda v. City and County of San Francisco (Sonoma County Superior Ct., Nov. 7, 1968). It has long been evident that cities are not always successful in implying the power to tax from their home rule powers. Prior to receiving specific legislative authorization to levy such a tax, St. Louis attempted to tax income on the basis of the home rule theory. This attempt was ruled invalid in Carter Carburetor Corp. v. St. Louis, 356 Mo. 646, 203 S.W.2d 438 (1947).

110. T. COOLEY. TAXATION § 125 (4th ed. 1924). *See also* the following ruling by the Attorney General of Alaska, denying municipalities the power to levy gasoline taxes: "Where there is doubt as to whether or not a municipality has been granted a power which it claims, such doubt is to be resolved against the use of such power by the municipality." U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS REPORT, *supra* note 98, at 81.

has imposed a tax in a particular field, the state taxing authority has presumably pre-empted that field so as to preclude local taxation in the same area. This presumption is made even though the state tax statute is silent as to the power of municipalities to tax in the same field. A logical construct of the pre-emption doctrine may be made in the following manner. Proceeding from the assumption that municipalities are merely creatures of the state and possess no intrinsic powers of their own, the conclusion that the state is all powerful in relation to local government may be reached. From this conclusion, it can easily be inferred that if the state taxes a particular area, the intention of the state is to occupy that area exclusively and without competition from its subordinate political units.[111]

The pre-emption doctrine is usually applied to curtail various types of municipal taxes, particularly non-property taxes such as the income tax. In relation to municipal income taxation, the doctrine simply means that where a state has levied an income tax of its own, this levy will be deemed to have ousted municipalities entirely from the field of income taxation.[112] At this point, an analysis of the case law will be undertaken to order to demonstrate three basic forms in which the pre-emption doctrine often appears.

(a) *State interdiction.*—Interdictory pre-emption, a purely legislative creation, is simply an express incorporation of the pre-emption doctrine into statutory form. An excellent example of this form of pre-emption is the Pennsylvania codification of the famous Sterling Act of 1932[113] and Act No. 481 in 1947.[114] While authorizing municipal income taxation on the one hand, these statutes also contained the limited language of the pre-emption doctrine by prohibiting municipalities from taxing anything which was then, or might in the future become, subject to state taxation. Another illustration of express statutory pre-emption is found in Virginia. As has already been noted,[115] the Virginia legislature found that the state

111. *See* Ohio Finance Co. v. City of Toledo, 163 Ohio St. 81, 125 N.E.2d 731 (1955). This case provides a prime example of the type of reasoning outlined in the text.

112. Excellent and somewhat divergent discussions of the pre-emption doctrine in relation to the municipal income tax can be found in the following law review articles: Glander, *Analysis and Critique of State Pre-emption of Municipal Excise and Income Taxes Under Ohio Home Rule*, 21 OHIO ST. L.J. 343 (1960); Hartman, *Municipal Income Taxation*, 31 ROCKY MT. L. REV. 123 (1959); Glander & Dewey, *Municipal Taxation: A Study of the Pre-emption Doctrine*, 9 OHIO ST. L.J. 72 (1948); Fordham & Mallison, *Local Income Taxation*, 11 OHIO ST. L.J. 217 (1950).

113. PA. STAT. ANN. tit. 53, § 15971 (Supp. 1969).

114. PA. STAT. ANN. tit. 53, § 6851 (1957) (repealed 1961). *See* note 9 *supra*.

115. *See* note 99 *supra* and accompanying text.

constitution gave the power to tax incomes to the state and used pre-emptive reasoning to expressly preclude municipal taxation of income.

(b) *Statutory pre-emption by implication.*—Statutory pre-emption by implication stands for the proposition that if a state enacts a taxing statute, pre-emption of the field of taxation by the state, to the exclusion of the municipalities, will be implied. The distinction between pre-emption by implication and interdictory pre-emption should be noted. In the latter type, there is an express prohibition of a municipal exercise of taxing power. In the former, the prohibition is simply implied from the existence of a similar state taxing statute, even though the statute does not expressly preclude municipal participation in the field.

Although the roots of this doctrine lie in the traditional proposition that the city is a mere creature of the state, the birth of statutory pre-emption by implication in its present form can be traced to judicial resoning in the case of *State ex rel. Zielonka v. Carrel.*[116] This ambivalent case contained language supporting a broad use of taxing power by municipalities and formulating the doctrine of pre-emption by statutory implication. Over an objection that the State had pre-empted the field of occupational taxation, the court concluded that under the broad home rule grant,[117] the City of Cincinnati could levy an occupational tax on all persons deriving income from businesses, trades, vocations, or professions in the city. The court first held that the city had the power to enter any area of taxation providing that the State had not invaded or pre-empted the particular area by passing a law limiting municipal power in the area.[118] The court, however, went beyond a mere approval of the doctrine of express interdictory pre-emption by statute and explained the type of law which could limit the municipal taxing power. The court indicated that municipal taxing power could be *restricted by implication* whenever a state legislative enactment pertaining to a new area of taxation could result in competition with cities for revenue. The court held that it was no longer necessary for the State to pass a "thou shalt not" statute in order to accomplish pre-emption, since the mere entrance by the State into the

116. 99 Ohio St. 220, 124 N.E. 134 (1919).

117. *See* OHIO CONST. art. XVIII, § 3.

118. *See id.* § 13: "Laws may be passed to limit the power of municipalities to levy taxes and incur debts for local purposes." The holding of the court is directly in line with this provision of the home rule amendment at this point in its chain of reasoning.

field "on its own account" was itself enough to work a pre-emption.[119]

The doctrine was reinforced in *Firestone v. City of Cambridge*,[120] where the court struck down a city excise tax on the privilege of operating automobiles on city streets because the state had imposed a similar tax. The court reasoned that section 13 of the Ohio home rule amendment allowed the legislature to limit city taxing power either expressly or by implication. The necessary implication could be made because the legislature had pre-empted the field of excise taxation by imposing a state levy on owners of motor vehicles. After *Firestone*, the doctrine of statutory pre-emption by implication became fully accepted in Ohio case law and has remained in force to the present. This doctrine will most probably be subject to increasing litigation in other states as the attractiveness of municipal income taxation increases.

Case law in Ohio applying the doctrine diverges as to the nature of the state statute which will result in pre-emption. *Ohio Finance Co. v. City of Toledo*[121] represents an extreme view in favor of pre-emption. In that case, the court invalidated a city income tax imposing a tax on the net income which a dealer in intangibles derived from the income yield of interest-bearing promissory notes. The dealer was also subject to a state five mill *property* tax on income yield from the shares of intangibles which he owned. The state tax contained a provision to the effect that the state tax should be "in lieu of all other taxes on property such as intangibles owned by such a dealer." The majority of the court concluded that the "in lieu of" provision not only applied to prevent the levy of other state taxes, but also clearly implied a legislative intent that a municipality could not impose a tax on income produced by the dealer's intangible property. Therefore, in this rather extreme holding, the court held that a state property tax could pre-empt a municipal income tax.

In a strong dissent, Judge Zimmerman posed the theory that has blossomed into the concept of pre-emption espoused by the more moderate view. The core of the dissent is succinctly set out as follows:

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119. It is interesting to note that *Zielonka* also contained restrictive dictum regarding the municipal income tax. The court stated that "it is clearly to be implied from the Constitution that municipalities are without power to levy an income or inheritance tax . . . . [T]he state alone can initiate taxation of this character." 99 Ohio St. at 228, 124 N.E. at 136. This dictum was later disregarded in the cases of Angell v. City of Toledo, 153 Ohio St. 179, 91 N.E.2d 250 (1950), and Stockwell v. City of Columbus, 86 N.E.2d 822 (C.P. Franklin Cty., Ohio 1949).

120. 113 Ohio St. 57, 148 N.E. 470 (1925).

121. 163 Ohio St. 81, 125 N.E.2d 731 (1955).

> [I]n order to say that the state has pre-empted a field of taxation to the exclusion of a municipality the situation should be confined to those instances where both the state and the municipality have imposed *the same* or *similar tax* on the *same taxpayer*.[122]

Judge Zimmerman's position appears to have provided the impetus for a decision upholding a municipal income tax levy in *Benua v. City of Columbus*.[123] Against an objection that the municipal income tax was unconstitutional as applied to rents received by a non-resident from real property, since a tax upon such income was in essence a tax upon the property itself and the state exclusively occupied the field of taxation of property owned by non-residents, the court found no pre-emption. In rejecting the pre-emption argument, the court held that where a municipal income tax is levied on rentals from realty, the tax is not levied on the property from which the income is derived. Consequently, there is no invasion of an area of taxation occupied by the state, and the doctrine of pre-emption is without application.

It is interesting to note that the *Benua* court attested to the ambivalence of the *Zielonka* case by citing it for the proposition that the power of a city to adopt a tax exists so long as the state has not pre-empted the field by enacting a state tax on the same area. Simply stated, the *Benua* court found that the state tax was too dissimilar to the local tax to pre-empt it. Despite the holding in *Benua*, the extent of protection afforded to local income taxation by this similarity test is dubious. Courts have often given effect to the pre-emption doctrine although the facts of a case present only attenuated similarities between the state and local taxes.[124] Recent cases seem to indicate that the moderate view formulated by Judge Zimmerman is tentatively followed, but that it is possible for courts to seize upon remote similarities to find pre-emption. For example, in the recent case of *East Ohio Gas Co. v. City of Akron*,[125] statutory pre-emption by implication was applied to invalidate a municipal income tax levy. The court found that the local tax, being a tax on net income of public utilities, was similar to a state levy on the adjusted gross income of public utilities. Thus, the former tax was pre-empted by the latter.

(c) Constitutional pre-emption by implication.—Another aspect of pre-emption is the doctrine of constitutional pre-emption by

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122. *Id.* at 89, 125 N.E.2d at 735 (emphasis added).

123. 170 Ohio St. 64, 162 N.E.2d 467 (1959).

124. *See, e.g.*, notes 132-38 *infra*; Haefner v. City of Youngstown, 147 Ohio St. 58, 68 N.E.2d 64 (1946); Youngstown Municipal Ry. v. City of Youngstown, 154 Ohio St. 311, 95 N.E.2d 585 (1950); Murray v. City of Philadelphia, 364 Pa. 157, 71 A.2d 280 (1950).

125. 7 Ohio St. 2d 73, 218 N.E.2d 608 (1966).

implication. This doctrine reached mature formulation in the Colorado case of *City and County of Denver v. Sweet*.[126] The court struck down an attempt by Denver to levy a municipal income tax under the broad powers granted the city in its home rule charter. In support of its decision, the court held that a "tax-sharing" amendment to the Colorado constitution,[127] providing that the state legislature could levy an income tax for the support of the state and/or *any other political subdivision thereof*, gave to the state exclusive authority to impose an income tax. Conceding that Denver may once have had the power to levy a tax under its home rule charter, the court concluded that it does not presently have the power because the state had pre-empted the field. Therefore, the court found pre-emption even though the legislature had passed no income tax legislation designed to benefit cities, and the "tax-sharing" amendment in no way expressly prohibited municipal income taxation.

