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National Bank Taxation in California

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IV. STATE TAXATION OF NATIONAL BANKS "ACCORDING TO OR MEASURED BY" THEIR NET INCOME

Among other things the 1926 amendment to Section 5219 of the United States Revised Statutes authorizes, subject to certain limitations to be discussed later, state taxation of national banks (1) "on" their net income, or (2) "according to or measured by" their net income. These two methods apparently offer the only means under the existing law of according preferential treatment to bonds, notes or other evidences of indebtedness, without invalidating the bank taxes. Taxes levied under these methods will be valid, so far as concerns Section 5219, even though intangibles are taxed at a low rate or not at all, for the reason that under these methods the bank rate is compared with that imposed on other corporations rather than with the rate on other "moneyed capital." The difference between the two new methods lies in the fact that if the banks are taxed "on" their net income, the income from tax exempt securities cannot be included in the base, whereas Congressional consent to a tax on the banks "measured by" their net income is designed to allow the inclusion within the tax base of net income from tax exempt securities. The purpose of the

1 It will be observed that Section 5219, in effect now authorizes the state to discriminate against national banks in favor of "other moneyed capital" not employed in corporate form or employed by individuals making investments in bonds, notes and other forms of indebtedness. Even under the share method of bank taxation discrimination against national bank shares has been upheld in at least one instance. See Des Moines National Bank v. Fairweather (1923) 263 U. S. 103, 44 Sup. Ct. 23, discussed in the first instalment of this paper (Jan. 1929) 17 CALIFORNIA L. REV. 83, 114-118. For an answer to the argument that permission thus given to discriminate against national banks by favoring competing capital is invalid, see the first section of the first instalment of this paper (Jan. 1929) 17 CALIFORNIA L. REV. 83-94.

2 See the report of the Committee on Banking and Currency, submitted to the House of Representatives, March 11, 1926, in which it is stated:

"In the states which now apply the net income tax method to corporations generally and denominate it an excise or franchise tax, the practice is to include income from all sources, including income from tax-exempt securities, in arriving at the measure of the tax based on net income. Therefore, it is desirable, in order to establish complete taxing parity, to remove any question as to the inclusion of the income from tax-exempt securities as part of the measure of the tax based on net income of national banking associations; so that the same basis of measuring the tax according to net income for corporations generally may be applied to national banking associations by the taxing state.

"To this end the pending bill clearly distinguishes between taxing national banking associations (3) on their net income and (4) according to or measured by their
discussion under this heading is to consider the validity of the consent thus given.

The question immediately arises, why did not Congress specifically authorize the inclusion of income from all sources when the banks were taxed "on" their net income rather than attempt to accomplish the same thing by sanctioning a tax "according to or measured by their net income"? The answer is perhaps twofold: (1) If valid, an authorization to include income from tax exempt securities in the tax base of a tax "on" net income, might have opened up to state taxation under personal income taxes the income from federal securities and thus have materially injured the market for such securities; (2) Congress has expressly set forth in several statutes that income from federal securities shall not be taxed, and a later declaration that such income may be taxed, if not lacking in due process of law, would at least have been a breach of net income. In the latter case the taxing state may 'include the entire net income received from all sources.'

"In Flint v. Stone Tracy Co. (220 U. S. 108) the Supreme Court upheld an excise tax on corporations where the measure of taxation was the income of the corporation from all sources, and held that 'it is no valid objection that this measure includes, in part at least, property which as such could not be directly taxed.'

"Therefore the proposed amendments to section 5219 are designed to accomplish the following:

"(a) The inclusion of income from tax-exempt securities as part of the measure in taxing national banking associations, providing other corporations generally are similarly treated by the taxing state . . . " 67 Cong. Rec. 5760-5761, 5822, 6080-6089 (1926).

The precise terms of the exemption are not the same in all issues of United States Bonds: In 12 Stat. 346, c. 33, § 2 (1862) it is provided:

"and all stocks, bonds and other securities of the United States held by individuals, corporations or associations, within the United States shall be exempt from taxation by or under State authority."

The statute relating to the Panama Canal Bonds, 32 Stat. 484 (1902), 31 U. S. C. § 744 (1926) declares:

"and such bonds shall be exempt from all taxes or duties of the United States, as well as from taxation in any form by or under State, municipal or local authority."

The statute relating to the First Liberty Loan bonds, 40 Stat. 35 (1917), 31 U. S. C. § 746 (1926) declared the bonds to be:

"exempt, both as to principal and interest, from all taxation, except estate or inheritance taxes, imposed by authority of the United States, or its possessions, or by any state or local taxing authority; . . ."


It is to be observed that the Constitution does not expressly prohibit the United States from impairing the obligation of contracts, see New York v. United States (1922) 257 U. S. 591, 42 Sup. Ct. 239; but the question arises whether the impairment of the obligation of contracts is prohibited the federal government because it is a taking of property without due process of law. That it is, is sug-
faith and a destruction of confidence in the national government of purchasers of government securities. In short, Congress apparently wanted to give a very limited consent to state taxation of federal securities; and to avoid unconstitutionality of the statute by bringing it within the class of statutes, which, like that involved in *Flint v. Stone Tracy Co.*, to be discussed presently, have been upheld on the ground that suggested in the following *dictum* quoted from the court’s opinion in the Sinking Fund cases (1878) 99 U. S. 700, 718: “The United States cannot any more than a State interfere with private rights, except for legitimate government purposes. They are not included within the constitutional prohibitions which prevent States from passing laws impairing the obligation of contracts, but equally with the States they are prohibited from depriving persons or corporations of property without due process of law. They cannot legislate back to themselves without making compensation, the lands they have given this corporation to aid in the construction of its railroad. Neither can they by legislation compel the corporation to discharge its obligations in respect to the subsidy bonds otherwise than according to the terms of the contract already made in that connection. The United States are as much bound by their contracts as individuals. If they repudiate their obligations it is as much repudiation with all the wrong and reproach that term implies, as it would be if the repudiator had been a State or a municipality or citizen.”

