Vanderbilt Law Review

Volume 16
Issue 3 *Issue 3 - June 1963*

Article 26

6-1963

State and Local Taxation – 1962 Tennessee Survey

Paul I. Hartman

Follow this and additional works at: https://scholarship.law.vanderbilt.edu/vlr

Part of the Tax Law Commons

Recommended Citation
Paul I. Hartman, State and Local Taxation -- 1962 Tennessee Survey, 16 *Vanderbilt Law Review* 865 (1963)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol16/iss3/26

This Article is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Law Review by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact mark.j.williams@vanderbilt.edu.

State and Local Taxation—1962 Tennessee Survey

Paul J. Hartman[*]

I. Exemption of Religious Institution From Property Taxation—Taxation of Parking Lots and Cafeterias Operated by Exempt Institution for Employees

II. Apportionment of Income From a Multistate Unitary Business for Excise Tax Purposes—Inclusion of Income From Sale of Extra-state Land in Measure of Tax

III. Taxability as Income to Stockholder of Distributions From Massachusetts Trust—Distributions in Cash and Stock of Capital Gains From Sales of Securities

IV. Sales Taxes—Taxability of Contractor Installing Air Conditioning Equipment for Tax Exempt User

V. Penalties for Delinquencies in Sales and Use Taxes—Mistake as Basis for Relieving Against Penalty for Delinquencies

I. Exemption of Religious Institution From Property Taxation—Taxation of Parking Lots and Cafeterias Operated By Exempt Institution for Employees

The case of *City of Nashville v. State Board of Equalization*[1] called into question the taxability of parking lots, cafeterias and snack bars operated as part of a tax exempt religious institution. The institution objecting to payment of the tax was the Sunday School Board of the Southern Baptist Convention (hereinafter referred to as taxpayer), which owns a large amount of real estate in Nashville. The taxpayer is a non-profit general welfare corporation organized for the purposes of supporting Sunday schools in the churches of the Southern Baptist Convention, printing and selling religious literature to them, and spreading their religious faith. In short, taxpayer is a tax exempt religious institution; its charter purposes are religious purposes. The property on which the taxpayer resisted the tax was used for parking lots, a cafeteria and a snack bar for its employees.

*Professor of Law, Vanderbilt University, member, Tennessee Bar; author, *State and Local Taxation of Interstate Commerce* (1953).

1. 360 S.W.2d 458 (Tenn. 1962).

The claim from tax exemption is bottomed on a Tennessee statute which expressly exempts the real estate of a "religious, charitable, scientific or educational institution" when "occupied by such institution or its officers exclusively for carrying out thereupon one (1) or more of the purposes for which said institution was created or exists."[2] However, the statute also provides that the property not "used exclusively for carrying out" such purposes shall be taxed to the extent of its value.

Taxpayer's headquarters are in Nashville, where it operates a publishing house and a bookstore, the principal activities of which are the publication and sale of religious materials or literature and books to the members of the churches in the Southern Baptist Convention throughout the South. The Board also carries on service programs for church conventions and for the training of people for the work of the Baptist churches.

From its operation taxpayer receives a gross income of upwards of $24 million per year; it employs some 900 employees; and its net assets exceed $28 million. Taxpayer also owns sixteen parcels of real estate in the city of Nashville. Upon one of these parcels it has a large building, known as its "Administration Building," part of which is used by taxpayer for a restaurant or cafeteria for its employees. The City of Nashville, over taxpayer's objection, sought to tax this restaurant. Upon another parcel of land, taxpayer has another large structure, its "Operations Building." It uses part of this building for the operation of a snack bar—a place with machines which dispense hot soups, coffee, snacks, etc., upon deposit of coins. Over taxpayer's protest, the city also taxed the part of the Operations Building devoted to these purposes. Taxpayer also owned five other parcels of land, used as parking lots for automobiles of its employees. Likewise the roof of taxpayer's Operations Building was used for parking of automobiles of employees, this space alone accommodating 365 automobiles. These areas were likewise taxed.

Reversing the Tennessee State Board of Equalization, the Chancery Court of Davidson County and the court of appeals, the Tennessee Supreme Court held that those parts of the taxpayer's property used by it for parking lots, a cafeteria, and a snack bar are taxable. Speaking through Mr. Justice Felts, a divided supreme court was of the opinion that these properties, in competition with similar tax-paying businesses, were not used *exclusively* for religious purposes, within the exemption provisions of the Tennessee statute.