The decision of the *Sweet* court appears firmly established in Colorado law since Denver's attempts to levy a one and four-tenths of one percent earnings tax on residents and non-residents was struck down in a recent case presenting essentially the same issues.[128] In this case, the court simply referred to the stare decisis effect of the *Sweet* decision.

Although there is precedent in favor of constitutional pre-emption by implication, some cases oppose such an approach. In rejecting the dictum of *Zielonka, Angell v. City of Toledo*[129] held that a tax-sharing clause in the Ohio constitution in no way provided sufficient grounds for a finding of state pre-emption. Rather, in upholding the validity of Toledo's municipal income tax levy, the *Angell* court found that:

> [I]n the absence of legislation by the General Assembly providing for a uniform or graduated income tax and the required apportionment thereof and subject to . . . [the constitutional provision] limiting the power of taxation, Ohio municipalities have power to levy and collect an income tax.[130]

By its holding, the *Angell* court strengthened language in *Stockwell v. City of Columbus*,[131] which expressly repudiated the dictum of *Zielonka* and upheld the Columbus City income tax.

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126. 138 Colo. 41, 329 P.2d 441 (1958).
127. Colo. Const. art. X, 17.
128. Duffy Moving & Storage Co. v. City and County of Denver, 450 P.2d 339 (Colo. 1969).
129. 153 Ohio St. 179, 91 N.E.2d 250 (1950).
130. *Id.* at 183, 91 N.E.2d at 252.
131. 39 Ohio Op. 499 (C.P., Franklin Co. 1949).

Thus, it appears impossible to determine the vitality of the constitutional pre-emption by implication doctrine. It is perhaps more applicable, although not necessarily so, in states whose constitutions contain a tax-sharing clause. Cases applying the doctrine are more recent than cases rejecting it; however, the paucity of cases in the area prevents a definitive determination of the prevailing trend.

2. Situations in Which Municipal Income Tax Ordinances Might Run Afoul of Pre-emption.—(a) *Ordinances similar to state taxing acts.*— The dissent in *Ohio Finance Co.*, indicating that a municipal taxing ordinance which is the "same or similar" to a state act is subject to pre-emption, appears to have established a trend in the area of statutory pre-emption by implication.[132] The test of similarity, however, appears to be of limited utility. Consistency in the case law is apparent only in the situation when the state and city use similar schemes for measuring tax liability. In *Haefner v. City of Youngstown*,[133] the court declared Youngstown's income tax levy on public utilities to be invalid since both city and state used the utility receipts as the measure of tax liability. Similarly, in *Youngstown Municipal Ry. v. City of Youngstown*,[134] a city excise tax was declared invalid and pre-empted. The city tax was measured by gross revenue that was too closely similar to the gross income measure employed by a state excise.

Looking beyond the measurement of tax liability, the similarity test does not offer a reliable guide in determining whether pre-emption will be applied. For example, in *East Ohio Gas Co. v. City of Akron*,[135] the levy of both state and local taxes on the same taxpayer contributed to a finding of pre-emption. In *Haefner v. City of Youngstown*,[136] however, pre-emption was found even though the taxpayers were different. The state tax in *Haefner* was a gross receipts tax on public utilities designed to tax the privilege of doing business; the city tax was a tax levied on the consumer of the electric service. Likewise, in *Murray v. City of Philadelphia*,[137] pre-emption was upheld when different taxpayers were involved. State franchise, excise, and capital

132. *See* notes 121-24 *supra* and accompanying text.
133. 147 Ohio St. 58, 68 N.E.2d 64 (1946).
134. 154 Ohio St. 311, 95 N.E.2d 585 (1950).
135. 7 Ohio St. 2d 73, 218 N.E. 2d 608 (1966).
136. 147 Ohio St. 58, 68 N.E.2d 65 (1946). *See also* note 124 *supra* and accompanying text.
137. 364 Pa. 157, 71 A.2d 280 (1950).

stock taxes levied directly on a corporation were held to pre-empt a municipal tax on income received by individual corporate shareholders. As the above cases indicate, the fact that a taxpayer is liable under both the state tax and the city ordinance is not determinative of the applicability of the pre-emption doctrine.

Although a logical application of the similarity test would prevent pre-emption of city taxes on different subject matter than the state tax, this has not been the case. In the *Haefner* and *Murray* cases, municipal taxation (in the latter case, municipal income taxation) has been invalidated by pre-emption even though the state tax was levied on an entirely different subject.[138] In light of this discussion, it is difficult to detect any firm guideline concerning the effect of similarity on the doctrine of pre-emption. Significantly, an analysis of these cases reveals that the presence of similarity has been employed in a negative sense to support findings of pre-emption. On the other hand, the lack of similarity has not proven a meaningful barrier to a finding of pre-emption. In reality, the lack of similarity between state and local taxing acts, as a reason for refusing to apply the pre-emption doctrine, has been utilized only in *Benua*. Therefore, when the similarity test is not ignored completely, it has proven to be a bulwark of state pre-emption.

(b) *The double taxation justification for pre-emption by implication.*—The statement that "double taxation is a policy consideration and not a legal consideration"[139] is undoubtedly correct. Courts have long sought to avoid the double taxation situation on policy grounds. Double taxation has been defined as "the levy of the same tax by more than one unit of government having jurisdiction over the taxpayer. . . ."[140] In the area of municipal income taxation, this concern with adhering to the policy against double taxation has often led to the justification of state pre-emption of a municipality's power to tax incomes. For example, in *Murray v. City of Philadelphia*,[141] the court pre-empted a municipal levy on income received by corporations since such corporations were already subject to state franchise, excise, and capital stock taxes. That court reasoned that the allowance of a municipal income tax on the net profits of these organizations would

138. For example, in *Haefner*, the city taxed the consumer for the *utility service* he received, and the state taxed the utility corporation for the *privilege of doing business*. For an excellent discussion of these similarity factors, see Hartman, *supra* note 112, at 142.

139. Glander, *Analysis and Critique of State Pre-emption of Municipal Excise and Income Taxes Under Ohio Home Rule*, 21 Ohio St. L.J. 343, 358 (1960).

140. *Id.* at 361.

141. 364 Pa. 157, 71 A.2d 280 (1950).

be a double tax and would result in such corporations bearing a heavier economic burden than those not subject to the municipal tax. Consequently, the economic burden would be duplicated.

A similar rationale for pre-emption was advanced in *East Ohio Gas Co. v. City of Akron.*[142] Akron was imposing a tax on the net income of a public utility, whose adjusted gross income was also subject to state taxation. As one basis for decision, the court concluded that statutory pre-emption by implication applies to prevent double taxation of the utility. Thus the city tax was invalidated although no statutory or constitutional provision expressly denied the city the right to levy such a tax.

Cities considering enacting a municipal income tax ordinance, therefore, would do well to consider the possible invalidating effects of the policy against double taxation. Such cities might argue that, regardless of well-meaning jurists and tax scholars who support the policy against double taxation, state-federal taxation of the individual demonstrates a most flagrant example of double taxation. Since sources of revenue cannot be separated at the state-federal level, they should not be separated at the state-local level.

(c) *The effect of tax-sharing schemes.*—Although the possible effect of statutory or constitutional tax-sharing clauses has previously been discussed,[143] the existence of such a clause can be a serious pitfall for cities desiring to enact a municipal income tax. Tax-sharing clauses have often been construed by courts as a statutory or constitutional implication that this field of taxation has been pre-empted by the state.

3. *The Kentucky Guise.*—Largely by judicial fiat and statutory construction of the most technical kind, cities in Kentucky have managed to avoid the pre-emption pitfall even though the state legislature has enacted a state income tax. Kentucky cities, with the approval of Kentucky courts, have avoided pre-emption problems by resorting to a characterization of municipal taxes measured by gross income as "occupational license taxes." Legal writers have duly noted that this tax is actually a form of municipal income tax which was expressly recognized by the United States Supreme Court in *Howard v. Commissioner of the Sinking Fund of Louisville.*[144] Construing the famous Buck Act, the Court found that the Act gave state and local governments the power to tax incomes of federal employees working

142. 7 Ohio St. 2d 73, 218 N.E.2d 608 (1966).

143. *See* notes 127-31 *supra* and accompanying text.

144. 249 S.W.2d 816 (Ky. 1952), *aff'd*, 344 U.S. 624 (1953).

within their boundaries. The Court further held that the Louisville Occupational License Tax was an income tax within the meaning of the Buck Act, which defined an income tax as any tax levied on or measured by net income, gross income, or gross receipts.

Contrary to the holding in *Howard*, many Kentucky cases have held[145] that the occupational license tax is distinguishable from a true income tax, although the measure, rate, and base are identical in form to those of a true income tax. In the recent case of *Batten v. Hambley*,[146] a Kentucky court held that the withholding provision of the occupational license tax does not make it synonomous with an income tax.

Since individual income in Kentucky is taxed by both the cities and the state, the policy against double taxation is contravened. Kentucky cities have managed to avoid having these levies invalidated because State courts do not recognize the validity of that policy. As one commentator has indicated:

> Kentucky courts have . . . taken the position that property or ownership is made up of a bundle of the varied and many privileges afforded by the local government, as well as by the state government. Those various privileges are proper subjects of taxation and they can be taxed collectively.[147]

Whether courts in other states would follow this reasoning concerning double taxation is unclear. Apparently, a similar characterization of an income tax as an occupational license tax met with success in only one other state.[148] Though the Kentucky approach may prove of limited use to cities in other states, such cities should at least consider the utility of attempting to avoid pre-emption problems by characterizing an income tax as an occupational license tax.[149]

4. *The Utility and Validity of the Pre-emption Doctrine.*—(a) *Is there a logical basis for pre-emption?*—It is

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145. *See, e.g.*, Kupper v. Fiscal Court, 346 S.W.2d 766 (Ky. 1961); Sims v. Board of Education, 290 S.W.2d 491 (Ky. 1956); City of Louisville v. Sebree, 308 Ky. 420, 214 S.W.2d 248 (1948).

146. 400 S.W.2d 683 (Ky. 1966).

147. Hartman, *supra* note 112, at 143.

148. *See* Estes v. City of Gadsden, 266 Ala. 166, 94 So. 2d 744 (1957).

149. This migbt be a worthwhile approach for Denver. In City & County of Denver v. Duffy Storage & Moving Co., 450 P.2d 339 (Colo. 1969), which struck down an "earnings" tax, the court cited the *Sebree* case from Kentucky as authority for sustaining a "Business Occupational Privilege Tax" that levied a flat $2 per month fee on every person employed in Denver making over $250 per month. This tax is not itself an income tax since it is not measured by income. The fiscal situation in Denver and the citing of *Sebree* as authority by the court, however, might make an attempt to enact a Kentucky-style occupational license tax worthwhile.

generally conceded that the state, by means of an express interdiction in the form of a "thou shalt not" statute, may effectively pre-empt local power to levy income taxes. The controversy surrounding the pre-emption doctrine arises from the closely related concepts of statutory pre-emption by implication and constitutional pre-emption by implication. These concepts present the issue of whether a pre-emption can be reasonably implied when a legislature levies a particular tax or a constitution grants to the state the power to levy a tax, both in the absence of an express prohibition of municipal taxation.