It seems that when the impairment in question amounts to *taking*, it will come under the due process clause of the fifth amendment as is evidenced by the opinion of the court in United States v. Northern Pacific Ry. (1921) 256 U. S. 51, 41 Sup. Ct. 439:

“The company accepted the proposal and at enormous cost constructed the road and put the same in operation and the road was accepted by the President. Thus, the proposal was converted into a contract as to which company by performing its part became entitled to perform by the Government. Such rights are within the protection of the due process clause of the Constitution. Giving effect to all that bears upon the subject we are of the opinion that after the company earned the right to receive what was intended by the grant it was not admissible for the Government to reserve or appropriate to its own uses lands in the indemnity limits required to supply losses in the place limits.” It might be argued that the repudiation of the exemption from state taxes, as provided in Section 5219, is such a direct and arbitrary taking of property as to violate the due process clause. To reach this conclusion, one need only take at its face value the language of the majority opinion in National Life Insurance Co. v. United States, *supra* n. 3: “No device or form of words can deprive him (holder of tax exempt bonds) of the exemption for which he contracted.” The case is discussed more fully later on.

A similar argument with respect to state securities, based squarely upon the impairment of the obligation of contracts clause of the Constitution, might be advanced to prevent the states from including within the tax base the value of state securities which have been declared by statute to be tax free. The answer to both contentions, if the court approves of the measurement theory, would seem to be that the immunity statutes have no application to *excise* taxes, of the kind discussed in the text, *indirectly* bearing upon tax-exempt securities, and would fall within the well-settled rule that statutory provisions for tax exemption are to be strictly construed. *Tucker v. Ferguson* (1874) 89 U. S. (22 Wall.) 527, 575; *Morgan v. Louisiana* (1876) 93 U. S. 217; *Chicago Ry. Co. v. Guffey* (1887) 120 U. S. 569; *Wilmington & W. R. Co. v. Alsbrook* (1892) 146 U. S. 279, 294, 13 Sup. Ct. 72; *Chicago Theological Seminary v. Illinois* (1902) 188 U. S. 662, 674, 23 Sup. Ct. 386; *Jetton v. University of the South* (1908) 208 U. S. 489, 499, 28 Sup. Ct. 375; *Millsaps College v. Jackson* (1927) 275 U. S. 129, 48 Sup. Ct. 94.

* (1911) 220 U. S. 107, 31 Sup. Ct. 342, discussed more fully later on.
the tax was not a tax "on" income from exempt securities at all but on something else, namely, the doing of business, and that if the tax were "measured by" net income which included some income which had come from exempt securities, the burden thereon would be considered too remote and incidental to render the tax invalid because of its effect.

If a state uses the "according to or measured by" method of taxing national banks, it is important to determine what is the subject taxed. Section 5219 reads: "The several states may . . . tax such associations . . . according to or measured by their net income." The states have always had authority to levy taxes on occupations and businesses carried on within their limits except businesses shielded by superior law, and they have had this authority irrespective of whether the occupation or business was carried on only by virtue of a license or franchise granted by the state. These taxes are variously called excise, privilege or occupation taxes. It seems, therefore, that it is no objection to the tax that a national bank carries on business in a state independently of state authority. The shield is now withdrawn from banking carried on under the national bank act and these banks fall into the taxable class to the extent permitted. Under the federal system of taxation, taxes on occupations have always been called excises. In *Flint v. Stone Tracy Co.* the court upheld a federal excise tax on corporations "with respect to the carrying on or doing business" by such corporations measured by their total net income. The tax there upheld was upon the exercise of privileges not granted by the federal government. If the federal government can levy an excise tax on the exercise of privileges it does not grant, it is difficult to see why the state cannot levy excise taxes on the exercise of privileges in the state which it does not grant. Such a tax does not conflict with an exercise of federal power over the same subject because the congressional legislation in question prevents that conflict by consenting to the tax. The two situations are perfectly analogous except for the source of the power in each instance, but it is submitted that this makes no difference, for the state's taxing power, being applicable to this subject because not in conflict with congressional legislation, and being one of the inherent sovereign powers of the state is at least as respectable and legitimate as Congress's power to levy excises granted by the Constitution.

The condition attached to taxing national banks according to or measured by their net income, is set forth in the statute as follows:

6 See 2 COOLEY ON TAXATION (3d ed. 1903) 1094-1102, 1104-1149, and cases there cited.
7 Supra n. 5.
"In case of a tax on or according to or measured by the net income of an association, the taxing State may, except in case of a tax on net income, include the entire net income received from all sources, but the rate shall not be higher than the rate assessed upon other financial corporations nor higher than the highest of the rates assessed by the taxing State upon mercantile, manufacturing, and business corporations doing business within its limits..."

