Vanderbilt Law Review

Volume 14
Issue 4 *Issue 4 - October 1961* Article 23

10-1961

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STATE AND LOCAL TAXATION—1961 TENNESSEE SURVEY

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Not many cases involving state taxes have been decided by the Tennessee courts during the period covered by this survey. Action taken in the halls of Congress, however, has the potential of a major revamping of the taxing power of all state and local governments.

I. INTERSTATE COMMERCE—COMPREHENSIVE CONGRESSIONAL STUDY OF POWER OF STATES TO IMPOSE TAXES ON MULTISTATE BUSINESS

In *State and Local Taxation—1960 Tennessee Survey*[1] it was pointed out that Congress had curbed the power of the states to tax income from interstate commerce by passing Public Law 86-272, which permits a person or company to go or send a representative into another state to solicit orders for the sale of tangible personal property without paying a state or local net income tax to the state of solicitation.[2] By that same congressional enactment the House Judiciary Committee and the Senate Finance Committee were required to make full and complete studies of state taxation of income derived from interstate commerce for the purpose of proposing "legislation providing uniform standards to be observed by the States in imposing income taxes on income" from interstate commerce. The committees were required by the act to report to their respective houses the results of such studies not later than July 1, 1962.

Subsequent to the authorization of that study, Congress has expanded the scope of the study. On April 7, 1961, Congress enacted and the President approved a law extending the study. This law,

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1. See Hartman, *State and Local Taxation—1960 Tennessee Survey,* 13 VAND. L. REV. 1257 (1960), for an analysis of the statute, as well as the cases precipitating the congressional action. Elsewhere the writer has dealt with this whole troublesome and extremely important problem in a much more extensive fashion. See Hartman, *State Taxation of Interstate Commerce,* 3 CORPORATE PRACTICE COMMENTATOR 33 (1961).
2. 73 Stat. 555 (1959), 15 U.S.C. §§ 381-84 (Supp. II 1959).

Public Law 87-17, amends section 201 of Public Law 86-272 to read as follows:

> Sec. 201. The Committee on the Judiciary of the House of Representatives and the Committee on Finance of the United States Senate, acting separately or jointly, or both, or any duly authorized subcommittees thereof, shall make full and complete studies of all matters pertaining to the taxation of interstate commerce by the States, territories, and possessions of the United States, the District of Columbia, and the Commonwealth of Puerto Rico, or any political or taxing subdivision of the foregoing.[3]

As noted above, section 201, as originally enacted, provided for studies only of matters pertaining to the taxation by the states of income derived from interstate commerce. This recent amendment of section 201 expands the scope of this study to include all forms of state taxation of interstate commerce such as franchise taxes, sales and use taxes, gross receipts taxes, and ad valorem taxes.

While Public Law 87-17 authorizes both the Committee on the Judiciary of the House of Representatives and the Committee on Finance of the United States Senate to make the study, it now appears that the Senate will not take part in the study. Congressman Willis, the sponsor of the bill and also the chairman of the subcommittee of the Judiciary Committee which is charged with the responsibility for the study, made this clear on March 21, 1961, when he said: "I might add that subsequently Senator Byrd proposed to defer to the House in this matter and, therefore, the study is now entirely the responsibility of my subcommittee."[4]

The House Judiciary Committee has been authorized to spend $160,000 during 1961 on this study. The committee, with the aid of both a sizeable staff and an advisory group of ten members composed of attorneys, law professors and economists, is now entering upon a fact-finding period during which it will attempt to ascertain rather specifically the problems which need solution and some of the recommended solutions. This facet of the study likely will consume several months and is intended to prepare the committee for hearings directed to specific problems and recommended solutions.

II. NET INCOME TAXES—TAX ON PRIVILEGE OF RECEIVING NET INCOME AS WITHIN BAN OF STATE CONSTITUTION

In unhorsing a state privilege tax in *Jack Cole Co. v. MacFarland*,[5] the Tennessee Supreme Court handed down an opinion that could

3. 75 Stat. 41 (1961), 15 U.S.C. § 381 (Supp. 1961).
4. Congressional Record, March 21, 1961, p. 4143.
5. 337 S.W.2d 453 (Tenn. 1960).

have very considerable importance in the fiscal affairs of Tennessee. The questioned tax was imposed upon "the privilege of being in receipt of or realizing net earnings in Tennessee."[6] Complainant—taxpayer, who brought suit to recover the tax on the ground that it was unconstitutional, was engaged exclusively in interstate commerce. The tax was applied to taxpayer's net earnings realized from transporting motor freight in interstate commerce in Tennessee. The tax was assailed on the ground that, while it was designated as a tax on the privilege of receiving income, it was nevertheless, in substance and effect, a property tax; as such, it ran afoul of the Tennessee constitutional provision which provides that all property taxes must be equal and uniform throughout the state.[7] The constitutional mandate regarding equality and uniformity of taxation does not apply to privilege taxes.[8] Moreover, the only species of income tax permitted by the Tennessee Constitution is that on income derived from stocks and bonds that are not taxed ad valorem.[9]