Approaching the statutory issue, it appears that logic simply will not support the implication of pre-emption. As one commentator points out, the illogicality of this implication is particularly apparent in states such as Ohio where cities operate under a home rule amendment, deriving their power to tax directly from the constitution.[150] In this situation, the *Angell* case accentuates the effect of a home rule grant in diminishing the state's sphere of power while concomitantly broadening the municipal sphere of power, including the power to tax.[151] Therefore, the state has no base of power from which to infer a pre-emption and preclusion of a home rule city tax. Instead, the state can limit municipal taxing power only by an express prohibition as is allowed in the home rule amendment.[152] Despite the appealing logic of *Angell*, the cases discussed in preceding sections indicate that pre-emption by implication is still a viable concept in Ohio.

Though the strongest argument for voiding the statutory pre-emption by implication concept can be made in states which have home rule cities, analogous reasoning appears applicable to uphold levies where home rule is not a factor. Assuming the state has power of express prohibitory interdiction, and in the absence of an express constitutional prohibition, there would seem to be little logic in implied pre-emption. This conclusion is reasonable because a legislature may expressly prohibit local levy by statute if it intends to pre-empt an area of taxation.

In a similar vein, the concept of constitutional pre-emption by implication is also lacking in logical support. As the *Sweet* case made

150. Glander, *supra* note 139, at 359.

151. Glander underscores the unreasonableness of pre-emption by implication by indicating that no provisions of the Ohio constitution and no decision of the Supreme Court of Ohio (save one which is quite old) would prevent state and local government from simultaneous occupancy of a field of taxation in the absence of an express legislative prohibition. *Id.* at 360.

152. *See* OHIO CONST. art. XVIII, § 13.

apparent, a constitutional grant to a state of the power to levy an income tax may pre-empt a similar city levy, even though the state has not exercised its power.[153] In view of the lack of constitutional prohibition granted to it, there are equally strong, if not stronger, grounds to support an implication that no pre-emption was intended. Even if the state had exercised the constitutional grant of power and levied an income tax, in the absence of express constitutional or statutory prohibition, there is no logically compelling reason why this circumstance demands a finding of pre-emption by implication.

In relation to constitutional and statutory pre-emption by implication, one commentator in the field has expressed his distaste for the two concepts as follows:

> On what basis can it realistically be contended that the state taxing statute [or the constitutional authorization for such a state statute] encompasses more than the primary objective of financing state business? On what basis can . . . it realistically . . . be said that the state taxing statute [or the constitutional authorization for such a state statute] constitutes a *limitation* on municipal or other local taxation? What intrinsic or extrinsic aid to statutory [or constitutional] interpretation compels, or even justifies, such a secondary purpose of a limitation, when the taxing statute or constitution, as the case may be, is *completely silent* regarding any such preclusion of municipal taxation? Raising state revenue is one thing, but limiting municipal taxation is a horse of an entirely different color.[154]

(b) *Does Dillon's Rule support pre-emption by implication?*—Since Dillon's Rule and the Pre-emption Doctrine both proceed from the same assumption about state-local relationships, the former might possibly offer some support for the latter. Both concepts are based on the general legal proposition that the city is a creature of the state and is capable of exercising only those powers given it by the state. Proceeding from this proposition, the first component of Dillon's Rule, along with pre-emption by implication (either statutory or constitutional), seems to stand for the proposition that the city cannot exercise power without an express grant of power from the state. The only difference lies in the manner in which the proposition is expressed. The first component of Dillon's Rule affirmatively states that express language is necessary to grant power, taxing or otherwise, to a municipality. On the other hand, the doctrine of pre-emption by implication expresses the same idea in a negative manner. The *lack* of express language giving power to a municipality, coupled with the existence of a similar state power may be grounds for the implication

153. *See* note 126 *supra* and accompanying text.

154. Hartman, *supra* note 112, at 147. For a similar discussion, see Fordham & Mallison, *Local Income Taxation*, 11 Ohio St. L.J. 217 (1950).

that the municipality has no authority.[155] Therefore, the first component of Dillon's Rule is consistent with and lends support to the doctrine of pre-emption by implication.

The first component of Dillon's Rule, however, cannot be read in isolation from the other two branches. It is submitted that in states where Dillon's Rule is accepted,[156] the second and third components offer cities a possible avenue of escape from pre-emption by implication. This conclusion is based on the belief that the doctrine of pre-emption by implication is inconsistent with Dillon's Rule when read in its entirety. The finding of pre-emption by implication appears to ignore the meaning of the second and third components of Dillon's Rule. The second component of the Rule indicates that a city can exercise those powers which can be *necessarily or fairly implied* from, or are *incident to*, powers expressly granted. With regard to home rule cities having broad express grants of general governmental power,[157] it seems likely that a taxing power could be fairly implied from or considered incidental to these sweeping but express grants of home rule power. Indeed, this idea has been tacitly given effect in at least one case involving a home rule city's levy of an income tax. In *Dooley v. City of Detroit*,[158] the Michigan court upheld the tax, over a pre-emption by implication objection, on the ground that under the constitution and Home Rule Cities Act[159] cities could exercise substantially greater powers than they had previously exercised. Although these new powers were not plenary and their exercise must be justified as essential to local government, the exercise of a power similar to the imposition of a municipal income tax was so fundamental that it could be undertaken without express authorization from the state.

The third component of Dillon's Rule also offers a method to evade pre-emption by implication. The third component indicates that a municipal corporation may exercise those powers absolutely essential to the declared objects and purposes of the corporation. The raising of revenue is certainly essential to the declared objects of government, for

155. *Compare* State *ex rel.* Zielonka v. Carrel, 99 Ohio St. 220, 124 N.E. 134 (1919), *with* City & County of Denver v. Sweet, 329 P.2d 441 (Colo. 1958), *and* note 105 *supra* and accompanying text.

156. It would appear that acceptance of the Rule is widespread. *See* U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS REPORT, *supra* note 98, at 81 n.9.

157. See note 107 *supra* and accompanying text.

158. 370 Mich. 194, 121 N.W.2d 724 (1963). *Contra*, Carter Carburetor Corp. v. City of St. Louis, 356 Mo. 646, 203 S.W.2d 438 (1947).

159. MICH. STAT. ANN. § 5.2082(1) (1949).

without adequate revenue those objects cannot be attained. There are numerous cases holding that a fundamental power of city government is the power to raise revenue.[160] Therefore, a persuasive argument can be made on the basis of the second and/or third components of Dillon's Rule for avoiding pre-emption by implication and sustaining city power to tax incomes. In contradistinction to supporting pre-emption by implication, Dillon's Rule may provide cities with an unexpected key to the avoidance of that restrictive doctrine.

(c) *Final criticisms of pre-emption.*—In the context of the fiscal needs of today's cities, pre-emption, particularly pre-emption by implication, is absurd. The tumultuous events of the past several years in our nation's cities can probably be attributed in large part to the inability of the city to raise revenue sufficient to support the services essential to efficient government. In continuing to apply pre-emption by implication, the judiciary is exhibiting a totally unrealistic attitude toward the fiscal needs of the city. They continue to prevent cities from reaching a sorely needed source of revenue even though the state levy is nominal or, as in the *Sweet* case, non-existent.

It seems clear that the pre-emption impediment should be removed and cities should be allowed to tax incomes. This could be accomplished in one of three ways: first, judicial decisions based on Dillon's Rule or some similar argument might be employed to defeat pre-emption by implication; secondly, interdictory pre-emption and statutory pre-emption by implication could be quickly disposed of by the simple expedient of permissive legislation, which expressly repudiates pre-emption and clears the path to local taxation; lastly, where constitutional pre-emption by implication is involved, constitutional amendment might be possible to remove the impediment.[161]

C. *Uniformity Problems—Due Process and Equal Protection*

1. *Classification Problems.*—(a) *Distinctions between residents and non-residents.* From the early days of its existence, municipal income taxation has been subjected to constitutional challenge on the ground that the taxation of non-residents amounts to a taking of property without due process of law. One of the first cases to consider

160. *See, e.g.*, Angell v. City of Toledo, 153 Ohio St. 179, 91 N.E. 2d 250 (1950).

161. Furthermore, the state legislature might possibly circumvent constitutional pre-emption by exercising its powers over taxation in such a way as to create special exceptions to the constitutional clause. *See* Hartman, *supra* note 112, at 145-46.

the problem of the taxation of non-residents was *Kiker v. City of Philadelphia.*[162] The court upheld the tax as applied to a non-resident federal employee, a citizen of New Jersey, working at a federal installation in Philadelphia. The court reasoned that since the non-resident worked in Philadelphia, he received the benefits and protection of the city during his working hours. These benefits and protections were held to justify the taxation of his income because the city had a right to expect the non-resident to render some payment in return for the services it provided. Thus, the tax was not held to constitute a deprivation of property without due process of law since the taxpayer received tangible benefits in return.[163] In the more recent Missouri case of *Arnold v. Berra,*[164] the St. Louis income tax was upheld on similar reasoning, over the objection of an Illinois resident that he was being deprived of property without due process of law, and that such a tax placed an undue burden on interstate commerce.

In a closely related group of cases, courts have considered due process challenges to the municipal income tax liability of persons who are residents of the taxing city but earn all or part of their income outside of the city. Once again, the courts have upheld the tax on the ground that the taxpayer receives tangible benefits, protection, services, and opportunities from the city of his residence. Consequently, the taxpayer should contribute to the city's support by paying the income tax, even though his income may have been earned elsewhere.[165]

Thus, both a non-resident earning income in the taxing city, and a resident earning income outside the city may be taxed without constitutional problems on the theory that each receives benefits from the taxing city for which he should pay.

(b) *Distinctions between earned and unearned income.*—As to the taxation of earned and unearned income, the cases demonstrate that unearned income, such as rents and dividends, may be subject to taxation in the same manner as earned income. Taxation of rental income has been upheld because the city provides protection for the realty from which the rental income is derived.[166] Again, due process

162. 346 Pa. 624, 31 A.2d 289 (1943).

163. The court found that among the most tangible benefits the non-resident received was the clearing of ice from the river during the winter which allowed the New Jersey resident to commute to his job.

164. 366 S.W.2d 321 (Mo. 1963).

165. *See, e.g.*, School Dist. v. Yeskey, 409 Pa. 12, 185 A.2d 516 (1962); City of Springfield v. Kennedy, 62 Ohio L. Abs. 123, 104 N.E.2d 65 (Ct. App. Clark County, 1951).

166. *See, e.g.*, Benua v. City of Columbus, 170 Ohio St. 64, 162 N.E.2d 467 (1959).

is not violated because a benefit is received for which the taxpayer should pay.

On the other hand, some cities have distinguished the tax liability on earned from unearned income, exempting the latter while taxing the former. Against challenges that such a classification denied equal protection of the law to those who were taxed on earned income by unfairly discriminating in favor of those who received unearned income, the courts have held a classification of this type valid and not a denial of equal protection. For example, in *Barhorst v. City of St. Louis*,[167] the court held that enabling legislation authorizing charter cities to levy an earnings tax on salaries, wages, commissions, and other earned compensation without including unearned income such as rents, dividends, and interest, is not so unreasonable and arbitrary with respect to classification as to violate due process and equal protection. The court employed the policy against double taxation to support its conclusion reasoning that such unearned income is derived primarily from property already subject to city property taxes. Therefore, the exemption of such unearned income from the income tax avoids double taxation and is not an unconstitutional classification.

