



OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
HOMESTXKE MINING COMPANY }

Appearances:

For Appellant: Garrett W. McEnerney, its Attorney

For Respondent: Chas. J. McColgan, Franchise Tax Commission

O P I N I O N

This is an appeal pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Statutes 1929, Chapter 13, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of Homestake Mining Company, a corporation, against a proposed assessment of an additional tax in the amount of \$5,461. The assessment of an additional tax was proposed by the Commissioner due to the fact that the Commissioner included in Appellant's income for the taxable year ended December 31, 1930, on the basis of which Appellant's tax liability was computed, interest from federal, state and municipal bonds in the amount of \$136,525.

Whether the Commissioner acted properly in thus including interest received from federal, state and municipal bonds in the income of Appellant for the taxable year ended December 31, 1930, is the sole problem involved in this appeal.

A corporation, of the classes taxable under the Act, is taxed for the privilege of exercising its corporate franchise in this State. This tax is computed in accordance with Section 4 on the basis of the corporation's net income for the preceding fiscal or calendar year.

Net income is defined in Section 7 of the Act as being "gross income less the deductions allowed". Gross income is defined in Section 6 as including

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

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In view of the above provisions, it is clear the act contemplates that interest from federal, state and municipal bonds should be included in the income upon the basis of which the tax imposed by the Act is to be computed. Hence, it follows that the Commissioner is to be regarded as having complied with the terms of the Act in including in Appellant's income for the taxable year ended December 31, 1930, interest from such bonds received by Appellant during said year.

The Appellant contends, nevertheless, that the Commissioner erred in including such interest in the income of Appellant by which the tax on Appellant under the Act was measured. The basis for this contention is that the Act, insofar as it provides for the inclusion of interest from federal, state and municipal bonds in the income by which the tax provided in the Act is measured, is unconstitutional.

Generally, we do not consider the constitutionality of legislation but leave the matter for the courts to determine. Our attitude in this respect has been expressed in a number of instances, particularly in the Appeal of Vortex Manufacturing Company decided by us on August 4, 1930. However, we are of the opinion, in view of recent decisions of the Supreme Court of the United States and of this State, that the inclusion of interest from federal, state and municipal bonds in the income on the basis of which the tax provided in the Act is computed is constitutional.

Article XIII, Section 16 of the State Constitution, pursuant to which the Bank and Corporation Franchise Tax Act was passed, expressly provides in subdivision 5 that the Legislature "shall define 'net income' and may define it to be the entire net income received from all sources". In view of the above provision, it would seem that the Act cannot be regarded as violating the State Constitution in providing for the inclusion of interest from federal, state and municipal bonds in the income, by which the tax provided therein is measured. Hence, if such inclusion is invalid it is so only because it is prohibited by the Federal constitution or laws of the United States passed pursuant thereto.

Unquestionably, bonds of the United States being Federal instrumentalities, may not be subjected to state taxation, nor may the income therefrom be taxed (*Weston v. City of Charleston*, 27 U.S. 289). State and municipal bonds are, by Section 1 3/4 of Article XIII of the State Constitution, expressly declared to be exempt from taxation. This exemption would seem to extend to the interest from such bonds inasmuch as a tax on the interest is to be regarded, in effect, as a tax on the bonds (*Pollock v. Farmer's Loan & Trust Co.* 158 U.S. 601). Hence, it would seem that a tax imposed by this State on interest from federal bonds would be void as being a tax on a federal instrumentality, and a tax on interest from state or municipal bonds, whether authorized by the State Constitution or not, would be void also, as being in violation of Article I, Section 10 of the Constitution of the United States forbidding states

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to pass any law impairing the obligation of contracts.

The question then arises, does the Act in providing for the inclusion of tax exempt interest in computing the income by which the tax provided in the Act is measured, impose a tax on such interest? Clearly, the Act does not purport to do so. Rather, as noted above, it purports to impose a tax on certain banks and corporations for the privilege of exercising their corporate franchises in this State according to or measured by their net income for the preceding year.

A well recognized distinction exists between a tax on net income and a corporate franchise tax measured by net income. The latter kind of tax has been regarded as strictly an excise tax, not an income tax and being an excise tax, nontaxable income may be included in the measure of the tax.

Thus, in Flint v. Stone Company, 220 U.S. 107, the United States Supreme Court sustained a Federal franchise tax on corporations measured by their net income, including interest from tax exempt securities. In the course of the opinion, at page 165, the Court states:

"It is * * * well settled by the decisions of this court that when the sovereign authority has exercised the right to tax a legitimate subject of taxation as an exercise of a franchise or privilege, it is no objection that the measure of taxation is found in the income produced in part from property which of itself considered is nontaxable. Applying that doctrine to this case, the measure of taxation being the income of the corporation from all sources, as that is but the measure of a privilege tax within the lawful authority of Congress to impose, it is no valid objection that this measure includes, in part at least, property which as such could not be directly taxed."

Notwithstanding the rule of Flint v. Stone Tracy Company, the Supreme Court held in Macallen Co. v. Massachusetts, 279 U.S. 620, that a taxing statute of Massachusetts purporting to impose a franchise tax on domestic corporations measured by net income, including income from federal and other tax exempt securities, was invalid insofar as income from tax exempt securities was included in the measure of the tax.