In a most cogent and exhaustive opinion, Mr. Justice Felts set forth the reasons why the parking lots, cafeteria and snack bar operated by this religious institution for the benefit of its employees are not

2. TENN. CODE ANN. § 67-502(2) (1956).

exempt from taxation under the exemption provisions of the Tennessee statute. Using as its point of departure the Tennessee constitution, the court's opinion pointed out that it provides that "all property . . . shall be taxed," but that the constitution also provides that the "legislature may except . . . such as may be held and used for purposes *purely religious,* charitable, scientific, literary, or educational."[3] After tracing the case law developments of the exemption provisions under prior legislative exemptions, the court concluded that the act of 1935 redefined, limited and restricted the exemptions.[4] This is the statute now in effect. After summarizing the relevant exemption provisions of the statute which excepts and exempts the property of religious institutions from the common burden of taxation, the court emphasized that such property is exempt only if it (1) is "occupied by such institution or its officers exclusively for carrying out thereupon one or more of the purposes" of its charter and (2) is being "used exclusively" for such purposes; and any part of such real estate "not so used exclusively" for such purposes, "but leased or otherwise used for other purposes" shall be taxed to the extent of its value.

The court was of the opinion that taxpayer's use of its property for parking lots, cafeteria and snack bar is not "for purposes purely religious" as contemplated in the Tennessee constitution, nor a use "exclusively" for the religious purpose of its charter, as contemplated by the relevant exemption statute.

To taxpayer's argument that its operation of the parking lots, restaurant and snack bar is for its employees only and neither for profit nor commercial purposes, the court responded that such operations are not religious activities but rather constitute secular businesses, carried on in competition with like businesses that pay taxes. Moreover, the court pointed out that a Tennessee statute imposes a privilege tax upon general welfare corporations for the privilege of operating restaurants, cafeterias, etc., for employees only and not for profit.[5]

In an effort to bring its property within the exemption provisions, taxpayer argued that its operation of the parking lots, restaurant and snack bar for its employees makes them more efficient and thus promotes the efficiency of taxpayer's operation in its religious work; that these parts of its property, though used for such other purposes, should nevertheless be held to be "used exclusively" for religious purposes, because their use for the other purposes is only incidental to their primary use for religious purposes. The court answered that this argument by taxpayer proceeds upon the premise that a religious

3. TENN. CONST. art. 2, § 28. (Emphasis added.)
4. TENN. CODE ANN. § 67-502(2) (1956).
5. TENN. CODE ANN. § 67-4203, item 92 (1956).

institution's property may be used for two purposes, one business and the other religious; that because the business operation results in benefits to the religious purpose, the business purpose is to be called incidental and the religious primary, for the purpose of bringing the whole operation of the property within the statutory exemption from taxation. The court was of the opinion that the exemption statute does not recognize such a two-purpose use of a religious institution's property. Pointing out that the statute exempts only property "occupied" and "used exclusively" by the institution for religious purposes, the court concluded that the statute exempts only where the use of the property is directly and immediately for religious purposes and does not exempt for any indirect and consequential benefit to such purposes which may be derived from the property's use.

It may well be, reasoned the court, that taxpayer, like many other large business concerns, finds that furnishing eating and parking facilities for employees makes them better satisfied and furthers efficiency. The same would no doubt be true, continued the court, as to furnishing them many other "fringe benefits" of modern day living; and if the taxpayer may operate the parking lot and restaurant business tax-free, why may it not also operate other businesses tax-free, such as a housing project, clothing store, automobile repair shop, etc., for its employees? To sustain taxpayer's contention that it could use its real estate for purposes of secular business enterprises outside the purposes stated in its charter, which bear no relation to such purposes except through consequential benefits to be derived from such operation, would be, thought the court, to disregard the Tennessee exemption statute and the public policy of exemption. Moreover, added the court, it would open the way for religious institutions to acquire real estate tax-free and run thereon tax-free business enterprises in competition with other like tax-paying businesses, which would in turn be driven out of business.

In conclusion, the court thought that reasons of public policy support the construction which it placed on the exemption statutes. The policy of tax exemption of religious institutions, established when they were struggling to get along, has enabled them to acquire large real estate holdings and to accumulate great wealth; and many of them are engaged in operating various kinds of secular businesses, tax-free, in competition with like businesses that are taxed. This development has created inequities and endangers both the churches and the state. The court quoted what it regarded as thoughtful leaders of churches who, recognizing this danger, are concerned by the frequent charge that tax exemptions are poorly-concealed forms of tax support for organized religion.[6]

6. Criticism has often been directed at the practice of granting exemptions to

One suggested motive for granting tax exemptions to philanthropic, educational and religious institutions is to assist these organizations in doing the state's work.[7] If the loss of revenue is equaled or exceeded by savings resulting from private performance of functions that would otherwise be the state's responsibilities, the state cannot lose. Assuming the validity of this conclusion when applied to educational and philanthropic organizations, it can hardly be urged with any great degree of cogency that the same may be said with respect to religious organizations, since they are not discharging a function which the state could lawfully undertake.