Thus, unearned income can either be taxed in addition to earned income or exempted. Considerations of due process or equal protection do not pose serious barriers in either case.

(c) *Distinctions between corporate and individual tax liability.*—A study of the cases in this area reveals a certain amount of inconsistency in the holdings. In *Youngstown Sheet & Tube Co. v. City of Youngstown*,[168] the City corporate income tax was held unconstitutional as a violation of equal protection since corporate net profits were taxed at a one percent rate, while individuals and unincorporated businesses were taxed at a rate of three-tenths of one percent. The court determined that the City had failed to demonstrate a reasonable basis for taxing corporations at a higher non-uniform rate, and thus equal protection was denied.

An ample demonstration that the quest for uniformity is not the controlling factor is provided by cases holding that a city tax is not an unconstitutional discrimination where residents were taxed on their entire income, but corporations were taxed only on income earned in the city.[169] Likewise, equal protection has not been denied to businesses

167. 423 S.W.2d 843 (Mo. 1968).

168. 91 Ohio App. 431, 108 N.E.2d 571 (1951).

169. *See, e.g.*, Barhorst v. City of St. Louis, 423 S.W.2d 843 (Mo. 1968); City of Springfield v. Krichbaum, 88 Ohio App. 239, 100 N.E.2d 281 (1950).

subject to the levy, where certain corporations such as insurance companies and express companies have been excluded from income tax liability because of the difficulty in measuring their net profits.[170]

Apparently, the rationale of these cases is gleaned from the determination of whether a city can demonstrate a justifiable reason for discrimination. If this is done, the discrimination will be upheld on the policy against double taxation or on a consideration of administrative feasibility. If a justifiable reason is not demonstrated, as in *Youngstown Sheet & Tube*, the discrimination will be held to deny equal protection.

(d) *Distinctions in the tax liability of wage earners and those deriving income from businesses or professions.*—The cases dealt with in this section involve the question of whether municipal ordinances, which impose a tax on wages and salaries on the one hand, and net profits derived from businesses and professions on the other, are unconstitutional because of the distinction made between wage earners and those engaged in businesses or professions. One of the first cases to consider this issue was *Dole v. City of Philadelphia*,[171] in which the Pennsylvania Supreme Court held that a city income tax differentiating between wages and net profits did not contravene constitutional requirements of uniform taxation. The court reasoned that because the tax burden fell equally on all wage earners as a class, and all business owners and professional persons as a class, the constitutionally imposed conditions of uniformity had been met.[172]

In *Walters v. City of St. Louis*[173] the United States Supreme Court upheld the St. Louis municipal income tax against a charge that it was discriminatory as between salaries and net profits and violated due process and equal protection. The Court stated that equal protection requires only that the statutory classification be based on actual differences, that the differentiation have some relevance to the purpose for which the classification was made, and that the different treatments "be not so disparate, relative to the difference in classification as to be wholly arbitrary."

As in other areas of classification, it appears that classifications which differentiate between the income earned by wage earners and that

170. *See* Barhorst v. City of St. Louis, 423 S.W.2d 843 (Mo. 1968).

171. 337 Pa. 375, 11 A.2d 163 (1940).

172. As additional support for the reasonableness of the classification, the court noted that the expected yields in wage income were more predictable and less speculative than the income derived from business and professional enterprise.

173. 259 S.W.2d 377 (Mo. 1953), *aff'd*, 347 U.S. 231 (1954).

earned from business enterprises or professional activities will be allowed where the city can demonstrate a reasonable basis for such discrimination.

(e) *Miscellaneous distinctions.*—It should be noted that municipal income tax ordinances which exempt residents who are members of the armed forces from income taxation are not unconstitutional for lack of uniformity. In this situation, the differentiation has been upheld as reasonable on the ground that serving in the armed forces was a sacrifice which entitled servicemen to such an exemption.[174] Also, municipal income tax which taxed the gross income of individuals but only the net income of businesses was held to be constitutional since the differentiation was reasonable.[175]

2. *Some Conclusions on Uniformity.*—A study of the relevant cases indicates a fairly consistent pattern in the decisional process which can be used to rationalize the results in most, if not all, of the cases. First, where an income taxing ordinance is challenged on equal protection grounds, decisions similar to *Walters* and *Farrell* demonstrate that the ordinance will survive the constitutional test if the city can show that the differentiations made by the ordinance were based on reasonable grounds, such as considerations of essential fairness or administrative feasibility. On the other hand, if the ordinance contains unreasonable classifications, as in *Youngstown Sheet & Tube,* it will not withstand constitutional attack.

Secondly, where an income taxing ordinance is challenged on the ground that property is taken without due process of law, the ordinance will be upheld if the city can show that it is giving the taxpayer a sufficient consideration, as in *Kiker*, in return for extracting the tax payment. Where the city cannot show a benefit from it to the taxpayer, however, the ordinance will most likely be invalidated on the due process challenge.

D. Problems Encountered in Extending the Scope of Municipal Income Taxing Liability

1. *Problems of Double Taxation.*—Double taxation problems can be resolved into two major areas of concern. The first area, which was discussed extensively in connection with the previous considerations of the pre-emption doctrine, involves a municipal levy

174. *See, e.g.*, City of Philadelphia v. Farrell, 205 Pa. Super. 263, 209 A.2d 867 (1965).
175. City of Springfield v. Krichbaum, 88 Ohio App. 239, 100 N.E.2d 281 (1950).

on income subject to a state tax of a similar or different nature.[176] The second area, which is the subject of this section, is taxpayer liability for income taxes imposed by more than one city. One authority has succinctly expressed the problem as follows:

> There is . . . a very real danger of double taxation for those taxpayers who live in one local taxing unit but earn all or a part of their income in another. In some states . . . local income taxes hit the suburban resident who earns his pay or carries on his business is a neighboring city. Often the suburbs strike back at the taxing city by passing their own local income tax laws. The unfortunate taxpayer may, therefore, be caught in the middle by a double local income tax.[177]

An excellent example of an "unfortunate taxpayer" was presented in *Thompson v. City of Cincinnati*.[178] That case involved a declaratory judgment action brought by a resident of Loveland, Ohio, who worked in Cincinnati, to determine his liability with respect to the payment of municipal income taxation. Both cities had enacted income tax ordinances. The court held that the plaintiff was subject to the taxes of both cities and determined, with respect to the Cincinnati tax, that a city may levy a tax on wages derived from work performed within its boundaries by a non-resident of that city. With regard to the Loveland tax, the court indicated that the city of residence could levy a tax on wages resulting from work done in another city. The court concluded that the plaintiff could be taxed by both cities because the burden of supplying necessary revenue to maintain municipalities must be shared by those who are provided with substantial benefits by municipalities. Thus, it appears that a benefit theory of taxation, which has been used to uphold the municipal income tax against due process contentions,[179] also supports taxation by the city of residence as well as the city of employment.

Although double taxation was upheld in *Thompson* through an application of the benefit theory, this does not necessarily represent the general practice. For example, in Pennsylvania, statutes alleviate the problem of double taxation. Cities of residence in Pennsylvania are given an exclusive right to tax the income of their citizens. Furthermore, a taxpayer is allowed to credit the tax paid to his resident city against any income tax liability he may have incurred in other cities.[180] Michigan has recently enacted a Uniform City Income Tax

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176. *See generally* notes 139-43 *supra* and accompanying text.

177. Hartman, *supra* note 112, at 130.

178. 2 Ohio St. 2d 292, 208 N.E.2d 747 (1965).

179. *See* note 162 *supra* and accompanying text.

180. *See* PA. STAT. ANN. tit. 53, § 6914 (Supp. 1969). Philadelphia is the lone city exempted from the coverage of this statute. Philadelphia has been given the exclusive power to

Ordinance which allows a person who earns income outside of his city of residence to credit the income tax paid to the city of his employment against the income tax liability incurred in his home city.[181] Thus, statutory solutions to the problem of double taxation may favor the city of residence, as in Pennsylvania, or the city of employment, as in Michigan. In light of the reasoning of the *Thompson* case, however, it appears that there is a persuasive argument that the double tax is a justifiable means of raising revenue to support both the city of residence and the city of employment.

2. *Problems in Taxing State and Federal Employees.*—(a) *Federal employee liability.*—Invariably two objections have been made to the taxation of federal employees: first, local taxation of the incomes of federal employees constitutes a direct, and hence unconstitutional, burden on the federal government; and secondly, that federal installations are not part of the taxing municipality in which they are located.

The first objection has met with complete rejection by the courts, which have generally held that the tax is levied on the private income of the government employee and in no way constitutes a burden on the federal government.[182] With the congressional enactment of the Buck Act and the subsequent interpretation by the United States Supreme Court, this objection to taxation of federal employees is no longer viable. In *Howard v. Commissioner of the Sinking Fund of Louisville*,[183] the Court construed the Buck Act as a congressional grant of consent to state and local governments to tax the income of federal employees. Even local methods of enforcement of the tax which might incidentally interfere with the conduct of federal activities (*e.g.*, the arrest of a federal employee on the job for non-payment of city income taxes) have been held not to constitute an illegal burden.[184]

The second objection also has little force. The leading case in the area, *Kiker v. City of Philadelphia*,[185] construed the Buck Act to mean that a local government may reserve to an area ceded to the federal government the power to tax within its geographical limits. Using the

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tax incomes of non-residents earned in the city. Double taxation is no problem, however, because other cities cannot tax the income of residents who earned wages or salaries in Philadelphia. PA. STAT. ANN. tit. 53, §§ 6901-6914 (Supp. 1969).

181. MICH. STAT. ANN. § 5.3194(75) (Supp. 1969).

182. City of Philadelphia v. Schaller, 148 Pa. Super. 276, 25 A.2d 406 (1942).

183. 344 U.S. 624 (1953).

184. Application of Thompson, 157 F. Supp. 93 (E.D. Pa. 1957).

185. 346 Pa. 624, 31 A.2d 289 (1943). *See also* City of Cincinnati v. Faig, 145 N.E.2d 563 (Cincinnati Mun. Ct. 1957).

"benefit theory," the court reasoned that the local government ceded the area, but retained the obligation of furnishing protection and benefits to persons and property within the confines of the area. Therefore, the federal employee received the benefits of this protection and should defray the cost to the city through tax payments. The scope of the *Kiker* decision can be demonstrated in the rather novel case of *City of Springfield v. Kenney*,[186] where the court used similar reasoning to hold a resident of a federal housing project within the coverage of the municipal tax. Thus, the general rule is that cities may levy income taxes in federal installations which are within the geographic boundaries of the city, and tax either residents or non-residents working at such an installation. Presumably, a city may also tax the income of a federal employee who lives in the taxing city but derives his income from federal work outside of the city. A levy of this nature would seem to be a valid exercise of municipal taxing power under the benefit theory.