The conditions herein set forth raise the question, can a state levy a tax on other financial corporations and other mercantile, manufacturing and business corporations doing business within its limits measured by their net income from all sources without deducting the income received from tax exempt securities? A negative answer to this question might mean that the same required deductions would have to be allowed national banks since the statute requires that the rate thereon must not be "higher than the rate assessed upon other financial corporations nor higher than the highest" of the rates upon mercantile, manufacturing and business corporations doing business within its limits," and numerous cases, discussed in the last issue of this Review, hold that prohibition of a "higher rate" prohibits unequal allowance of deductions. Unless implied, there is no congressional consent to state taxation of corporations other than national banks according to their total net income, including income from federal securities, for Section 5219

8 44 STAT. 223 (1926).
9 The limitation that the rate on national banks shall not be "higher than the highest" of the rates on mercantile, manufacturing and business corporations doing business within the limits of the state, rather than the limitation that such rate shall not be "higher" than that imposed on such corporations, allows the state a reasonable freedom in classifying corporations for purposes of taxation. Some classes of corporations which the state may want to encourage may be taxed at a lower rate than the bank rate without invalidating the bank tax, but national banks cannot be taxed higher than the least favored class of mercantile, manufacturing and business corporations doing business within the limits of the state, or in other words, national banks cannot be, as regards state taxation, the least favored class of corporations doing business within the state.
10 (Jan. 1929) 17 CALIFORNIA L. REV. 83, 107 et seq.
11 The decisions under the share method of taxing national banks have permitted the taxation of national bank shares by different methods from those employed in the taxation of "other moneied capital" as long as the ultimate burden was not discriminatory as regards national bank shares. See (Jan. 1929) 17 CALIFORNIA L. REV. 83, 107 et seq. It would seem that if national banks are taxed according to or measured by their total net income, the tax on the other corporations mentioned need not be in form an income tax as long as the ultimate tax burden when translated into an income tax does not violate the conditions above quoted. It is difficult, however, to see how there would be any way of knowing in advance what the ultimate burden of a tax, not an income tax, would be if translated into an income tax, and although the burden of proving a violation of the conditions of Section 5219 is upon the taxpayer, the state would find its bank tax inoperative if actual discrimination were proved. The practical difficulties seem almost insurmountable in devising any other tax not an income tax
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does not purport to authorize state taxation of the other corporations mentioned in the manner authorized for national banks. It would seem, therefore, that if the court strictly interprets the restriction above quoted, a state can take full advantage of the authorization to levy a tax measured by the total net income of national banks, only if, independently of Section 5219, it can levy a tax upon the other corporations mentioned, measured by their total net income, including therein income from federal securities.

But even though it be held that the states cannot measure excise taxes on the other corporations mentioned according to total net income without deducting income from exempt securities, it would still be possible for the court to uphold the tax on national banks measured by total net income without requiring such deductions to be made, on the authority of Des Moines National Bank v. Fairweather. As was pointed out in the last installment of this paper, there was one possible criticism of, and therefore ground for doubting, the decision in the Fairweather case. In that case, it will be recalled, the Supreme Court upheld an Iowa tax upon national bank shares as against the objection that it favored "other moneyed capital," although no deduction was made of the value of federal securities owned by the bank from the taxable assets of the shares, whereas such deduction was made from the value of assets of private bankers who were taxed upon their banking capital. It was pointed out that the court might reasonably and quite logically have held that since there was a substantial amount of competing moneyed capital, the measurement of a tax upon which could not include exempt securities, the tax on national bank shares which did include exempt securities in its measurement was void, for even though the state could not refuse the exemption to the competing capital, it could have made the deduction from the value of the national bank shares and therefore have avoided the discrimination. The court could, therefore, quite properly have said that it considered the discrimination sufficiently serious to compel the state thus to limit its taxation of national banks. But in the instant situation, on the other hand, this argument is not possible. Congress has expressly consented to a tax on national banks measured by total net income. If the court holds that the state cannot similarly tax foreign corporations doing business within the

that will uniformly result in the same burden as if an income tax were imposed. If the state does not want to impose an income tax on the other corporations specified in Section 5219 but wants to make sure that such a tax on national banks will not be invalidated, it should impose taxes high enough on the other corporations that there will be no doubt that if translated into income taxes they would be free of discrimination against national banks.

12 Supra n. 1.
state, it cannot compel the state to grant a similar indulgence to national banks without forbidding them to levy a tax which Congress has, in so many words, consented to. The court could so hold only on the ground that the consent was unconstitutional. And so to hold would be to contradict the fundamental proposition, discussed at length in the first installment of this article, and implied in every case that has upheld a tax under Section 5219 since it was enacted, that a state tax upon a federal instrumentality is void, if at all, only because it hampers and interferes with that instrumentality, and that since the only limitation upon Congressional power to create instrumentalities is that they in some degree subserve the lawful purposes of Congress, it is for Congress and not for the courts to say whether an instrument subjected to this or that burden of state taxation will subserve the purposes of Congress in the manner it desires them to be subserved. It should be noted that under the interpretation of the statutes which we are now considering the tax which Congress has authorized is not only a burden upon, but a discrimination against, a federal instrumentality. It seems clear, in the light of the above discussion, that the power of Congress to burden its instrumentalities includes power to authorize discrimination against them. This, be it noted, is a necessary premise to the decision in the Fairweather case.

The foregoing discussion of the "measured by" method of taxing national banks makes it apparent that two of the vital provisions thereof: (1) authorization of the inclusion of income from tax exempt securities in the measurement of the tax on national banks; and (2) the condition that the equivalent at least of such tax be imposed upon other financial corporations and that the burden on national banks be no greater than that on the least favored of the mercantile, manufacturing and business corporations doing business within the state, apparently depend for their validity or full operation upon the truth of the proposition that these taxes when "measured by" net income may include income from exempt securities which could not be taxed as income directly. We turn, then, to an examination of the "measured by" theory, which, it may be observed, was invoked by Congress for the express purpose of rendering taxable the net income of national banks, including that derived from exempt securities. It should be said at this point, however, that this discussion does not purport to exhaust the refinements and implications in the rules of decision in the cases which have dealt with the measurement theory. An attempt will be made, however, to analyze all the cases which seem vital to an understanding of the present state of the law on this subject so far as concerns the immediate problem involved.
A state tax upon bonds of the United States is clearly void as a tax upon a federal instrumentality. The inclusion of income arising therefrom in a tax on net income is invalid for the same reason. But a long line of cases have held that a corporate franchise tax measured by property or by income from the property of a corporation, is not a tax on the income itself, and is, therefore, valid even though the property or the income is itself not taxable. The reasons assigned in these cases are summed up in the opinion of the court in Home Insurance Co. v. New York. In that case an annual franchise tax was imposed upon every corporation, with certain exceptions, doing business in the state, to the amount of one quarter of a mill upon its capital stock for each