Moreover, the wider the area subsidized by tax exemptions, with its consequent increased tax burdens on others, the greater will become the financial and political pressure to curb all exemptions.[8] In Tennessee such exemptions are purely discretionary with the legislature; The Tennessee constitution merely gives the legislature the power, if the legislature so desires, to except such property from taxation. The constitution presumably would not prohibit the legislature from wiping out the present exemptions from taxation given the property of religious, educational and philanthropic organizations.

II. Apportionment of Income From a Multistate Unitary Business for Excise Tax Purposes—Inclusion of Income From Sale of Extra-State Land in Measure of Tax

When a corporation engages in a multistate business, there inevitably arises the troublesome question of how to determine that portion of the total amount of income of the business which may be attributed to a particular state for tax purposes. This recurring and important problem arose in *Woods Lumber Co. v. MacFarland*.[9] There the complaining taxpayer, a Tennessee corporation, engaged in the business of manufacturing lumber in Tennessee and Arkansas. It had sawmills and lumber yards in both states. Separate ledgers were maintained for the operations in each state. However, there was a single ownership, single management, one set of offices, and one board

religious organizations. See Stimson, *The Exemption of Churches from Taxation*, 18 Taxes 361, 397 (1940).

7. See 64 Harv. L. Rev. 288 (1950) for a consideration of exemptions not only to religious organizations, but also to educational and philanthropic institutions.

8. The court observes that if churches continue to accumulate land and business, the results could be disastrous; that revolutionary expropriation of church properties was the solution resorted to in 16th-century England, 18th-century France, 19th-century Italy, and 20th-century Russia; and that Mexico still suffers social convulsion from such a seizure. See City of Nashville v. State Bd. of Equalization, 360 S.W.2d 458, 470 (Tenn. 1962). For a detailed discussion of the historical development of troubles stemming from exemption of church property from taxation, see Stimson, *supra* note 6, at 397.

9. 209 Tenn. 667, 355 S.W.2d 448 (1962).

of directors; and the entire management and supervision of the business was carried on in Tennessee.

The precise problem in *Woods* was whether a portion of the income from the sale of a tract of land lying in Arkansas should be attributed to Tennessee for the purpose of computing the amount of excise tax due Tennessee. The amount of the excise tax is determined by taxpayer's net income. Tennessee applied her apportionment formula to taxpayer's entire net earnings, including the net income from the sale of the Arkansas land. Taxpayer paid the tax under protest and sued to recover.

Tennessee imposes an excise tax on all corporations, cooperatives conducted for profit, joint stock associations and business trusts, organized under the laws of Tennessee, other than those organized for general welfare and not for profit.[10] When these business organizations do business in Tennessee and elsewhere, the net earnings are apportioned to determine the amount of earnings attributable to business done within Tennessee; such net earnings thus apportioned to Tennessee constituted the measure of the excise tax involved in *Woods*.[11] Where a taxpayer is engaged in selling, distributing, or using tangible personal property, as in the *Woods* case, the portion of net earnings attributable to Tennessee for excise tax purposes is determined by the use of a three-factor formula of property, origin of sales and location of customers.[12] The apportionment of net earnings to Tennessee is made on the basis of the proportion which the average of the factors of the formula within Tennessee bears to the average of such factors both within and without Tennessee. Taking the position that the *Woods* taxpayer conducted a unitary business and that the total net earnings of taxpayer, including the net proceeds from the sale of the Arkansas land, could be apportioned to determine the amount of earnings attributable to Tennessee for tax purposes, the Supreme Court of Tennessee affirmed the lower court's decision denying a refund for that part of the tax attributable to the Arkansas land transaction.

When a corporation engages in a multistate business, there are three rather general methods for assigning income to a particular state for net income and excise tax purposes.[13] They are (1) specific allocation, *i.e.*, the allocation of particular classes of income to a particular state

10. TENN. CODE ANN. § 67-2701 (1956).
11. TENN. CODE ANN. § 67-2706 (1956).
12. TENN. CODE ANN. § 67-2708 (1956).
13. Elsewhere the author has written in considerable detail regarding the various methods of assigning income to a particular state for tax purposes. See Hartman, *State Taxation of Income From a Multistate Business*, 13 VAND. L. REV. 21, 56-82, plus tables at 127-28 (1960). This material is updated and expanded somewhat by the author in Hartman, *State Taxation of Corporate Income*, in CORPORATE PRACTICE 55-80, plus tables at 126-27 (Roady & Anderson ed. 1960);

wherein the income is said to have a taxable situs; (2) separate accounting as a method properly reflecting a reasonable attribution of income; and (3) apportionment by means of a statutorily prescribed mathematical formula.