(b) *State employee liability*.—The right of a city to tax state employees has been upheld as against two objections: first, that the city is without power to tax a state employee because the city is merely a creature of the state; and secondly, that the tax imposes an illegal burden on the state government.

The first objection was rejected in *Marson v. City of Philadelphia*.[187] In an opinion analogous to the Supreme Court's *Howard* decision, the court found that the city tax was levied on the private incomes of the state employees and in no way impaired the power of the state nor subordinated it to local power. The second objection was rejected in *McConnell v. City of Columbus*.[188] In that case, the city levied an income tax on wages earned by non-residents for services performed at a state university on property of the university located within the city. Upholding the tax, the court reasoned that a non-discriminatory tax on income earned from services rendered to an instrumentality of the state government does not constitute a tax on that government and is not an interference with or burden upon the activities of the government. Thus, it is conclusively established that municipalities can tax the income of federal and state employees.

186. 65 Ohio L. Abs. 123, 104 N.E.2d 65 (Ct. App. Clark County, 1951).

187. 342 Pa. 369, 21 A.2d 228 (1941).

188. 172 Ohio St. 95, 173 N.E.2d 760 (1961).

E. *Administrative Problems*

1. *The Withholding Burden.*—All jurisdictions imposing the municipal income tax require resident employers to withhold tax payments from the wages and salaries of employees. This requirement is considered an absolute necessity to the successful collection and administration of the tax.[189] As an example, Ohio cities obtained 70 to 80 percent of their total collections from employers' withholdings in 1966.[190] The withholding requirements not only allow tax administrators to consolidate many individual accounts into relatively few accounts for employers, but they substantially decrease the likelihood of tax evasion since the individual employee does not compute and remit his own tax. Where employers are located outside the taxing jurisdiction, state laws generally do not give the cities the power to require employers to withhold tax payments for residents of the cities.[191]

Indicating a strong concern for the administrative feasibility of municipal taxation, courts have allowed the cities to shift much of the burden involved in collecting the tax to the business community by means of mandatory withholding provisions. The decisive factor is whether the employer is doing business within the taxing community. No cases have been found which allow a city to force a non-resident employer not doing business within the city to withhold wages of residents of the city. Although it is possible that a city might convince non-resident employers to cooperate voluntarily, jurisdictional problems would provide a formidable obstacle.

2. *The Exemption Problem.*—In the interest of decreasing administrative costs and increasing ease of collection, courts have held that a city exemption of persons whose annual income falls below a minimum level is not an unconstitutional discrimination against persons of higher income levels.[192] The apparent discrimination is

189. Conlon, *Enforcement of the Municipal Income Tax*, 28 ACAD. POL. SCI. PROC. 481 (1968).

190. Collection from withholdings as a percent of total collections in the major Ohio cities in 1966 were: Akron 79.9%; Cincinnati 74.2%; Columbus 74.4%; Lima 76.5%; Toledo 80%; and Youngstown 77.8%. OHIO MUNICIPAL LEAGUE, *supra* note 58.

191. It is also noteworthy that a city cannot impose the task of withholding provisions upon federal and state agencies since this would be considered an illegal burden on those higher governmental agencies. Usually, federal and state agencies will furnish employee lists with a record of wages earned to the taxing city. This list is of some aid in ehecking compliance.

192. *See* City of Springfield v. Kennedy, 62 Ohio L. Abs. 123, 104 N.E.2d 65 (Ct. App. Clark County, 1951); *cf.* Butcher v. City of Philadelphia, 333 Pa. 497, 6 A.2d 298 (1938) (denying certain types of exemptions).

justified on the ground that the benefit derived by the city in terms of being relieved of collecting the negligible sums due on small incomes more than balances the inequity suffered by those persons in higher income brackets who cannot take advantage of the exemption.

Also, cities do not discriminate unreasonably against resident employers by waiving statutory interests and penalties for non-resident employers in order to gain their voluntary cooperation and compliance with withholding schemes.[193] Although there are serious jurisdictional questions as to whether such penalties could actually be imposed on non-residents, the waiver has been allowed in light of the need to decrease administrative costs.

3. *Enforcement.*—The third administrative problem in applying a municipal income tax is enforcement. Most tax ordinances provide for penalties on delinquent taxes, and many provide that delinquent taxes shall accumulate interest at the rate of six percent per annum.[194] The new New York City ordinance provides a stiff penalty of 5,000 dollars or one year's imprisonment for any person willfully evading the tax. In a further step to facilitate compliance with the New York ordinance, any employer who willfully fails to withhold the amount of tax owed by employees from their wages will also be liable for a penalty of 5,000 dollars or one year's imprisonment.[195] New York City's penalties are more stringent than the penalties imposed for evasion in most cities, and it seems likely that New York's enforcement record will be superior to that of most other cities. In the rare instances where delinquency penalties have been administered, the penalties have been generally light. Naturally, this leniency has contributed little to increase compliance with the tax. Vigorous enforcement of such penalties as exist in the New York City law, however, would considerably reduce evasionary practices.

Evasion is most often attempted by self-assessing individual taxpayers whose tax liability is not withheld by an employer. It is estimated that only ten percent of this group willfully evade the tax.[196] Nevertheless, the tax revenue which is incurred but not paid because of such illegal practices in most cities would probably justify harsher penalties of the New York type and a concomitant increase in enforcement efforts.

193. City of Philadelphia v. Farrell, 205 Pa. Super. 263, 209 A.2d 867 (1965).
194. R. SIGAFOOS, *supra* note 5, at 56.
195. N.Y. SESS. LAWS ch. 773, § 25-a(§ 75) (McKinney 1966).
196. R. SIGAFOOS, *supra* note 5, at 81-82.

Evasion by resident businesses of municipal income taxation presents a particularly difficult problem. Businesses have unusual opportunities for successful evasion because the tax is levied on their net profits. Since the net profit figure is derived from the records of the businesses themselves, the difficulty of enforcement becomes obvious. Although an estimation of how much tax revenue is lost to cities each year by business evasion would be imprecise, it is probably a substantial amount. In order to prevent widespread evasion by businesses, cities would be required to conduct periodic, detailed investigations of the profit and loss account of every resident firm, which would involve prohibitive costs for most municipalities. Thus, it is apparent that where cities must depend upon self-assessment, either by individuals or by businesses, the problems of enforcement are greatly increased.

One factor which increases the enforcement problem is the lack of cross-checking with income tax authorities at higher levels of government. Under the *Internal Revenue Code of 1954*, the governor of each state may request that certain state officials, or officials of local governments which administer tax laws, inspect tax returns for all individuals or corporations within the state. Such inspection is limited, however, to the Internal Revenue offices during normal business hours.[197] Even though checking does occur at the state level, there have been no reported instances in which it has been used by the local income tax administrators. In relation to coordination of tax administration at the state and local levels, Kentucky and New York are the only states which specifically authorize the state tax agencies to exchange tax information with local government. Alabama and Missouri authorize the state official to exchange information with the Internal Revenue Service, but no similar provisions are allowed for the local tax administrators.[198] Missouri specifically prohibits municipalities from exchanging tax information with the State.[199] Baltimore has no problem in this area, since its tax is administered by the State. The Michigan cities are authorized to contract with the State tax administration for collection of local income taxes.[200]

197. INT. REV. CODE of 1954, § 6103(b)(2); Treas. Reg. § 301.6103(b)-1(a)-(d) (1961).

198. Conlon, *supra* note 189, at 483-84.

199. *Id.*

200. *See* note 20 *supra*.

V. Comparison of the Other Sources of Local Revenue with the Income Tax

A. The Property Tax

A study of the municipal income tax is not complete without a comparison with other local sources of tax revenue. Aside from grants from the federal and state governments, city officials generally depend upon the property, sales, gross receipts, and income taxes as their main sources of revenue. The majority of tax revenues in the cities has traditionally come from the property tax, which is generally overburdened, regressive, and in need of administrative reform.

An examination of the percentages of local revenues obtained from the various types of taxation illustrates the relative dependence of local governments upon the property tax. In 1902, the property tax accounted for 73.1 percent of all local government revenues; other taxes contributed 20.4 percent; and state and federal grants totaled 6.5 percent. Over the years, the property tax has decreased as a percentage of total revenues received by the cities, amounting to 73.9 percent in 1927, 60.1 percent in 1940, 50.2 percent in 1950, 48.7 percent in 1957, and 47.9 percent in 1962. In 1962, contributions from the state and federal governments rose to 30.3 percent, and non-property taxes totaled 34.9 percent of total revenues.[201] When the property tax is compared with other local taxes, it can be noted that property taxes account for a much higher proportion of revenue than all other taxes in many cities. The cities without income taxes are much more dependent upon the property tax than those with the income tax. In 1966, Los Angeles derived 56 percent of its total tax revenues from the property tax and 25 percent from the sales tax. Chicago received 63 percent of its revenues from the property tax and nine percent from the sales tax. On the other hand, Philadelphia and Detroit, both of which have the income tax, derived only 42 percent and 28 percent respectively of their total revenues in 1966 from the property tax.[202]

The two most prevalent criticisms of the property tax are its inequities due to non-uniformity of assessment and its regressiveness. Problems of non-uniformity of assessment are widespread throughout most municipalities and arise from a number of different factors. In

201. J. Bollens & H. Schmandt, The Metropolis 348 (1965).

202. Tax Foundation, Inc., *supra* note 24, at 43. In 1966, for cities with populations ranging from 1/2 to 1 million not including St. Louis, Pittsburg, or Cincinnati, the property tax averaged 86% of total tax revenues. In the same year, St. Louis, which has the income tax, derived 40% of its tax revenues from the property tax, and 34% from the income tax.

all but four states, the tax applies to both real and tangible personal property,[203] thus making valuation a tremendous task even if a uniform method of valuation is used. Assessments in most communities are usually at a fraction of the fair market value of the property.[204] Assessment levels will often vary on properties with different age, use, and location. Where the tax covers business inventory, fixtures, and machinery, manipulation of assets by the businesses subject to the tax often results.[205] One often noted defect is the political nature of the position of municipal tax assessors and administrators, many of whom may be unfamiliar with the statutes and regulations in the area at the time of their appointment or election.[206] Another political problem which causes wide variation in the percentage of assessed value is the conflict between the state and local methods of assessment.

In addition to being poorly administered, property tax is regressive since it takes a higher percentage of income from the lower income groups than those in the higher brackets. Expenditures for housing, as well as local taxes paid, generally absorb a smaller percentage of income as the level of income rises. Furthermore, valuable residential properties in many communities tend to be more under-assessed relative to their market value than properties of low or average value.[207]

B. The Sales Tax

Since the turn of the century, the retail sales tax has grown to be the largest non-property source of local revenues in many cities.[208] As of January 1, 1968, sales taxes were in use in 44 states and the District of Columbia.[209] Approximately 3,000 local taxing authorities in seventeen states now levy the sales tax which generated almost one and one-half billion dollars in revenue for local governments in 1965-66.[210]

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203. Harriss, *Economic Evaluation of Real Property Taxes*, 28 ACAD. POL. SCI. PROC. 489, 490 (1968).