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See supra n. 3, for references to Congressional statutes declaring United States bonds exempt from taxation. In Plummer v. Coker (1900) 178 U. S. 115, 20 Sup. Ct. 829, which sustained a state inheritance tax on the succession to non-taxable federal securities, and which will be discussed more fully later, the court was of the opinion that such statutes were unnecessary to prevent state taxation of the bonds: "As, then, for the reasons advanced and applied in the previous cases, it is not within the power of a State to tax Federal securities, it was not necessary for Congress, in order to secure such immunity, to declare in terms, in the act of July 14, 1870, and on the face of the bonds issued thereunder, that the principal and interest were exempt from taxation in any form by or under State, municipal, or local authority. Such a declaration did not operate to withdraw from the States any power or right previously possessed, nor to create, as between the States and the holders of the bonds, any contractual relation. It doubtless may be regarded as a legitimate mode of advising purchasers of such bonds of their immunity from State taxation, and of manifesting that Congress did not intend to waive this immunity, as it had done in the case of national banks, which are admittedly governmental instrumentalities."


16 Supra n. 15.
one per centum of its dividends. A less rate was provided where there were no dividends or where the dividends were less than six per cent. It was contended by plaintiff company that the tax was in fact levied upon the capital stock of the company and that there should be deducted from it the value of federal bonds held by the corporation. The court held, however, that the tax was not upon the capital stock nor upon any bonds of the United States composing part of that stock, but was upon the corporate franchise and that reference was made to capital stock and dividends for the purpose of determining the amount of the tax to be exacted. The basic principle upon which the case was decided is set forth in the following language of Mr. Justice Field who delivered the opinion of the court:

"The right or privilege to be a corporation, or to do business as such a body, is one generally deemed of value to the corporators. . . . The granting of such right or privilege rests entirely in the discretion of the State, and, of course, when granted, may be accompanied with such conditions as its legislature may judge most befitting to its interests and policy. It may require, as a condition of the grant of the franchise, and also of its continued exercise, that the corporation pay a specific sum to the State each year, or month, or a specific portion of its gross receipts, or of the profits of its business, or a sum to be ascertained in any convenient mode which it may prescribe. The validity of the tax can in no way be dependent upon the mode which the State may deem fit to adopt in fixing the amount for any year which it will exact for the franchise. No constitutional objection lies in the way of a legislative body prescribing any mode of measurement to determine the amount it will charge for the privileges its bestows. It may well seek in this way to increase its revenue to the extent to which it has been cut off by exemption of other property from taxation. As its revenues to meet its expenses are lessened in one direction, it may look to any other property as sources of revenue, which is not exempted from taxation. Its action in this matter is not the subject of judicial inquiry in a federal tribunal."\(^{17}\)

In \textit{Plummer v. Coler}\(^{18}\) the Supreme Court of the United States upheld a state inheritance tax upon the succession to $40,000 of United States bonds.\(^{19}\) The rule of the case is clearly stated by the court, per Mr. Justice Shiras, as follows:

\(^{17}\) \textit{Supra} n. 15, at p. 599.
\(^{18}\) \textit{Supra} n. 15.
\(^{19}\) In \textit{Greiner v. Llewellyn}, \textit{supra} n. 15, the court upheld the federal estate tax on the transfer of an estate by death measured by the net value of the estate without deducting therefrom the value contributed by non-taxable municipal bonds forming part of the estate. The court, per Mr. Justice Brandeis distinguished between a direct tax on municipal bonds and an excise tax on the transference of the bonds:

"That the Federal Government has power to tax the transmission of legacies was settled by \textit{Knowlton v. Moore}, 178 U. S. 41; and that it has the power to tax the transfer of the net assets of a decedent's estate was settled by \textit{New York
"We think the conclusion, fairly to be drawn from the state and Federal cases, [for the most part franchise tax cases] is, that the right to take property by will or descent is derived from and regulated by municipal law; that, in assessing a tax upon such right or privilege, the State may lawfully measure or fix the amount of the tax by referring to the value of the property passing; and that the incidental fact that such property is composed, in whole or in part, of Federal securities, does not invalidate the tax or the law under which it was imposed."  

It was contended by the plaintiff that the cases on corporate franchises which were measured by non-taxable property were not controlling because of the vital differences between individuals and corporations but the court after reviewing at length the corporate franchise cases dismissed this contention as follows:

"... we are unable to perceive any sound distinction that can be drawn between the power of the State in imposing taxes upon franchises of corporations, composed of individual persons, and in imposing taxes upon the right or privilege of individuals to avail themselves of the right to grant and to receive property under the statutes regulating the descent of the property of decedents."  