Under the specific allocation method, the taxing statutes often require that particular items or classes of income be allocated or assigned in toto to that state wherein the income can be said to have a taxable situs. The allocation may be on the basis either of the location of the recipient of the income or that of its source. Thus, classes of income commonly said to be specifically allocable by source are generally designated "nonbusiness" income and usually include (a) rents; (b) dividends and interest; (c) compensation for personal services; (d) royalties from patents and copyrights; and (e) gains and losses from the sale of capital assets.

However, the great bulk of "business" income (as distinguished from "nonbusiness" income) does not lend itself to specific allocation to one particular state in toto. Thus, the operating income of a manufacturer, wholesaler or retailer cannot, where the business is multistate, be satisfactorily allocated by source. To deal with this problem of dividing income, the states employ either one or both of two methods: (a) separate accounting and (b) apportionment by mathematical formula. When the separate accounting method is used in a multistate business, the business operations within the taxing state are treated as though separate and distinct from the business carried on outside the state. An attempt is made to determine the net income from the taxing state in the same manner that it would be if the entire business operations were confined to the taxing state. The income producing activity within each taxing jurisdiction is accounted for separately. So far as possible, each item of revenue and expense is associated with its source, and general overhead expense items are associated with specific revenues on some acceptable accounting basis. Since the business in the taxing state is considered separate, the income is determined without reference to the success or failure of the taxpayer's operations in other states.

Certain types of multistate businesses generally do lend themselves to the separate accounting method, such as mining, banking, farming and hotel operations. However, when the business within the taxing state is not a separate business, but an integral part of a multistate unitary business, the income from the operations within each state cannot be determined in any satisfactory fashion by separate accounting. The income may be earned by a series of multistate transactions beginning with buying profit in one state, followed by manufacturing or production profit in another state and ending with sales profit in still another state. Moreover, in a unitary multistate business, any at-

tempted separate accounting for such central staff functions as purchasing, advertising, financing, accounting, engineering, and legal services would, at best, be arbitrary, uncertain and difficult.[14]

In such a unitary business, some formula which gives weight to the different factors responsible for earning the income is the only satisfactory solution to the problem of apportioning income from the entire unitary business organism among the various states where it is conducted.

As concerns separate accounting, the statutory provisions generally take one of three approaches: (1) allow the corporation to use such a method if the business is not unitary; (2) require the taxpayer corporation to petition the commissioner of revenue or similar official if it wishes to use this method or thinks any other method to be improper; or (3) give the commissioner discretionary power to require or reject such a method as he thinks necessary. Tennessee allows separate accounting only if the taxpayer is a construction company.[15]

When a unitary multistate business is involved, apportionment of income by means of a mathematical formula is the method most generally used to assign net income to a particular state for tax purposes. The mathematical formula method of apportionment is based upon the assumption that the entire income of a business enterprise is the final result of certain income producing factors or elements, such as *property, payrolls, sales* and *costs of manufacturing.* From this premise it is reasoned that the income produced by the combination of these factors or activities has its source at the locations of the factors. How does the formula method operate as to the apportionment of net income? After the total net income is determined, then income not connected with the unitary business is usually deducted from the entire net income.[16] Also, the statutes usually provide that "nonbusiness" income (gains from capital assets, interest, dividends, etc.) can be deducted. The residue of the net income from the unitary business is then apportioned to the particular state according to the relevant formula. This apportionment is made according to the ratio of the average of the factors of the formula within the taxing state to the average of such factors both within and without the taxing state. In the *Woods* case, as we have seen, the three factors in the apportionment formula consisted of property, origin of sales and location of

14. See Cohen, *State Allocations and Formulas Which Affect Management Operating Decisions,* 1 J. TAXATION 1 (1954).

15. TENN. CODE ANN. § 67-2710 (Supp. 1962).

16. Tennessee is different from most states in that it does not have a statutory definition of net earnings. That is determined by the commissioner of revenue within the guide-lines established by the Tennessee Supreme Court, which has said that the phrase "net earnings" is to be used in its ordinary meaning, *i.e.,* what is left of earnings after deducting necessary and legal items of expenses incident to the business. Brookside Mills, Inc. v. Atkins, 204 Tenn. 517, 520, 322 S.W.2d 217, 218 (1959).

customers.