204. For example, the total assessment for property in Cuyahoga County (Cleveland) in 1958 was $5.1 billion, but its fair market value was determined to be over $15 billion. S. SACKS, *supra* note 55, at 227.

205. Macioce, Comments, 28 ACAD. POL. SCI. PROC. 537, 538 (1968).

206. *Id.*

207. S. SACKS, *supra* note 55, at 238.

208. In 1902, non-property sources contributed around $80 million or 11.4% of state and local revenues. By 1961, revenues from non-property taxes had risen to $2.4 billion, but this accounted for only 12.3% of the total state and local revenues. When only state revenues are considered, non-property taxes contributed 97% of the total tax revenues in 1961. The cities have remained dependent on the property tax. U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, *supra* note 98, at 73-75.

209. U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS 2 (1968).

210. *Id.*

Despite this revenue, cities still remain much more dependent upon the property tax which produced six and nine-tenths billion dollars for local governments in 1966 as compared with one and eight-tenths billion dollars from the sales and gross receipts taxes.[211]

The sales tax can be imposed by several different methods, all of which are in use by several cities. The method recommended by the Advisory Commission on Intergovernmental Relations is the "piggy back" sales tax.[212] Under this system, the state administers and collects the tax for the cities. Nine state legislatures have required that the state impose the tax for the cities; state administration is optional in four other states.[213] Where each local government applies its own sales tax, whether administered locally or by the state, local businesses may be hurt by shoppers and industries who purchase outside the taxing district to avoid the sales tax.[214] If the state automatically rebates part of the sales tax to the community, the unfairness of the tax to businesses is avoided by eliminating buyers' incentive to shop outside the taxing district.[215] The rates imposed by the cities vary from 0.5 to 3 percent, with most cities limiting the local tax to one percent.[216]

In addition to penalizing businessmen in many areas where shoppers tend to go out of the taxing jurisdiction, the sales tax requires extensive bookkeeping. Where many items, such as food, drugs,[217] and sales to charitable organizations are exempt, problems of bookkeeping are increased. Several states require retailers to maintain records concerning the destination of goods and sales office operations, such records being used to determine the amount of tax payable.[218] In all states, the sales tax is highly regressive. Regressiveness is moderated if food for home consumption is exempted, since this item accounts for almost 30 percent of consumer expenditures for the average family.[219]

Another non-property tax in wide use today is the gross receipts tax. By applying a flat rate to gross receipts, the tax becomes a turnover tax at each level of the exchange of consumer goods. Since it

211. U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE U.S. No. 601, at 425 (89th ct. 1968).

212. U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS 6 (1968).

213. *Id.* at 2.

214. S. SACKS, *supra* note 55, at 251.

215. *Id.*

216. U.S. ADVISORY COMMISSION OF INTERGOVERNMENTAL RELATIONS 2 (1968).

217. As of 1968, 14 states excluded food for home consumption and 22 states excluded prescription medicine. *Id.*

218. Macioce, *supra* note 205, at 538-39.

219. S. SACKS, *supra* note 55, at 254.

does not differentiate between businesses with high and low profit margins, the tax is highly discriminatory towards those with low profit margins. Also, the gross receipts tax gives great advantage to large firms which distribute their own goods, thereby eliminating wholesalers and jobbers who normally pass the tax to the consumers in the form of higher prices.[220]

C. *Advantages of the Municipal Income Tax*

Many cities urgently need to reduce the burden of the property tax. The income tax offers a means to relieve this burden.[221] To produce the same levels of revenue which could be received from a modest flat rate income tax, sharp increases in the property tax rate would be required.[222] Although property taxes in cities with income taxes have risen, the increase is substantially less than for cities of comparable size without the income tax.[223] As an illustration, from 1956-66 the property tax in Philadelphia, which has an income tax, increased 52 per cent, as compared with a 101 percent increase in Los Angeles, a non-income tax city.[224] A reasonable conclusion is that "the effect of any broad-based [municipal] income tax—applicable to both business and individuals alike—is to reduce the potential over-all municipal tax payments by owners of property."[225]

The income tax, like the general sales tax, but unlike the property tax, produces an expanding yield during inflation. To keep pace with rising service costs due to inflation, the property tax requires constant property reassessment or rate increases. By taxing a certain percentage

220. Slater, *Evaluation of Municipal Business Taxes*, 28 ACAD. POL. SCI. PROC. 527, 532-33 (1968).

221. . In 1966, the municipal income tax accounted for the following percentages of total tax collections: Philadelphia, 42% ($90 million); Detroit, 28% ($45 million); St. Louis, 34% ($27 million); Cincinnati, 39% ($17 million). Deran, *An Overview of Municipal Income Tax*, ACAD. POL. SCI. PROC. 441, 446 (1968).

222. Dayton, Ohio, collected $8.1 million from its income tax in 1963. It would have required a property tax assessment of $10.57 per $1,000 assessed valuation to produce an equivalent amount of revenue from the property tax. Similar figures in other cities are: $15.92 in St. Louis; $8.72 in Toledo; $8.40 in Akron; and $8.30 in Youngstown. R. Sigafoos, *The Stake of Business in the Growing Municipal Income Tax Movement*, in STATE AND LOCAL TAXES ON BUSINESS --TAX INSTITUTE OF AMERICA 113, 123 (1965).

223. TAX FOUNDATION, INC., *supra* note 24, at 29.

224. Christian Science Monitor, April 13, 1968, at 3, col. 3 (midwest ed.).

225. Sigafoos, *supra* note 222, at 124. Another example is Detroit which obtained 98% of its tax revenue from the property tax prior to instituting the income tax. In 1966, after four years with the income tax, it obtained 69% of its tax revenue from the property tax. TAX FOUNDATION, INC., *supra* note 24, at 29.

of personal and corporate income, the municipal income tax automatically accounts for fluctuations in the business cycle. Even though the need for city service does not flucutate with the business cycle, it is generally assumed that the tax burden should reflect the ability to pay. Also, the municipal income tax provides a means for the consolidation or elimination of many of the various local taxes. By imposing the income tax at a sufficient rate to suppport a major portion of the city budget, great administrative savings could be achieved. Furthermore, residents and non-residents would be relieved of many regressive and often hidden taxes. The U.S. Advisory Commission on Intergovernmental Relations has advised that:

> Local jurisdictions should be discouraged from levying many kinds of taxes, none of which produces enough to warrant reasonably good enforcement. Extensive tax diversification is not practicable at the local level, especially in the smaller jurisdictions.[226]

Another major advantage of the income tax is the central city's taxation of the earnings of non-residents. This allows the metropolitan area to avoid the gaps caused by artificial political boundaries which split the urban area into numerous taxing jurisdictions. Presumably, daylight residents can justifiably be required to contribute to the tax burden borne by residents of the core city. The yield from the tax on commuters has been found to be roughly proportionate to that part of the city's labor force residing outside the central city.

A common criticism of the city income tax is that it encourages local businesses and individuals to relocate elsewhere. Beside the loss of employees who follow migrating industries, the chief concern of many governmental officials seems to be the loss of capital and demand in purchasing. The results of the studies on this point are inconclusive, but no trend in migration was noticeable when Detroit enacted the tax in 1962.[227] Also, there has been no noticeable migration of either labor or capital in Ohio or Pennsylvania, where the local income tax is commonly imposed.[228] Rather, it appears that the total effect of the tax has been advantageous to the local economy, and has moderated much of the unfairness of the present structure of municipal taxation.[229]

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226. U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS REPORT, *supra* note 98, at 14.

227. White, *Economic Evaluation of the Municipal Income Tax*, 28 ACAD. POL. SCI. PROC. 455, 457-58 (1968).

228. Taylor, *supra* note 52, at 124.

229. Buehler, *Philadelphia's Experience*, 28 ACAD. POL. SCI. PROC. 449, 451 (1968).

VI. Two Alternative Proposals for the Administration of a Municipal Income Tax

It is reasonable to assume that both the taxpayer and the tax collector desire a system of income tax administration which is characterized by fairness, simplicity, uniform compliance, and a maximum tax yield at minimum costs. This desire is rarely fulfilled, however, where adjoining or substantially contiguous municipalities each impose an income tax and administer it separately. Often the taxpayer, if he is an individual, lives in one of these municipalities and works in another. If the taxpayer is a corporation, it may do business in several of the towns as well as employ persons from more than one of these municipalities. In such instances, the individual taxpayer may be required to file returns for his city of residence as well as his city of employment. The corporate taxpayer may have the same requirement plus the additional burden of determining how much tax it should withhold from the wages of employees for each municipality imposing an income tax. These difficulties make uniform compliance difficult to achieve, and certainly do not promote the attainment of either simplicity or fairness. From the standpoint of the tax collectors, application of the current system results in neither maximum revenue yields nor minimum administrative costs. Within a single metropolitan area, where several municipalities levy and collect separate income taxes, the duplication of effort involving the use of separate return forms, payroll records, allocations, taxing offices, and tax administrators has resulted in area-wide administration costs which amount to nearly 50 cents of each dollar of tax revenue collected.[230]

To negate this absurd result, there appear to be two major alternative plans of administration. First, an intergovernmental coordination plan which would require the local income taxing authority to coordinate its administrative efforts with the state income taxing authority and/or the Federal Internal Revenue Service. Secondly, a metropolitan-wide administration plan, either in connection with metropolitan government or through the use of a cooperative central administrating agency, which would provide for centralized collection at the metropolitan level. Both of these plans, which will be discussed in detail, are commendable because they greatly increase the simplicity of the tax system for the taxpayer while simplifying the administration of the tax and reducing the costs of collection.

230. Cook, *Effects, Problems, and Solutions of Central Collection of Municipal Income Taxes*, 19 Case W. Res. L. Rev. 900, 902 (1968).

A. Intergovernmental Coordination

For some time there has been interest in coordinating state and federal income tax administration.[231] With the increasing popularity of the municipal income tax it would seem appropriate to include local income tax administration in an intergovernmental coordination scheme. Coordination seems particularly logical since such problems as computation of taxable income, deductions, exemptions, credits, withholding, collection, and the entire process of checking income tax returns are common with income taxes applied at any level of government.

While coordination of local income tax administration with the federal government appears to be an attractive plan, there is more precedent to support state-local coordination efforts. The U.S. Advisory Commission on Intergovernmental Relations supports a plan under which local and state governments would share information and administrative facilities. The Commission's support for this plan grows out of the position that it is incumbent upon the state to assist local governments overcome administrative problems.[232] State cooperation could certainly help alleviate administrative burdens for the city. Particularly where the state already imposes an income tax, state collection of the municipal tax would result in great savings to the city at little increased cost to the state.[233] As in New York, some states would probably be unwilling to cooperate.[234] In other states, which already cooperate with local governments in the administration of other types of non-property taxes, the addition of the income tax to the coordinated program would seem to pose no great problem. For example, in Mississippi, California, Illinois, and New Mexico, the state collects non-property taxes for the cities and returns to each city its appropriate share.[235] Such an arrangement, called a tax supplement, is

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231. *See* C. PENNIMAN & W. HELLER, STATE INCOME TAX ADMINISTRATION 213-48 (1959); Bureau of Internal Revenue, *Exchange of Information for Purposes of Federal, State and Local Tax Administration*, 2 NAT'L TAX J. 151 (1949).