And somewhat earlier in the opinion in answer to the contention that the tax in question would burden the borrowing power of the United States it was asserted:

"And here, again, it is obvious that to affirm the second proposition [that the tax would burden the Federal borrowing power] will require an overruling of our previous cases. For, on principle, if a tax on inheritances, composed in whole or in part of Federal securities, would, by deterring individuals from investing therein, and, by thus lessening the demand for such securities, be regarded as therefore unlawful, it must likewise follow that, for the same reasons, a tax upon corporate franchises measured by the value of the corporation's property, composed in whole or in part of United States bonds, would also be unlawful."
The basic theory of these cases seems to be that if the state chooses a proper subject for taxation the court will not concern itself with the form or measure of the assessment of the tax. Simply stated, "The constitutionality or unconstitutionality of a state tax is to be determined, not by the form or agency through which it is to be collected, but by the subject upon which the burden is laid." 23

The decisions upholding these taxes would seem definitely to sustain any corporate franchise taxes measured by total net income which may be levied in order to take advantage of the new provisions of Section 5219. 24 But the states cannot rely too confidently upon the language of these decisions. The court in recent cases seems to be withdrawing from the broad position originally taken and its present position, as will presently appear, cannot with certainty be precisely and definitely stated.

In 1910, in Western Union Telegraph Co. v. Kansas, 25 the measurement theory, set forth in the cases just discussed, was for the first time greatly qualified. Indeed, the reasoning of the court seemed to repudiate the theory completely. The Supreme Court in that case held invalid an excise tax on a foreign corporation for the privilege of doing an intrastate business, measured by the total capital stock of the corporation. The statute provided that corporations not paying the tax should be ousted from doing all intrastate business. The case was brought to the United States Supreme Court upon the question whether a decree of ouster granted by the State supreme court restraining the corporation from all intrastate business for non-payment of the tax was invalid as a regulation of interstate commerce as to a corporation engaged in both interstate and intrastate commerce. The case came clearly within the language of the earlier cases to the effect that as long as the subject taxed was a proper one the measure of assessment adopted was of no concern to the court. The court held, however, that the statute was an invalid attempt to tax the right to do interstate business and to tax property beyond the confines of the state:

"The authorities cited show that this court has guarded with both diligence and firmness the freedom of interstate commerce against hostile state or local action, as such action has been manifested by regulations

24 In Macallen Co. v. Commonwealth (1928) — Mass. —, 163 N. E. 75, the Supreme Judicial Court of Massachusetts upheld such a tax. In an able opinion, the court, per Mr. Chief Justice Rugg, emphasizes the point that the tax in question is an excise tax as distinguished from a property tax, and very effectively summarizes the traditional law sustaining the measurement of corporate excise taxes by income from property of corporations, although a part of such income is derived from non-taxable property.
25 (1910) 216 U. S. 1, 30 Sup. Ct. 190.
operating, in some instances, directly, in others indirectly, upon the means or instruments employed in that commerce. . . .

"But it is said that none of the authorities cited are pertinent to the present case, because the State expressly disclaims any purpose by the statute in question to obstruct or embarrass interstate commerce, but seeks only to prevent the Telegraph Company from entering the field of domestic business in Kansas without its consent and without conforming to the requirements of its statute. But the disavowal by the State of any purpose to burden interstate commerce cannot conclude the question as to the fact of such a burden being imposed, or as to the unconstitutionality of the statute as shown by its necessary operation upon interstate commerce. If the statute, reasonably interpreted, either directly or by its necessary operation, burdens interstate commerce, it must be adjudged to be invalid, whatever may have been the purpose for which it was enacted, and although the company may do both interstate and local business. This court has repeatedly adjudged that in all such matters the judiciary will not regard mere forms, but will look through forms to the substance of things. Such is an established rule of constitutional construction as the adjudged cases abundantly show. . . .

"Looking, then, at the natural and reasonable effect of the statute, disregarding mere forms of expression, it is clear that the making of the payment by the Telegraph Company, as a charter fee, of a given percent of its authorized capital representing, as that capital clearly does, all of its business and property, both within and outside of the State, a condition of its right to do local business in Kansas is, in its essence, not simply a tax for the privilege of doing local business in the State, but a burden and tax on the company's interstate business and on its property located or used outside of the State."26

In other words, this case apparently holds that if the tax is in substance and effect a tax upon interstate commerce and on property outside the state, the measure through which the burden is imposed cannot be employed. The cases following the Western Union case, hold, in accordance with the principle there laid down, that the determining factor is the question whether the tax in fact imposes a burden on interstate commerce.27

26 Ibid. pp. 26, 27, and 30. The principle of this case is not confined to foreign corporations engaged in interstate transportation where, because of the nature of the facilities used, ouster from intra-state commerce might have a greater effect upon interstate commerce than would be the case where other forms of interstate commerce are carried on but applies equally to foreign corporations engaged in making interstate and local sales or engaged in interstate sales and local manufacturing. Looney v. Crane Co. (1917) 245 U. S. 178, 38 Sup. Ct. 85; International Paper Co. v. Massachusetts (1918) 246 U. S. 135, 141, 38 Sup. Ct. 292; Locomobile Co. of America v. Massachusetts (1918) 246 U. S. 146, 38 Sup. Ct. 298.

Before discussing the apparent inconsistency between this decision and the *Home Insurance* case, it will be well to set out a fairly full statement of three cases decided since the *Western Union* decision. Some fourteen months after the *Western Union* case the Supreme Court decided *Flint v. Stone Tracey Co.*, which is one of the most important of the cases sustaining an excise tax on corporations measured by their total net income and the case most nearly in point on the problem arising in this connection under Section 5219. The court in that case upheld a federal excise tax on corporations measured by their net income without deduction from such income of the interest received from tax exempt securities, both state and federal. In the course of the court's opinion, delivered by Mr. Justice Day, the early cases supporting this type of tax are briefly summarized. The court also distinguished the case from *Western Union Telegraph Co. v. Kansas*:

"It is further contended that some of the corporations, notably insurance companies, have large investments in municipal bonds and other nontaxable securities, and in real estate and personal property not used in the business, that therefore the selection of the measure of the income from all sources is void, because it reaches property which is not the subject of taxation. . . . But this argument confuses the measure of the tax upon the privilege, with direct taxation of the estate or thing taxed. . . ."