The Tennessee method of assigning income for tax purposes is somewhat different from that of most states in that Tennessee does not permit the "nonbusiness" income to be deducted from the net income before applying its apportionment formula. The item of income involved in *Woods*, being income from the sale of real estate, would likely be regarded as "nonbusiness" income by many states and thus not includable in apportionable income.[17] However, the Tennessee legislature, perhaps unwisely, has not seen fit to eliminate "nonbusiness" income from the apportionable taxable net income when the multistate business is unitary.

When he thinks that the application of the standard apportionment formula to the income of a particular taxpayer would cause hardship or injustice, the Commissioner of Revenue for Tennessee, upon application of the taxpayer and upon such showing, with approval of the attorney-general, may adopt such other method of apportionment as would be fair and just under the facts of the case.[18] In the *Woods* case, such variation from the standard apportionment formula was thought by the Tennessee Supreme Court not to be called for.

The *Woods* taxpayer appears to be a unitary business under Tennessee law. Although separate accounts were kept for the operations in Arkansas and Tennessee, nevertheless, there was single ownership, single management, one set of offices, and one board of directors; and the entire management and supervision of the business was carried on in Tennessee.[19] These factors, plus the fact that taxpayer is a Tennessee corporation, would appear to be sufficient nexus of taxpayer with Tennessee to satisfy due process requirements.

The *Woods* case is a forceful illustration of the need for uniformity among the states of methods of assigning income to different states for tax purposes, in order to prevent the inequity of multiple state taxation of the *same* income. Since the land which was sold was located in Arkansas, that state can quite properly reach the entire net proceeds of the sale for tax purposes. Tennessee has also taxed a portion of the same proceeds of the sale. Double taxation of the *Woods* income becomes more probable by reason of the fact that it likely would be treated as "nonbusiness" income, which usually is assigned in entirety to the state which is the situs of the land that is sold. Arkansas will, therefore, most probably tax the entire proceeds of the sale.

Uniformity in apportioning income is thus an obviously desirable

17. See, *e.g.*, UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT §§ 4, 8, which allocate capital gains from sales of real and personal property to the state where the property has a situs, or commercial domicile if not taxed at the situs.

18. TENN. CODE ANN. § 67-2711 (Supp. 1962).

19. Dickey Clay Mfg. Co. v. Dickinson, 200 Tenn. 25, 289 S.W.2d 533 (1956).

objective which will provide equality of tax treatment at the state level. The problem of uniform allocation and apportionment, though highly desirable, has proved an elusive goal, even though efforts to improve the tax climate in this respect have been quite considerable. The Uniform Division of Income for Tax Purposes Act, drafted by the National Conference of Commissioners of Uniform State Laws and approved by the American Bar Association, has been the subject of very considerable study since its preparation. Yet it has received sparse acceptance by the state legislatures.

The upshot has been that Congress has taken a hand in the matter. Under the chairmanship of Representative Willis, a subcommittee of the House Judiciary Committee with the help of a sizeable staff and an advisory group of ten members, is conducting a comprehensive congressional study of state taxation of multistate business not only to ascertain the problems that need solution but also to recommend some feasible solutions. It is hoped that Congress will establish some guide lines by way of requiring state adoption of uniform methods for assigning income from a multistate business to states for tax purposes.

III. TAXABILITY AS INCOME TO STOCKHOLDER OF DISTRIBUTIONS FROM MASSACHUSETTS INVESTMENT TRUST—DISTRIBUTIONS IN CASH AND STOCK OF CAPITAL GAINS FROM SALES OF SECURITIES

Lawrence v. MacFarland[20] presents the question whether amounts received by owners of shares in the Massachusetts Investors Trust, which consist of gains realized by the Trust from trading in securities, are subject to the Tennessee tax levied upon income from stocks and bonds. Article 2, section 28 of the Tennessee Constitution provides that the "Legislature shall have power to levy a tax upon incomes derived from stocks and bonds that are not taxed ad valorem." This provision has been construed as forbidding a general income tax.[21] As a result of this limiting interpretation of the constitution, the Tennessee legislature enacted what is known as the Hall Income Tax Law,[22] which levies an income tax on incomes derived by way of dividends from stocks or by way of interest upon bonds.[23] The statute imposing the tax provides in part:

> No distribution of capital by stock dividend, or liquidation or otherwise, shall be taxed as income; but earned surplus shall not be considered as capital, and shall be taxed as income when and in whatever manner it may be distributed, irrespective of when it was earned.[24]

20. 209 Tenn. 376, 354 S.W.2d 78 (1962).
21. Evans v. McCabe, 164 Tenn. 672, 52 S.W.2d 159 (1932).
22. Statute now contained in TENN. CODE ANN. §§ 67-2601 thru -2641 (1956).
23. TENN. CODE ANN. § 67-2602 (1956).
24. TENN. CODE ANN. § 67-2609 (1956).