Without passing upon the uniformity provision objection to the tax, urged by taxpayer for declaring the tax invalid, the Tennessee court invalidated the *Jack Cole* tax and permitted taxpayer to recover. The court had a double-barreled basis for its decision. As one ground for nullifying the tax, the court thought that, since the tax was not imposed on income derived from stocks and bonds, it violated the constitutional provision outlawing income taxes, except where the income is from stocks and bonds. In short, the tax falls because it is a constitutionally forbidden net income tax. As a second ground for upsetting the *Jack Cole* tax, the court says that "realizing and receiving income or earnings is not a privilege that can be taxed."[10] Therefore, the tax cannot be sustained under the authority of the legislature to tax privileges. The court reasoned that "since the right to receive income or earnings is a right belonging to every person, this right cannot be taxed as privilege."[11]

Support can be found for the first ground of the *Jack Cole* decision to the effect that the exaction in question is, in substance, a tax on net income, although the taxing statute expressly phrased it in terms of an imposition on the privilege of receiving net income.[12] The court

6. TENN. CODE ANN. § 67-2725 (Supp. 1961).
7. TENN. CONST. art. II, § 28.
8. Evans v. McCabe, 164 Tenn. 672, 677, 52 S.W.2d 159 (1932); Shields v. Williams, 159 Tenn. 349, 366, 19 S.W.2d 261 (1929); Foster & Creighton Co. v. Graham, 154 Tenn. 412, 285 S.W. 570 (1926).
9. TENN. CONST. art. II, § 28; Evans v. McCabe, 164 Tenn. 672, 680, 52 S.W.2d 159 (1932).
10. 337 S.W.2d at 455.
11. *Id.* at 456.
12. International Harvester Co. v. Wisconsin, 322 U.S. 435 (1944). A tax on the privilege of receiving dividends out of income derived from property

thus disregarded the statutory ritual of the taxing statute and held that the operating incidence of the tax is net income. In making the constitutional issue turn on the operating incidence of the tax, rather than the precision of technical statutory phrasing, the court has adopted a commendable, if not always used,[13] approach. After all, a constitution should not be treated as a formulary. Moreover, if the court had sustained the *Jack Cole* tax, it would have, for all practical purposes, emasculated the Tennessee constitutional provision against income taxes.

While adopting a test of substance rather than form in resolving the constitutional issue, the approach in the *Jack Cole* decision does raise certain potentially troublesome problems. The court may have opened up a Pandora's box of troubles for other privilege taxes. If the privilege tax in the case at hand is to be regarded, for constitutional purposes, as an income tax, although expressly phrased as a privilege tax, what is the status of other privilege taxes that reach net income that does not come from stocks and bonds? A substantial amount of Teunessee's revenue comes from excise taxes on corporate earnings; these privilege taxes are expressly levied on corporate net earnings.[14] Are these taxes to be invalidated under the *Jack Cole* doctrine on the ground that they are, in substance, net income taxes?

In the writer's opinion the court should have stopped after declaring that the tax violated the constitutional ban against income taxes.

It will, however, be recalled that the *Jack Cole* tax was nullified on the additional ground that "since the right to receive income or earnings is a right belonging to every person, this right cannot be taxed as privilege."[15] This basis for giving the *coup de grace to* the

within taxing state was treated, in practical operation, as an additional tax on corporate earnings. *Cf.* Wisconsin v. J. C. Penney Co., 311 U.S. 435 (1940).

13. Although it is an unrealistic approach for commerce clause purposes, the statutory formula into which the taxing statute is cast has often seemed to be the touchstone for determining whether the tax is valid. Thus, a tax levied "on" a subject that is regarded as part of interstate commerce, with apportioned net income used as the measure of the tax, violates the commerce clause. Spector Motor Serv., Inc. v. O'Connor, 340 U.S. 602 (1951). However, a tax levied directly "on" the net income from exclusively interstate commerce can successfully overcome the commerce clause hurdle. Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959). The statutory verbalization used by the respective legislatures made the constitutional difference. Yet one type of tax would be no greater burden on interstate commerce than the other, since both types would have the same economic impact on the commerce. Elsewhere in an earlier survey of Tennessee law the writer has discussed the significance of a statutory formula in determining constitutionality of a Tennessee privilege tax involving interstate transportation of gas, when challenged on commerce clause grounds. Hartman, *State and Local Taxation—1960 Tennessee Survey*, 13 VAND. L. REV. 1262-64 (1960).

14. TENN. CODE ANN. §§ 67-2707 to -2710 (1956).

15. 337 S.W.2d at 456.