"Nor does the adoption of this measure of the amount of the tax do violence to the rule laid down in *Galveston, Harrisburg & San Antonio Ry. Co. v. Texas*, 210 U. S. 217, nor the *Western Union Tel. Co. v. Kansas*, 216 U. S. 1. In the *Galveston Case* it was held that a tax imposed by the State of Texas, equal to one percent upon the gross receipts 'from every source whatever' of lines of railroad lying wholly within the State, was invalid as an attempt to tax gross receipts derived from the carriage of passengers and freight in interstate commerce, which in some instances was much the larger part of the gross receipts taxed. This court held that this act was an attempt to burden commerce among the States, and the fact that it was declared to be 'equal to' one percent made no difference, as it was merely an effort to reach gross receipts by a tax not even disguised as an occupation tax, and in nowise helped by the words 'equal to.' In other words, the tax was held void, as its substance and manifest intent was to tax interstate commerce as such.

"In the *Western Union Telegraph Case* the State undertook to levy a graded charted fee upon the entire capital stock of one hundred millions of dollars of the Western Union Telegraph Company, a foreign corporation, and engaged in commerce among the States, as a condition of doing local business within the State of Kansas. This court held, looking through forms and reaching the substance of the thing, that the tax thus imposed was in reality a tax upon the right to do interstate business within the State, and an undertaking to tax property beyond the limits of the State; that whatever the declared purpose, when reasonably interpreted, the

28 Supra n. 5.
necessary operation and effect of the act in question was to burden inter-
state commerce and to tax property beyond the jurisdiction of the State,
and it was therefore invalid.

"There is nothing in these cases contrary, as we shall have occasion
to see, to the former rulings of this court which hold that where a tax is
lawfully imposed upon the exercise of privileges within the taxing power
of the State or Nation, the measure of such tax may be the income from
the property of the corporation, although a part of such income is derived
from property in itself non-taxable. The distinction lies between the at-
tempt to tax the property as such and to measure a legitimate tax upon
the privileges involved in the use of such property.

"In Home Ins. Co. v. New York, 134 U. S. 594, a tax was sustained
upon the right or privilege of the Home Insurance Company to be a cor-
poration, and to do business within the State in a corporate capacity, the
tax being measured by the extent of the dividends of the corporation in
the current year upon the capital stock. Although a very large amount,
nearly two of three millions of capital stock, was invested in bonds of the
United States, expressly exempted from taxation by a statute of the United
States, the tax was sustained as a mode of measurement of a privilege
tax which it was within the lawful authority of the State to impose.
Mr. Justice Field, who delivered the opinion of the court, reviewed the
previous cases in this court, holding that the State could not tax or bur-
den the operation of the Constitution and of laws enacted by the Congress
to carry into execution the powers vested in the General Government.
Yielding full assent to those cases, Mr. Justice Field said of the tax then
under consideration: 'It is not a tax in terms upon the capital stock of
the company, nor upon any bonds of the United States composing a part
of that stock. The statute designates it a tax upon the 'corporate franchise
or business' of the company and reference is only made to its capital stock
and dividends for the purpose of determining the amount of the tax to
be exacted each year.' In that case, in the course of the opinion, previous
cases of this court were cited, with approval, Society for Savings v.
Coite, 6 Wall. 594; Provident Institution v. Massachusetts, 6 Wall. 611.

"In the Coite Case a privilege tax upon the total amount of deposits in
a savings bank was sustained, although $500,000 of the deposits had been
invested in securities of the United States, and declared by act of Congress
to be exempt from taxation by state authority. In that case the court
said: 'Nothing can be more certain in legal decision than that the privi-
leges and franchises of a private corporation, and all trades and avocations
by which the citizens acquire a livelihood, may be taxed by a State for
the support of the state government. Authority to that effect resides in the
State independently of the Federal Government, and is wholly unaffected
by the fact that the corporation or individual has or has not made investment
in Federal securities.' In Provident Institution v. Massachusetts, supra,
a like tax was sustained.

"It is therefore 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 non-taxable. 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. See in this connection *Maine v. Grand Trunk Ry. Co.*, 142 U. S. 217, as interpreted in *Galveston, Harrisburg & San Antonio Ry. Co. v. Texas*, 210 U. S. 217, 226.¹²⁹

In *Kansas City, M. & B. R. Co. v. Stiles*, a case decided six years after the decision in the *Western Union* case, the court upheld a franchise tax on a domestic railroad corporation measured by total capital stock. The corporation was formed by the consolidation of three different railroad corporations incorporated after the taxing law had been enacted and was engaged in both intrastate and interstate commerce. It was contended that the tax was void as a tax upon property beyond the jurisdiction and because it imposed a direct burden upon interstate commerce. The court, per Mr. Justice Day, dismissed these contentions as follows:

"Objections of this character were so recently discussed and the previous cases in this court considered, in *Kansas City &c Railway Co. v. Kansas*, 240 U. S. 227, that it would be superfluous to undertake extended discussion of the subject now. In that case, after a full review of the previous decisions in this court, it was held that each case must depend upon its own circumstances, and that while the State could not tax property beyond its borders, it might measure a tax within its authority by capital stock which in part represented property without the taxing power of the State. As to the objection based upon the due process clause of the Constitution, we think that principle controlling here. There is no attempt in this case to levy a property tax; a franchise tax within the authority of the State is in part measured by the capital stock representing property owned in other States.