The complaining taxpayer in the *Lawrence* case received (a) cash and (b) shares of stock from his investment in the Massachusetts Investors Trust, whose only business is buying, selling and holding securities of other companies and governmental obligations.[25] The distributed income taxed by Tennessee in *Lawrence* came from "capital gains," which had been derived from the sale of certain capital assets (securities in which the Trust traded) wherein the sale produced proceeds in excess of the cost of the asset.

In its bookkeeping system the Massachusetts Investors Trust maintains two accounts, which it denominates as an "income account" and a "principal account." The "income account" contains amounts realized by the Trust from dividends and interest upon its security holdings, while the "principal account" contains amounts realized from the sale of securities in which it trades. Out of the "income account" are paid to the shareholders what are denominated as "dividend distributions." The complaining taxpayer raised no question regarding the taxability of distributions made to him from dividends and interest. Taxpayer did resist the tax as applied to distributions by way of shares of stock and money, both of which resulted from gains on the sale of securities and which were regarded by the Trust as a "principal item" rather than an "income item." The tax in question was, in short, imposed on net income, consisting of "capital gains distributions."

The Tennessee Supreme Court affirmed the chancellor who sustained the tax both as to the distribution by way of shares and cash. This decision seems to be a correct interpretation of the Tennessee statute imposing the tax. That statute, after first providing that a distribution of capital shall not be taxed as income, clearly and unequivocally declares that "earned surplus shall not be considered as capital, and shall be taxed as income when and in whatever manner it may be distributed, irrespective of when it was earned."[26] While it may be somewhat more unsatisfactory to tax a distribution by way of a "stock dividend" than a cash distribution, nevertheless the statute makes it clear that earned surplus should be taxed as income when and in "whatever manner" it may be distributed. The complaining taxpayer did receive cash and stock representing profits made from the sale of certain assets.[27] One facet of the transaction which makes

25. The Massachusetts Investors Trust is regulated in its operation by the Investment Company Act of 1940, 15 U.S.C. § 80a-1 (1958). As there stated, the principal activities of such companies is that of investing, reinvesting and trading in securities.

26. TENN. CODE ANN. § 67-2609 (1956).

27. A statement from the Massachusetts Supreme Court, upholding the taxability of a stock distribution is pertinent here: "In essence the thing which has been done is to distribute a symbol representing an accumulation of profits, which instead of being paid out in cash is invested in the business, thus augmenting its durable assets. In this aspect of the case the substauce of the transaction is no different from what

it appear more reasonable to put the stock dividend distribution in the same category as the cash distribution for purposes of this tax is the fact that the stockholder was given the option by the Trust either to take the capital gains in cash or to re-invest in the Trust and receive additional stock. He thus turned down the opportunity to receive cash, undeniably taxable, when he elected to take the stock dividend.

Whether or not the distribution in the *Lawrence* case is from capital or profits must be determined from the standpoint of the corporation making the distribution rather than from the standpoint of the stockholder receiving the distribution. In determining whether or not the distribution was from capital or earned surplus, the bookkeeping methods of the corporation should be immaterial.[28]

From a policy standpoint the *Lawrence* decision is sound. If the taxpayer's position had been adopted in *Lawrence*, it seems that it would have opened up an avenue for making much of the distributed earned income of the Trust immune from the Tennessee income tax. In all probability much of the income which the Trust earns and distributes will come from the capital gains realized from trading in securities, rather than from the dividends the Trust receives on its securities. If the Trust can determine the taxability of this earned surplus distributed to the stockholder by the simple expedient of its bookkeeping method, by allocating such gains to its "principal account," then it has successfully insulated the stockholder who receives distributions of earned surplus from this account from payment of an income tax to Tennessee.

Apparently much of the argument on behalf of the *Lawrence* taxpayer was that such capital gains would not be taxable as income under the federal income tax. The short answer to that argument is that any such exclusion from federal taxation is made by the federal statute which defines taxable income. The Tennessee statute, in defining taxable income, has no such exclusionary provision in it. It specifically provides that distributed earned surplus (capital gains) shall be taxed as income when and in *whatever* manner it may be distributed, thus showing the legislative intent to tax as income the total amount of revenue produced by stocks and bonds. In no respect, however, does the tax deplete the stockholder's original investment in the Trust; that remains undiminished by this tax. Only income earned by the Trust by trading in shares was involved in the contested *Lawrence* tax.