232. *See* U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS REPORT, *supra* note 98, at 12-15.

233. Mayor Lindsey has estimated that state collection of the New York City income tax would result in an annual savings of up to eight million dollars to the city without substantial increase in costs to to the state. Current city collection costs are over ten million dollars annually, or about one dollar of cost for every $16 collected. *See* N.Y. Times, July 2, 1966, at 8, col. 4.

234. *See* N.Y. Times, July 2, 1966, at 8, col. 4.

235. I. Labovitz & L. Ecker-Racz, *Practical Solutions to Financial Problems Created by Multilevel Political Structures*, PUBLIC FINANCES: NEEDS, SOURCES, AND UTILIZATION 149 (1961) (a Report of the National Bureau of Economic Research).

recommended by the United States Advisory Commission on Intergovernmental Relations,[236] because it has resulted in less duplication, superior enforcement, and general ease of administration. Under this plan, the city would retain the power to alter or amend the local tax, using the state administrative machinery for the purposes of collection.

As mentioned above, the coordination of local income tax administration with the federal income levy could potentially provide the best answer to the problems of local administration of the tax. Coordination plans are now in effect between several states and the Internal Revenue Service, although local-federal coordination has not yet been attempted. Such a plan would allow the taxpayer to compute his taxable income for federal purposes and also use the same figure for his local return. The use of identical tax rules would allow the tax administrators to check on the taxpayer's veracity simply by comparing the federal and municipal returns.[237] One of the major arguments against the federal-local plan is the possible loss of municipal income due to the numerous deductions and exemptions contained in the *Internal Revenue Code of 1954* and the federal definition of taxable income. This argument looses its force, however, upon a realization that coordination would make possible many improvements in enforcement procedure.[238]

There appears to be one major statutory obstacle to federal-local coordination. Although section 6103(a) of the *Internal Revenue Code of 1954* indicates that federal returns are matters of public record, section 6103(b) is susceptible to an interpretation that access to the returns is limited to a request by the governor for an examination by state officials for state tax purposes. It is unclear whether the meaning of the word "state" is intended to exclude local officials even though duly commissioned by the governor. Thus, until this statute is clarified,

236. "In states where a particular tax, such as the sales or income tax, is in widespread use by local governments and is simultaneously used also by the State, the most promising coordinating device is the local tax supplement to the State tax." U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS REPORT, *supra* note 98, at 14.

237. On the state level, greater compliance has been observed as to the federal rather than the state income tax laws. C. PENNIMAN & W. HELLER, *supra* note 231, at 216. An official of the California State Board of Equalization has observed: "For some unknown reason . . . individuals apparently believe that it is a more serious matter to make false reports to the Federal Government than to the state." Pierce, *The Use by State Authorities of Federal Income Tax Returns*, 17 TAXES 637, 640 (1939).

238. *See* Miller, *Proposal for a Federally-Based New York Personal Income Tax*, 13 TAX L. REV. 183, 189 (1958).

amended or repealed, the possibility for local-federal coordination appears to be in doubt. Although it might be possible for local officials to obtain the information indirectly through state officials, this practice would present obvious coordination difficulties.

If the laws were liberalized, however, to allow local-federal coordination, it might be possible to reach the ultimate level in ease of administration and simplicity to the taxpayer. This, of course, would be a situation in which the taxpayer could comply with local, state, and federal filing requirements with a single tax return.[239] Perhaps the simplest manner to achieve this goal would be the utilization of the 1040 federal return to determine the net taxable income as a base figure upon which local and state surcharges could be made in appropriate percentages. The entire tax bill could then be paid by the taxpayer in a single check, with the IRS then remitting to each state and city their share of the revenue collected. Such a scheme would obviously reduce administrative cost at the state and local level and would not impose too great a burden on the IRS which is already in possession of quite formidable machinery for the collection of income taxes. Also, the compliance burden of the individual taxpayer, as well as the withholding employer would be greatly reduced because only one return and withholding operation under one set of tax laws and regulations would be necessary.

It is readily apparent that the benefits of intergovernmental co-ordination can be attained only if federal-state-local tax administration is characterized by close co-operation and a certain degree of substantive and procedural continuity. Such close co-operation would almost certainly necessitate the prospective incorporation of a large part of the Federal *Internal Revenue Code* as part of the state or local income tax ordinance. Although there is no case law on the adoption of federal income tax laws as part of local tax ordinances, there are numerous cases dealing with incorporation of federal tax law as part of a state's income tax laws. These cases present situations analogous to those which would occur if local governments attempted similar incorporation. Therefore, the legal validity of adding the local level to a prospective intergovernmental co-ordination process can be determined to some extent by examining the validity of attempted state incorporation.

An analysis of cases in the area demonstrates that no generalization can safely be made respecting the validity of prospective

239. *See* U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL REALTIONS REPORT, *supra* note 98, at 142.

conformity provisions in state and local tax acts. The validity of such provisions depends entirely upon the scope of the language of the respective state or local statute and the extent to which it requires conformity with the federal statute. Such provisions, where enacted, have invariably been challenged on the ground that the incorporation of federal tax law into the state taxing act is an unconstitutional delegation of the states' legislative powers to the Federal Congress.

There are numerous cases to the effect that such prospective conformity statutes, making state tax liability dependent on future as well as present provisions of the federal tax code, are unconstitutional. *Cheney v. St. Louis Southwestern Ry.*[240] is a recent case which is representative of this line of reasoning. A state income taxing statute which provided for the determination of the taxable income of a railway corporation on the basis of variable rate fixing standards set by the Federal Interstate Commerce Commission was declared invalid. The court reasoned that the state statute was an unconstitutional delegation to a federal agency of power expressly reserved to the state legislature by the state constitution. The court held that the state statute provided a "fluid formula" since the standard for tax liability could be varied with discretionary changes by the ICC in its rate fixing standards. Subjecting the corporation to tax liability based on a formula subject to such prospective federal legislation or administrative rules was deemed to be an unconstitutional delegation of state legislative power to the federal government because the state could exercise no control over the future actions of the federal agency.[241]

On the other hand, several cases have adopted a more liberal interpretation of attempts by the states to incorporate prospective federal tax laws. The leading case is *Alaska Steamship Co. v. Mullaney*.[242] In this case, the court upheld a state income tax statute which calculated state tax liability as a certain percentage of the taxpayer's federal income tax liability. The state statute incorporated present and prospective federal income tax law. In upholding the statute against the contention that it was an unconstitutional attempt to delegate state legislative functions to Congress, the court concluded

240. 239 Ark. 870, 394 S.W.2d 731 (1965). The same court disapproved a state statute which provided that minimum wages to be paid must be predicated upon the minimum wages determined by the Secretary of Labor of the United States. Crowly v. Thronborough, 226 Ark. 768, 294 S.W.2d 62 (1956).

241. *See also* Commonwealth v. Warner Bros. Theatres, Inc., 345 Pa. 270, 27 A.2d 62 (1942).

242. 180 F.2d 805 (9th Cir. 1950).

that the legislature's attempt to make local law conform to future changes in federal law was not a mere labor-saving device for the legislators, but was undertaken in order to obtain a degree of uniformity. The court reasoned that:

> The effort of the Alaska legislature to make its territorial income tax machinery conform to the federal act, and to preserve and continue such conformity, makes sense. It makes for convenience to the taxpayer and for simplicity of administration . . . . A similar coordination has been recommended by students of income tax problems for adoption by the states generally. *Since the attainment of this uniformity was in itself a major objective of the Alaska legislature, in enacting that the local law must conform, the Alaska legislature, which alone could make this decision, was itself acting, and was not abdicating its functions, nor, in our opinion, making an invalid delegation to Congress.*[243]

The reasoning of *Alaska Steamship* was followed in the recent Nebraska case of *Anderson v. Tiemann.*[244] Upholding a state income tax statute based on present and future federal income tax laws, the court concluded that the state legislature was acting within the authorized powers granted it by the state constitution. The court reasoned that the legislature could use all, part, or none of the laws of the federal government. Although the present state tax was based on federal law, the court noted that the state legislature was free to repeal the present enactment and adopt a completely different method of imposing its income tax. Therefore, the court concluded that the adoption of a state income tax based upon present and future federal income tax laws did not constitute a waiver of the sovereignty of the state or a violation of the requirement of a representative form of government.

Thus, it appears that the problem of legislative delegation of power does not present an insurmountable constitutional hurdle to the incorporation of present and prospective federal tax law into a state (or local) taxing statute. Indeed, the best reasoned cases allow prospectivity. As long as the state retains the ultimate power to create the sort of taxing scheme it desires, the legislature may exercise a legitimate power to incorporate present and future tax law into the state statute. Such incorporation does not appear to amount to an

243. *Id.* at 816-17 [emphasis added]. *See also* Hickel v. Stevenson, 416 P.2d 236 (Alaska 1966). This case, decided since Alaska became a state, gave approval to the same income tax act which was the subject of the principal case. In upholding the tax, the court pointed to the fact that the prime objective of the legislature in passing the conformity statute was to promote convenience to the taxpayer and simplicity of administration. *Id.* at 239.

244. 182 Neb. 393, 155 N.W.2d 322 (1967).

unconstitutional delegation of ultimate legislative powers of taxation.[245] Certainly, this liberal interpretation of the delegation of powers problem is preferred to the more narrow approach illustrated by the *Cheney* case. As long as the ultimate power of repeal and change remains with the state legislature, then the state (and local) taxing statute should be upheld against challenges of unconstitutional delegation of powers. Such an approach would greatly facilitate federal-state-local co-ordination in tax administration with a consequent savings in administration at the state and local levels.[246]

B. *Metropolitan Area Administration*

1. *Administration Coincident With The Metropolitan Form of Government.*—With the growing popularity of the metropolitan form of area-wide government which was pioneered in Nashville, Tennessee, the importance of the municipal income tax as a feasible revenue source increases. Indeed, such a tax appears to be particularly compatible with the metropolitan form of government, although it has yet to be implemented by such a system.[247] Assuming that the power to levy an income tax existed in a metropolitan government, the municipality would enjoy a number of unique advantages in levying the tax.

First, because of the large land area within the jurisdiction of such forms of government, there is a great likelihood that the tax would be levied and collected within the same economic unit in which the taxpayer lives, works, and shops. This would avoid the problems

245. *See, e.g.*, First Fed. Sav. & Loan Ass'n v. Connelly, 142 Conn. 483, 115 A.2d 455 (1955). In *Connelly*, the court upheld a state statute adopting the federal definition of "gross income" against a challenge that this was an unconstitutional delegation of state legislative power. The court reasoned that only the federal definition was adopted and no legislative power over taxation was relinquished because the state legislature retained ultimate power to define base and rate, or to change the system. The court concluded that a state may adopt some of the standards employed by the federal taxing statutes as a matter of taxpayer convenience and economy to the state. *Compare* Columbia Gulf Transmission Co. v. Barr, 194 So. 2d 890 (Miss. 1967), *with* City Nat'l Bank v. Iowa State Tax Comm'n, 251 Iowa 603, 102 N.W.2d 381 (1960).