"The tax is not of the character condemned in *Western Union Telegraph Co. v. Kansas*, 216 U. S. 1, and kindred cases. In the latter case, a

¹³⁰ *Supra* n. 27.
¹³¹ That this fact was of some importance is evidenced by the consideration given to it in the opinion of the court: "The railroads comprising this consolidation entered upon it with the Alabama statute before them and under its conditions, and, subject to constitutional objections as to its enforcement, they cannot be heard to complain of the terms under which they voluntarily invoked and received the grant of corporate existence from the state of Alabama." *Supra* n. 27, at p. 117.

³² The case here cited by the court upheld a graduated state franchise tax upon a domestic corporation measured by total paid-up capital stock with a proviso, however, that the tax should not exceed $2,500. The Stiles case is stronger authority for the measurement theory than this case because of the fact that the decision in the latter was not made fully dependent upon the measurement theory and can be explained on the ground that the fixed limit prevented a burden upon interstate commerce from arising and upon the ground that even if the maximum were reached it would be at most a fair equivalent of what the state could have exacted directly without the use of a measure.
tax of large amount was imposed upon a foreign corporation engaged in interstate commerce for the privilege of doing local business within the State. Under the circumstances therein disclosed and the character of the business involved, this court held that the statute was in substance an attempt to tax the right to do interstate business, and to tax property beyond the confines of the State, and was therefore void. Here, a franchise tax is levied upon a corporation consolidated under the laws of the State by its own acceptance of that law in incorporating under it.

"So of the objection that the tax imposes a burden upon interstate commerce, the test of validity recognized in previous cases and repeated in Kansas City &c Railway Co. v. Kansas, supra, is the nature and character of the tax imposed. The State may not regulate interstate commerce or impose burdens upon it; but it is authorized to levy a tax within its authority, measured by capital in part used in the conduct of such commerce, where the circumstances are such as to indicate no purpose or necessary effect in the tax imposed to burden commerce of that character. In the present case, the franchise tax is imposed upon the capital stock of a corporation consolidated under the state law, and engaged in both interstate and intrastate commerce.

"We find nothing in the amount or character of the tax which makes it a burden upon interstate commerce, and so beyond the authority of the State to impose." 3

In the recent case of Frick v. Pennsylvania34 it was held that a state cannot levy a tax upon the transfer, upon the death of the owner, of tangible personal property having an actual situs outside the state even though the owner was domiciled within the taxing state. It was also held that in measuring a tax on the succession to property within the state, tangible personal property having an actual situs in other states cannot be included in the measure. The measurement theory by which such an attempt was made to reach extraterritorial tangibles, was emphatically condemned:

"One ground on which the state court put its decision was that, in taxing the transfer of property which the decedent owned in Pennsylvania, it was admissible to take as a basis for computing the tax the combined value of that property and the property in New York and Massachusetts. Of course, this was but the equivalent of saying that it was admissible to measure the tax by a standard which took no account of the distinction between what the state had power to tax and what it had no power to tax, and which necessarily operated to make the amount of the tax just what it would have been had the state's power included what was excluded by the Constitution. This ground, in our opinion, is not tenable. It would open the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of no avail. If Pennsylvania could tax according to such a standard other states could. It would mean, as applied to the Frick estate, that Pennys-

34 (1925) 268 U. S. 473, 45 Sup. Ct. 603.
vania, New York, and Massachusetts could each impose a tax based on the value of the entire estate, although severally having jurisdiction of only parts of it. Without question each State had power to tax the transfer of so much of the estate as was under its jurisdiction, and also had some discretion in respect of the rate; but none could use that power and discretion in accomplishing an unconstitutional end, such as indirectly taxing the transfer of the part of the estate which was under the exclusive jurisdiction of others.


The court thus appears in no uncertain terms to repudiate the notion that the measurement theory can be used as a disguise to impose a tax burden that could not have been imposed by a direct tax. It seems fairly clear, from the language quoted, that if a forbidden burden is actually imposed the measurement theory will not save it.

85 Ibid. pp. 494-495.  
86 The language of the court in Miller v. Milwaukee (1927) 272 U. S. 713, 47 Sup. Ct. 280, is important in this connection. In that case the court held invalid an income tax exempting shareholders from taxation on dividends on which the corporation had already paid a tax. Inasmuch as the most conspicuous instance of exemption from the corporate income tax was the interest from United States bonds, the income tax on the shareholder reached little else but the income from those bonds. In holding the tax invalid, the court, per Mr. Justice Holmes, declared:

"If the avowed purpose or self-evident operation of a statute is to follow the bonds of the United States and to make up for its inability to reach them directly by indirectly achieving the same result, the statute must fail even if but for its purpose or special operation it would be perfectly good. Under the laws of Wisconsin the income from the United States bonds may not be the only item exempted from the income tax on corporations, but it certainly is the most conspicuous instance of exemption at the present time. A result intelligently foreseen and offering the most obvious motive for an act that will bring it about, fairly may be taken to have been a purpose of the act. On that assumption the immunity of the national bonds is too important to allow any narrowing beyond what the Acts of Congress permit. . . . A tax very well may be upheld as against any casual effect it may have upon the bonds of the United States when passed with a different intent and not aimed at them, but it becomes a more serious attack upon their immunity when they are its obvious aim. In such a case the Court must consider the public welfare rather than the artifices contrived for private convenience and must look at the facts." Italics added.