Jack Cole tax is somewhat difficult to support. Aside from the income tax prohibition, what constitutional limitation commands that the "receiving of income or earnings" cannot be treated by the legislature as a taxable privilege?[16] Very respectable judicial authority has concluded: "That the receipt of income by a resident of the territory of a taxing sovereignty is a taxable event is universally recognized."[17] Moreover, recent declarations by the Tennessee Supreme Court do not seem consistent with the court's *Jack Cole* declaration that the receipt of income is not a taxable privilege. Thus, in the 1947 tax case of *Hooten v. Carson*,[18] the Tennessee Supreme Court declared: "'A privilege is whatever the legislature choose to declare to be a privilege, and to tax as such.'"[19] Also, it might not be amiss to inquire whether receiving income should be any more immune from a privilege tax than receiving property by will or inheritance. Tennessee upholds this sort of death tax on the ground that it is *"a privilege tax upon the right to inherit property."*[20]

To buttress its position that the receipt of income is not a privilege, for tax purposes, the *Jack Cole* opinion quotes from the 1871 criminal miscegenation decision of *Lonas v. State*[21] that "privileges are special rights, belonging to the individual or class, and not to the mass; properly, an exemption from some general burden, obligation or duty; a right peculiar to some individual or body."[22] However, the foregoing sweeping declaration by the Tennessee Supreme Court in its 1947 *Hooten v. Carson* definition of a taxable privilege would seem to sap much of the vitality, for tax purposes, of the 1871 *Lonas* definition of a privilege.

Moreover, the alleged "privilege" of miscegenetic cohabitation, questioned in *Lonas*, and the "privilege" of receiving income would appear to involve somewhat different problems.

16. "[A] constitutional limitation upon the power of taxation will not be inferred nor implied but must be distinctly and positively expressed." Evans v. McCabe, 164 Tenn. 672, 680, 52 S.W.2d 570 (1926).
17. New York *ex rel.* Cohn v. Graves, 300 U.S. 308, 312-13 (1937) (taxpayer was domiciled in taxing state). The *Jack Cole* decision does not state whether taxpayer is a domestic or foreign corporation.
18. 186 Tenn. 282, 209 S.W.2d 283 (1947).
19. *Id.* at 286, 209 S.W.2d at 274.
20. Murfreesboro Bank & Trust Co. v. Evans, 193 Tenn. 34, 39, 241 S.W.2d 862, 864 (1951). *Cf.* Mitchell v. Carson, 186 Tenn. 228, 231, 209 S.W.2d 20, 21 (1948); Hutchison v. Montgomery, 172 Tenn. 375, 383-84, 112 S.W.2d 827, 830 (1938).
21. 50 Tenn. 287 (1871).
22. *Id.* at 307.

III. PRIVILEGE TAXES—TAX LIABILITY OF SURVIVING CORPORATION IN MERGER OR CONSOLIDATION WHERE CONSTITUENT CORPORATION HAD PAID THE PRIVILEGE TAX—PROBLEM OF DOUBLE TAXATION OF GROSS RECEIPTS

General Telephone Co. v. Boyd[23] involved the validity of a privilege tax imposed upon the corporation remaining after a merger or consolidation had dissolved a corporation which had already paid the privilege tax for the period in question. Among the "persons" taxed in Tennessee for the privilege of engaging in local business are those who operate an intrastate telephone business, the tax being determined at a specified rate on the gross receipts.[24] The complaining taxpayer (General Telephone Company), a foreign corporation, began doing telephone business in Tennessee on October 1, 1957. Prior to that date this particular telephone business had been carried on by Southern Continental Telephone Company, a Delaware corporation. On October 1, 1957, taxpayer consolidated (rather it merged) with Southern Consolidated, leaving taxpayer the surviving corporation since Southern Continental had ceased to exist. Thereafter taxpayer operated the same business theretofore operated by Southern Continental with the same personnel, the same equipment, at the same location, and without the addition of any new or different operations.

For the fiscal year beginning July 1, 1957, Southern Continental paid the entire annual tax for the privilege of doing business, although it could properly have paid the tax in quarterly installments.[25] Under an applicable Tennessee statute, if Southern Continental had paid on a quarterly basis, and transferred its business during the fiscal year in which such quarterly payments were being made, then the transferee (taxpayer here) would have been liable only for the quarterly payments that remained unpaid and would not have been liable for an entire year's tax.[26]

In the case at hand, taxpayer took the position that since Southern Continental had paid a full year's tax for the fiscal year beginning July 1, 1957, the taxpayer, who still existed after the merger or consolidation with Southern Continental, should have no tax liability for the remainder of the fiscal year beginning July 1, 1957. Taxpayer paid under protest the tax for the entire fiscal year beginning July 1, 1957, and sued to recover that amount. The Tennessee Supreme Court affirmed a lower court decision denying recovery.