246. Cases have long allowed the adoption by the state of present federal income tax law as part of the state tax statute. As long as no attempt was made to include future federal legislation or regulations within its operation, the statute was upheld. *See, e.g.*, Opinion of the Justices, 95 N.H. 540, 64 A.2d 322 (1949); Commonwealth v. Warner Bros. Theatres, Inc., 345 Pa. 270, 27 A.2d 62 (1942); Pennsylvania v. Columbia Steel & Shafting Co., 62 Dauphin Co. Rept. 1 (1951). The *Alaska Steamship* and *Tiemann* cases represent a comparatively recent trend. For further material on this problem, see note, *Constitutionality of North Dakota's Federalized State Income Tax*, 35 N.D.L. Rev. 151 (1959).

247. State constitutional prohibitions against such a tax have prevented its implementation in the states of Florida or Tennessee, where Metropolitan Miami, Metropolitan Jacksonville, and Metropolitan Nashville are located.

caused by artificial political boundaries. Such a plan would allow the entire economic power of the area to be harnessed to the governmental needs. It has long been recognized that metropolitan areas have sufficient economic capacities to easily support the needs of local government. The growing fiscal problems of cities can be attributed in large part to the fragmentation of the metropolitan area, which is a single economic unit, into many local political subdivisions. Consequently, the area-wide capacity adequate to meet governmental needs is distributed unevenly between different local jurisdictions and different governmental functions. Also, politically fragmented metropolitan areas have been marked by competition between the various local units for the available revenues, with little or no sense of area-wide responsiblity.[248] This discouraging result could be effectively changed by tax administration under a metropolitan form of government.

The second advantage afforded by metropolitan governmental administration of the municipal income tax is that the opportunity to avoid the tax by migrating to a location beyond the reach of the metropolitan taxing authority is lessened because of the broad geographical area covered. The phenomenon of the "flight of wages" from the city to the suburbs would become a minimal problem. Presently, this "flight of wages" is a serious problem for cities whose revenue needs are increasing sharply as operating costs spiral. For example, a recent study of the New York City area reveals that in 1939 the city generated 69.8 percent of wage earnings for the entire 22 county metropolitan area, and that city residents accounted for 65.2 percent of the total earnings. By 1956, however, the city still generated 62 percent of the total wages for the area, but only 48.7 percent was retained by city residents.[249] Coupled with this were reports of a great number of business firms migrating to the suburbs to escape city taxes.[250] Simply because its jurisdiction encompasses the suburbs, metropolitan government would be able to minimize these problems and levy the income tax on previously untaxable incomes.

The third advantage to be found in metropolitan administration of the income tax would result from the virtual elimination of the problem of double taxation between the suburban taxing jurisdictions and the central city. Recalling the fate of the "unfortunate taxpayer"

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248. *See* S. SACKS & W. HELLMUTH, *supra* note 55, at 156.

249. Knowles, *City Tax on Incomes? Arguments Weighed*, N.Y. Times, July 20, 1958, § 4, at 7, col. 1.

250. N.Y. Times, Feb. 16, 1967, at 25, col. 1.

in *Thompson v. City of Cincinnati*,[251] it would seem that the fairness of the income tax would be enhanced by metropolitan administration. There would be no possibility of double taxation under such an administration because the suburban taxing authorities would have disappeared.

The fourth advantage is the lessening of the withholding burden on business within the area-wide jurisdiction of the taxing authority. Businesses would no longer be faced with the frustrating problem[252] of allocating withheld income between the various local taxing jurisdictions, such as the employee's city of work and his city of residence. Only one withholding operation would have to be made.

Finally, this type of system affords greatly reduced administrative costs by reducing duplication of effort and enhancing enforcement.[253] It is generally agreed that the income tax is more efficiently and economically administered over a broad metropolitan area than it is in a single municipality, particularly a small one. Because of large initial costs, it is more expensive to establish and maintain the necessary collection and administrative machinery for the purpose of collecting a small number of returns than it would be for a large number. The per return cost decreases as the number of returns processed increases.[254]

The foregoing discussion graphically demonstrates the advantages of administering the municipal income tax coincident with a metropolitan form of government. Areas evaluating the metropolitan form of government should seriously consider the municipal income tax as an additional revenue source.

2. *Centralized Collection by Contract.*—For cities not operating under the metropolitan form of government, an alternative plan offers some of the advantages of metropolitan administration. Under this plan, a central collection agency is created by agreement between the central city and surrounding municipalities levying an income tax. This agency administers the tax on a contract basis for all participating municipalities and charges them a relatively nominal fee.

This type of plan is currently in operation in various Pennsylvania jurisdictions and in the Cleveland, Ohio area. At present, 45 cities in the Cleveland metropolitan area impose local income taxes. Of this number, 34 have joined the City of Cleveland in a program of central

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251. See text accompanying note 178 *supra*.

252. *See* R. Sigafoos, *supra* note 5, at 53-54.

253. See note 230 *supra* and accompanying text.

254. *See* S. Sacks & W. Hellmuth, *supra* note 55, at 242.

collection and administration. The Cleveland Central Collection Agency operates under a contract which vests administrative authority in the collection agency and provides for uniformity of ordinances and regulations, responsibility of participants, audit, cost allocation, distribution of revenue, cancellation, and exchange of information between participating municipalities. Uniform return and witholding forms are provided to taxpayers and employers.[255]

Metropolitan government administration of an income tax has an advantage over central collection in that after revenues are collected, they can be channeled into projects of area-wide significance. Under the central collection plan, revenue collected is divided and funnelled to each participating municipality; therefore, political fragmentation continues to endure. Despite this weakness, the central collection plan is far superior to the present situation in most metropolitan areas levying the municipal income tax. For example, the uniformity in ordinances, regulations, and return and withholding procedures greatly simplifies the compliance burden of the taxpayer and at the same time contributes to ease of administration. Evasion is reduced as a result of the centralized information file. Finally, administrative cost should be greatly reduced over the entire metropolitan area since duplication in administration of the tax is curtailed.[256] Although administrative costs may be reduced by central collection, problems of double taxation and reciprocity between cities of residence and cities of employment still remain. Likewise, the problems of the "flight of wages" and migration to avoid the tax are not avoided.

In summary, a local income tax which is coincident to the metropolitan form of government is preferable to the centralized collection plan. Metropolitan government offers coordination in both the collection and use of income tax revenue. On the other hand, the central collection plan merely offers coordination in collection of revenue with consequential savings in administrative costs. Either is preferable to no plan at all, however, and both offer reasonable alternatives to intergovernmental coordination.

VII. THE POLITICAL FEASIBILITY OF ENACTING A MUNICIPAL INCOME TAX

Suprisingly, there has been only minor local opposition to the levy of a municipal income tax in many municipalities where the tax has

255. *See* Cook, *supra* note 230, at 903.
256. *Id.* at 910.

been proposed. Usually the opposition diminished markedly after the tax was enacted. In Ohio and Pennsylvania, the two states which have had the most experience with the tax, the popularity of the city levy on income has constantly increased.[257] In other areas of the country, however, the picture has been somewhat different. Voters in Duluth, Minnesota, decisively rejected a local income tax proposal; in Los Angeles, the city council dropped consideration of the tax because of unfavorable public reaction.[258]

Many people believe that enacting a municipal income tax would prove difficult because any new tax would be more onerous to the average voter than simply raising the rates on the existing taxes.[259] The validity of this theory probably depends on the type of total tax burden experienced in the community under consideration.[260] On the other hand, a recent study of voter attitudes toward a state income tax levy in Detroit, Michigan, reveals a different view. Respondents in a random sample favored an income tax "based on ability to pay", a phrase which implies a progressive rate structure, over the traditional sales and property taxes. This group considered the sales tax to be the most inequitable of the three taxes and indicated that the income tax was the fairest.[261] Public acceptance of the municipal income tax probably depends on whether the taxpayers of a community, as a group, perceive a need for increased revenues to finance government services and whether they recognize the necessity of tapping new revenue sources.[262] Furthermore, it is reasonable to conclude that such a perceived need for new revenue must be so strong that it will overcome the obvious reluctance of the public to incur the expense of a new tax. The Detroit survey possibly supports this proposition since the majority of respondents thought the income tax to be the "fairest"

257. It has been reported, however, that initial proposals of a municipal income tax failed to win approval by popular vote in several Ohio cities: Portsmouth, Lancaster, and Grandview Heights. *See* R. SIGAFOOS, *supra* note 5, at 5.

258. *Id.* at 6.

259. *See, e.g.*, Knowles, *The City Eyes a Tax on Income*, N.Y. Times, Dec. 5, 1965, § 4, at 4.

260. Interview with C.W. Cook, Official, Tennessee Taxpayers Association, April 25, 1968, and interview with Austin Adkinson and Herbert Bingham, Officials, Tennessee Municipal League, April 25, 1968, All of the respondents in these interviews agreed that the public in general would be very reluctant to see any new type of tax imposed.

261. David, *Public Preference and State-Local Taxes*, in ESSAYS IN STATE AND LOCAL FINANCE 74-80 (H. Brazer ed. 1967). This study was made from 767 respondents in the Detroit area in the spring of 1959 when Michigan was in the throes of a severe financial crisis.

262. The Detroit area study lends credence to this proposition. *See id.* at 75. *See generally* Wessel, *Cincinnati Income Tax—An Emergency Financing Device*, 9 NAT'L TAX J. 84 (1956).

tax, but favored a one percent increase in the existing sales tax rather than the implementation of the income tax.[263]

In view of this discussion, it is reasonable to conclude that implementation of a municipal income tax would probably prove difficult in states where approval by a public referendum, requiring direct expression of public attitudes toward the tax, is a prerequisite to enactment. Enactment of a local levy, however, would also be difficult in a state like New York, where only legislative approval is necessary for implementation. Indeed, legislative approval may prove more difficult than public approval because many legislators, who privately agree with the need for a municipal income tax, might not wish to risk the wrath of the electorate by attempting to initiate a new tax.[264] The political difficulties in enacting the municipal income tax are manifold; it is submitted, however, that the continually increasing need for new revenue sources in cities[265] and the exhaustion of old sources[266] will eventually create a more favorable public and legislative attitude toward the tax.

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263. David, *supra* note 261, at 90-93.

264. Interview with Austin Adkinson and Herbert Bingham, Officials, Tennessee Municipal League, April 25, 1968. The respondents in this interview indicated that many state and local officials privately supported a local tax. However, it was considered that their overt support of such a measure would jeopardize their positions with the public.

265. *Id.* The respondents reported that in Tennessee over the four year period from 1968-72 the projected revenue needs of cities exceeded the projected revenue collections from all sources by over $200 million.

266. Interview with Austin Adkinson and Herbert Bingham, Officials, Tennessee Municipal League, April 25, 1968, and interview with C.W. Cook, Official, Tennessee Taxpayers Association, April 25, 1968. The respondents agreed that there was a limit above which the sales tax rate could not be increased.. When this point was reached, the respondents indicated that the legislature would be forced to amend the Tennessee constitution to allow municipalities to tax incomes. None of the respondents believed that this would occur within the next ten years.