At one time the receipt of common stock by a stockholder of stock

---

it would be if a cash dividend had been declared with the privilege of subscription to an equivalent amount of new shares." Trefry v. Putnam, 227 Mass. 522, 116 N.E. 904, 911 (1917).

28. See Fidelity-Bankers Trust Co. v. McCanless, 181 Tenn. 476, 181 S.W.2d 747 (1944).

dividends on common was held not to be taxable income under the sixteenth amendment of the federal constitution.[29] There are those who think that it seems manifest from the opinions of the Supreme Court of the United States that all stock dividends can now constitutionally be taxed as income, if Congress so desires.[30] If stock dividends were declared on a different type of stock from that originally held by the owner, the stock dividends have been regarded as taxable federal income.[31] Moreover, there is no showing in the *Lawrence* case that the stock dividend distributed to the taxpayer was that of common stock on common, although the Trust presumably has only one class of shares.

The 1963 session of the Tennessee legislature has amended the section of the statute imposing the tax in the *Lawrence* case. The statute now provides that stock dividends, whether paid out of surplus or otherwise, shall not be taxable as income if the stock dividend is not issued within one year prior to liquidation of the company or transferred to a non-resident within one year prior to liquidation.[32]

IV. Sales Taxes—Taxability of Contractor Installing Air-Conditioning Equipment for Tax Exempt User

The issue in *S. M. Lawrence Co. v. MacFarland*[33] was whether the taxpayer must pay a sales tax on air-conditioning equipment which it had installed in churches and municipal buildings. Taxpayer took the position that it sold the materials at retail and for that reason was not liable for the sales tax, because the sales were made to purchasers which were exempt from the sales tax.[34] The taxing authority, on the other hand, took the position that taxpayer was not engaged in the business of retail selling of air-conditioning equipment as such but was engaged in the construction or improvement of real property and

29. Eisner v. Macomber, 252 U.S. 189 (1920).

30. Lowndes, *The Taxation of Stock Dividends and Stock Rights*, 96 U. Pa. L. Rev. 147, 157 (1947).

31. See Lowndes, *supra* note 30.

32. The statute as amended now reads: "No distribution of capital shall be taxed as income under this chapter, and no distribution of surplus by way of stock dividend shall be taxable in the year such distribution is made; but all other distributions out of earned surplus shall be taxed as income when and in whatever manner made, irrespective of when such surplus was earned. Provided, however, that stock issued within one (1) year of liquidation shall be taxable in the year received to the extent made out of earned surplus; and further provided that gains over and above the par or original pro rata capital value of original shares held shall be taxed to the shareholder upon any transfer of stock to nonresidents in the year of such transfer, when such transfer occurs within one (1) year prior to liquidation or redemption." Tenn. Code Ann. § 67-2609 (Supp. 1963). See CCH Tenn. State Tax Cas. Rep. ¶ 15-211 (1962).

33. 355 S.W.2d 100 (Tenn. 1962).

34. See note 36 *infra*.

thus was liable for sales taxes as the *consumer* of materials and equipment used in the consummation of its contract, irrespective of the tax exempt status of the ultimate users. The Tennessee Supreme Court held the taxpayer liable for the tax.

Tennessee imposes a tax on "retail sales" or "sales at retail" of tangible personal property,[35] but exempts such sales to schools, churches, municipalities, counties and the State of Tennessee.[36] However, "sales for resale" are not taxable.

A taxable "retail sale" or a "sale at retail" means a sale of tangible personal property to a *consumer* or to any person for any purpose *other than for resale*; whereas the non-taxable "sale for resale" signifies those sales whereby a supplier of materials, supplies and equipment makes such tangible personal property available to (1) legitimate dealers actually selling such property in their businesses or (2) buyers using the property such that it becomes an industrial material or supply in a manufacturing or processing operation.[37] A Tennessee statute specifically imposes a sales tax on a contractor who purchases and then uses tangible personal property in the performance of his contract or in fulfilling contract obligations, irrespective of who has title to the property.[38] Although the court's opinion contains no citation to any statute which it says makes the taxpayer liable, presumably this latter statutory provision is the basis of imposing the tax.