There are several facets to the reasoning of the court's decision

23. 343 S.W.2d 872 (Tenn. 1960).
24. TENN. CODE ANN. §§ 67-4102 (item q), -4317, -4320 (1956).
25. TENN. CODE ANN. § 67-4318 (1956).
26. TENN. CODE ANN. § 67-4319 (1956). The court points out that the state concedes this position. 343 S.W.2d at 874.

denying recovery. To the taxpayer's argument that when a business is transferred during the fiscal year the transferee is liable only for quarterly payments that remain unpaid, the court answered that this provision of the statute applied only when the transferor had elected to pay the tax on the installment basis, rather than on an annual basis as had been done in the case at hand. The court made this holding, although a relevant statute declares that it is the legislative intent that only one gross receipts tax shall be paid on account of the operation of a business during any one year.[27] The court reasoned that, since this declaration of legislative policy appears only in that portion of the statute dealing with a transferee's liability when payment by the transferor is made on a quarterly basis, such legislative policy against double taxation of gross receipts was confined to the situation where the installments are paid on a quarterly basis and is not applicable where the full annual tax has been paid at one time.

To be sure, the declaration of a legislative policy forbidding double taxation of gross receipts on account of the operation of a business during any one year is contained in the code section dealing with payments of the tax on a quarterly basis. It does seem a bit odd, however, that it should be the legislative intent that only one gross receipts tax should be imposed on gross receipts when the tax is paid on a quarterly, but not a yearly, basis. Such a construction of the statute seems to penalize the conscientious taxpayer who pays an entire year's tax at one time and rewards the taxpayer who pays only in quarterly installments. It is hard for the writer to believe that such an unusual policy was intended by the legislature of Tennessee, even though the court's opinion seems to indicate that taxpayer's attorneys concede the correctness of the court's construction of the statute in this regard.[28]

Another of taxpayer's arguments resisting the tax turned on the meaning of a statute defining the powers, privileges, etc., of the corporation that survives after a consolidation. A Tennessee statute provides that where corporations consolidate, the constituent corporations shall cease, and the surviving corporation shall possess all the rights, privileges, powers, franchises and immunities of each of the consolidated corporations.[29] Taxpayer contended that this statutory provision exempted it from the tax in question because the consolidated corporation (Southern Continental) had paid the privilege tax for the entire year, and thus taxpayer possessed the privilege of con-

27. TENN. CODE ANN. § 67-4319 (1956).
28. See 343 S.W.2d 872, 875 (Tenn. 1960).
29. TENN. CODE ANN. § 48-505 (1956).

ducting its business tax free for the remainder of the year. Under this statute, argued taxpayer, it received from the consolidated corporation its "privilege" of continuing operation of the same business at the same location during the same period without additional gross receipts tax.

In rejecting this argument by taxpayer, the court held that since the statute did not expressly relieve taxpayer from this state tax, the exemption would not be implied. The court pointed out that the state is not bound by the general words of a statute, which, if applied, would guaw away at its sovereign right, unless specifically or necessarily implied. Moreover, the taxpayer claiming an exemption must affirmatively show that he is entitled to it, since taxation is the rule, and exemption from taxation is the exception. So reasoned the court in *General Telephone* in holding that the statute giving to the surviving corporation in a consolidation the "privileges" of the consolidated corporation did not exempt taxpayer from the tax on the ground that the consolidated corporation (Southern Continental) had paid the tax for a full year.

There is some doubt whether this statutory provision invoked by taxpayer has any application whatsoever to the *General Telephone* case. This statute applies only to consolidations, and the transaction in this case appears to be a merger rather than a consolidation. In a strict sense a consolidation is the uniting or amalgamation of two or more existing corporations to form a *new* corporation.[30] A merger, on the other hand, is a union effected by the absorbing of one or more existing corporations by another which survives and continues the combined business.[31] That appears to describe what took place in the case at hand. Southern Continental was merged into General Telephone Company, an existing corporation; Southern Continental ceased to exist, but General Telephone continued to survive. However, the terms merger and consolidation are frequently used loosely and interchangeably in some statutes and decisions.[32] The Tennessee statute in question reads as though it refers only to a technical consolidation rather than to a merger, because it provides, among other things, that the constituent corporations shall cease.[33] Moreover, Tennessee does have a separate statute dealing with mergers.[34]

30. See BALLANTINE, CORPORATIONS 680 (rev. ed. 1946).
31. See BALLANTINE, CORPORATIONS 681 (rev. ed. 1946).
32. See BALLENTINE, CORPORATIONS 681 (rev. ed. 1946).
33. TENN. CODE ANN. § 48-505 (1956).
34. TENN. CODE ANN. §§ 48-517 to -523 (Supp. 1961).