The inclusion of interest from tax exempt securities was effected by an amendment to the statute in question defining net income as

"the net income for the taxable year as required to be returned by the corporation to the federal government under the federal revenue act applicable for the period * * * and all interest and dividends not so required to be returned".

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Prior to this amendment, net income was defined so as to expressly exclude nontaxable income.

The state court held the tax to be an excise tax on the privilege of doing business, and hence, under the rule above noted, not invalid because nontaxable income was included in its measurement.

The United States Supreme Court, however, held that the inclusion of nontaxable income in the measurement of the **tax** was for the purpose of taxing such income, and hence, the tax was in substance and reality a tax on income derived from tax exempt securities, and not an excise tax on the privilege of doing business. The purpose to reach such nontaxable income was found in the fact that it was included by an amendment to the statute in question, whereas before the amendment such **income** was expressly excluded, and from the fact that such purpose was plainly disclosed by a report of a special commission to the Massachusetts Legislature.

It is to be noted that the Court did not overrule Flint v. Stone Tracy Company, supra. This is well evidenced by the case of Educational Films Corporation v. Ward, 282 U.S. 379, wherein the Court held valid the New York Tax Act which imposed a corporate franchise tax measured by net income, although royalties from copyrights were included by-implication in such income. It was contended that royalties from copyrights were nontaxable inasmuch as royalties from patents had been held nontaxable in Long v. Rockwood, 272 U.S. 142, and, consequently in view of Macallen Co. v. Massachusetts, supra, the inclusion of such royalties in the measurement of the tax should be held invalid. The Court did not determine whether royalties from copyrights were nontaxable, but simply applied the rule of Flint v. Stone Tracy Company. Macallen Co. v. Massachusetts was distinguished on the grounds that the Massachusetts statute evinced an intent to reach nontaxable income, whereas no such intent was apparent in the New York Act insofar as royalties from copyrights were concerned.

Hence, it would seem, in view of the above noted decisions, that unless the California Act can be brought within the rule announced in Macallen Co. v. Massachusetts, supra, the inclusion of interest from tax exempt bonds in computing the income by which the tax under the Act is measured must be held valid.

In this connection, it is to be noted that the California Act specifically provides for the inclusion of tax exempt interest, whereas no such specific provision existed in the Massachusetts statute before the Court in the Macallen case, the inclusion of such interest being effected by general terms along with other income not required to be returned to the federal government. Furthermore, it is to be noted that the report of the California Tax Commission, which was before the Legislature when it enacted the California Act, contains observations on the possibility of taxing exempt income similar to those contained in the report of the special commission to the

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Massachusetts Legislature, which the Court in the Macallen case relied upon as showing an intent *on* the part of the Massachusetts Legislature to tax forbidden income.

Hence, it might seem that the California Act should be accorded the same treatment as the Massachusetts statute. Nevertheless, the Supreme Court of **this State** held in Pacific Company, Ltd., v. Johnson, 212 Cal. 148, that the Act was **valid**, although interest from tax exempt improvement district bonds was included in the income by which the tax provided in the Act was measured. On appeal to the United States Supreme Court, this case was affirmed, (United States Daily, **April 12, 1932**, page **6**; 52 Sup. Ct. Rep. **424**).

It was contended by the taxpayer that inasmuch as the bonds, at the time of issue, were exempt from taxation under Section 1 $\frac{3}{4}$ of Article XIII of the California Constitution, the inclusion of interest therefrom in the measurement of the franchise tax would result in violating Article I, Section 10 of the United States Constitution forbidding states to pass any law impairing the obligation of contracts. From the holding that the inclusion of interest from tax exempt improvement district bonds does not violate the impairment of the obligation of contracts clause, we are of the opinion it necessarily follows that the **inclusion** of such interest does not result in taxing such interest.

Whether the Supreme Court of the United States in affirming Pacific Company, Ltd. v. Johnson, supra, repudiated the intent test applied in Macallen Co. v. Massachusetts, supra, **or**, whether the court, for reasons not apparent, **held** that the California Act did not evince an intent to tax **forbidden** income to the same extent as did the Massachusetts statute although of great interest, is not of particular consequence for the purpose of the instant appeal. The important point is that the Court considered that the **constitutionality** of the California Act was to be controlled, not by Macallen Co. v. Massachusetts, but by the rule of Flint v. Stone Tracy Company, supra, and Educational Films Corporation v. Ward, supra.

It is true that Pacific Company, Ltd. v. Johnson, supra, was concerned, not with the inclusion of interest from tax exempt federal bonds, but only with the inclusion of interest from tax exempt improvement district bonds. But if the inclusion of interest from one class of tax exempt bonds does not result in taxing such interest, it is difficult to see why the inclusion of interest from another class of tax exempt bonds should be regarded as having any different effect.

Consequently, we conclude that the Act is constitutional, although it provides for the imposition of a tax measured by net income' in the computation of which income from tax exempt bonds is included.

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O R D E R

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

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, that the action of **Chas. J. McColgan**, Franchise Tax Commissioner, in overruling the protest of Homestake Mining Company, a corporation, against a proposed assessment of an additional tax of \$5,461, with interest, under Chapter 13, Statutes of 1929, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of May, 1932, by the State Board of Equalization.

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

ATTEST: Dixwell L. Pierce, Secretary