In the *Lawrence* case, taxpayer handled packaged air-conditioning equipment, which consisted of factory-assembled units of heavy capacity operated by electricity and cooled by water. These units were placed by taxpayer both in existing structures occupied by customers and in buildings being constructed for customers. To make the air-conditioning equipment perform its purpose, it was necessary that it be tied in to the electrical and plumbing facilities of the building. In order to do this, it was necessary to cut through walls, ceilings and floors in existing structures. Taxpayer's contracts for the air-conditioning equipment units thus required connecting the equipment with the plumbing facilities of the building, running of conduits for electricity, erecting cooling towers and installing circulating pumps and thermostats. To transmit the warm or cool air over the buildings, taxpayer installed systems of ducts running from the basic units through walls, ceilings and floors to registers. The contracts called for completed

35. TENN. CODE ANN. § 67-3003 (Supp. 1962).

36. Churches and schools exempt: TENN. CODE ANN. § 67-3014 (1956); sales to municipalities, counties and State of Tennessee exempt: TENN. CODE ANN. § 67-3012 (Supp. 1962).

37. TENNESSEE SALES AND USE TAX RULES AND REGULATIONS, no. 62 (Dep't of Revenue 1961).

38. TENN. CODE ANN. § 67-3004 (Supp. 1962).

air-conditioning systems, which became permanent parts of the buildings and improvements to the realty.

The court thus seems on sound ground in its holding that taxpayer was engaged in the taxable activity of using tangible personal property in the performance of its contract, rather than acting as a retailer engaged in the nontaxable activity of tangible property to tax exempt users.

V. Penalties for Delinquencies in Sales and Use Taxes—Mistake as Basis for Relieving Against Penalty for Delinquencies

In *Combustion Engineering Co. v. MacFarland*,[39] the Supreme Court of Tennessee was confronted with the question whether a taxpayer which failed to make timely tax returns because of errors caused by taxpayer's record keepers and accountants should be relieved of a penalty for such failure. The delinquencies consisted of failure to pay certain sales and use taxes.

Taxpayer, a foreign corporation, is a large manufacturing concern with manufacturing branches located in a number of places throughout the country, including Chattanooga, Tennessee. In the course of its manufacturing business, large quantities of raw materials are purchased and used. The failure to report certain items subject to the tax was caused by errors, oversights, improper coding of machines, etc., of its various record keepers and accountants, whose duty it was to attend to this phase of the business. In one situation an independent firm was employed to install IBM machines to be used for determining the tax liability of new equipment and expense orders. The machines were improperly installed, and errors resulted. However, there was no showing that the failure to make timely tax returns was in any way caused by taxpayer's being misled by anyone connected with the Tennessee Department of Revenue.

The court held the taxpayer liable for the penalty for failure to make timely tax returns. The court thought that the taxpayer had not made out a case entitling it to equitable relief from the penalty.

A relevant statutory provision, after setting forth specific penalties for delinquencies, goes on to provide that all such penalties shall be payable to and collectible by the commissioner in the same manner as if they were a part of the tax imposed.[40] The court thought that the principles for excusing the penalty, as laid down in *Swartz v. Atkins*,[41] did not afford a basis for relief to the *Combustion Engineering* tax-

39. 209 Tenn. 75, 349 S.W.2d 138 (1961).
40. Tenn. Code Ann. § 67-3026 (1956).
41. 204 Tenn. 23, 315 S.W.2d 393 (1950).

payer. *Swartz* refused to relieve against a penalty where the taxpayer based his claim on his ignorance of the existence of the tax. In denying relief in the *Swartz* case, the court observed that when the claim is a legal claim or demand as fixed by the statute in that case, equity will, as a rule, apply the requirement of the statute and will not excuse payment of the claim.

The *Combustion Engineering* decision is a rough one on the taxpayer, since his delinquencies apparently arose through no intent to evade on his part. However, *Swartz* makes it clear that where the penalty for delinquencies is not based on the larger one for fraud, it was the intention of the legislature to apply the smaller penalty to anyone who failed to make a return and pay his tax within the time set by the taxing statute. An intent to evade is not a condition precedent to the imposition of such penalty. *Combustion's* penalties were not based on fraud and thus required no intent to evade. Moreover, the *Combustion* delinquencies were in no way the fault of the Tennessee Department of Revenue; they were solely the fault of the employees or independent contractors hired by the taxpayer to compute the amount of the tax. To have held that mistakes thus caused would be an adequate basis for relieving against the penalties would have opened up a Pandora's box of troubles for the revenue department. If delinquencies caused by mistakes of the taxpayer's employees or those under the control of the taxpayer, would relieve taxpayer from the penalties, it would, to a large extent, nullify the penalty provision of the statute. In most delinquency cases, no doubt the unfortunate taxpayer could discover some sort of a mistake that gave rise to the delinquency.