The portion of the opinion italicized is of particular importance when it is observed that the avowed purpose and self-evident operation of a franchise tax measured by total net income is to reach income from tax exempt securities. The debates in Congress over the adoption of the 1926 amendment to Section 5219, supra n. 1, clearly show that such was the purpose of that amendment. Such purpose is also admitted by the California tax commission in recommending that method of bank and corporation taxation in its Special Report of August 10, 1928, at p. 40:

"As has been pointed out, the 1926 amendment to section 5219 was drafted
We have, then, two lines of cases which, so far as the reasoning stated by the court is concerned, seem hard to reconcile. On the one hand the rule stated is that so long as the subject taxed is taxable the amount of the tax can be measured by property or income which is not taxable: This, because the rate lies completely within the discretion of the legislature, a premise which is unquestionable whatever be the merit in the conclusion drawn therefrom. On the other hand, the Western Union and Frick cases seem to say clearly and forcefully that if a tax on a taxable subject is measured by the amount of a class of property or income which is not taxable, it follows that since the necessary effect is in substance a tax on the property or income used as a measure the tax is void. It seems unquestionable that the rules as just stated cannot exist simultaneously in any coherent system of law. Some solution which will distinguish these two lines of cases must be sought. A number of solutions seem to be possible: (1) It may be that the rules as stated are not the rules laid down in the cases. It is submitted, however, that they fairly paraphrase the reasoning of the court contained in its opinions as above quoted. (2) It may be that the Western Union case was intended to repudiate the doctrine of the Home Insurance case. This explanation, however, does not seem satisfactory because it convicts the court of a degree of vacillation which it would be unreasonable to suppose the court guilty of in fact. Thus, this explanation would require the conclusion that the court repudiated the doctrine of the Home Insurance case in the Western Union case, repudiated the latter, and returned again to its original position in the Flint case and again reversed its position and returned to the Western Union doctrine in the Frick case. (3) It is possible to argue that the court is upholding or condemning each tax as it is presented according as the court believes it to be excessively burdensome as a matter of degree. This theory gathers some weight from the circumstance that the court has upheld taxes which could not possibly be justified under the measurement theory as qualified in the Western Union case, putting their validity on the ground that the burden on non-taxable property was inconsiderable.\textsuperscript{37} Moreover, with the avowed object of permitting the inclusion in the tax base of such income as the interest from tax-exempt bonds. In the case of corporations other than banks, the point is not of vital importance. But the banks hold such large quantities of these tax exempt bonds that the effect of a decision holding that the state may not include them in the base would be very serious indeed. An analysis of the replies of the banks to the Commission's questionnaire indicates that the non-inclusion of federal bond interest would reduce the tax base of the banks approximately one-fourth and the non-inclusion of all interest exempt from the federal income tax would reduce that base by more than one half.\textsuperscript{38}

\textsuperscript{37} Baltic Mining Co. v. Massachusetts, \textit{supra} n. 27; General Ry. Signal Co. v. Virginia, \textit{supra} n. 27.
over, it has upheld taxes which were in lieu of other taxes on the ground that they were a fair compromise in a situation admittedly difficult of solution. But this conclusion that the court is deciding each case simply on the basis of the extent of discrimination or burden there imposed by the tax does not seem to be an adequate explanation of the apparent contradiction between the cases above quoted, for the reason that in almost all of those cases the court, far from basing its decision on the extent of the burden, attempts carefully and at length to base its decision upon other grounds, that is, upon the measurement theory in the one group and in the other group upon the proposition that the tax is in substance and effect a tax upon non-taxable property.

One other solution seems to be possible, which, although not supported by any clear language in the court's opinions, is, nevertheless, consistent with and serves to explain all of the decisions if the facts of each case be kept in mind. In the Home Insurance case, the tax was a franchise tax upon the privilege of being a domestic corporation and the tax was measured by dividends paid, i. e., by the benefits derived by the share-
holders from the corporation’s exercise of its franchise. In the Stiles case, the tax was also upon the franchise granted by the taxing state, and was measured by the amount of capital employed in the exercise of the franchise, in other words was measured by the extent of the franchise granted. The Flint case involved a federal tax on doing of business as a corporation (a tax under the constitutional grant of power to levy excise taxes), and the tax was measured by the net income of the corporation, i.e., by the benefits derived from the operations taxed, namely, the doing of business as a corporation.

On the other hand, in the opposing group of cases one element common to the cases just mentioned is missing. In Western Union Telegraph Co. v. Kansas the tax was on the privilege of doing intrastate business within the taxing state and the tax was measured, not by the benefits derived from the privilege taxed nor by the amount of property employed in its exercise, but by the total capital stock of the company, a great part of which represented property located outside the state. In Frick v. Pennsylvania, the tax was upon the privilege of succession to property of one who died domiciled in the state. The measure of the tax included the value of tangible personal property located outside the state. The court held that the succession to the outside property could not be controlled by the taxing state merely because it was the domicile of the deceased owner. It follows that although the tax was upon the privilege of succession, it included in its measure property succession to which was not attributable to the privilege taxed.

It is apparent that a principle can be inferred from these two groups of cases which is not only consistent with all of them, but which, if law, is a sufficient ground for each of the decisions. This principle is that a tax upon the privilege of owning property as a corporation can be measured by the extent of the privilege (specifically, capital stock outstanding), even though some at least of the property so owned is beyond the borders of the taxing state; and that a tax either upon this privilege or upon the doing of business as a corporation, (whether the existence of the corporation was granted by the taxing state or not), may be measured by the fruits of the privileges exercised, or derived from the doing of business (net income), even though it be true that part of those fruits were received as income not taxable as such. This principle is submitted not as having any necessary validity a priori, but simply as an inference which can be drawn from the cases. The fact is that in all these cases the court was faced with a dilemma and, since it had to decide, was forced to find a compromise. In the Home Insurance case, for example, the state's power to tax the privilege of existence and operation as a corporation was unquestionable and, as
between the state and the federal government was a power with which the latter should not lightly interfere. But this corporation derived income from bonds which the federal government, in the exercise of its unquestionable powers, had forbidden the states to tax. If the court upheld the tax, the result would undeniably be, in a sense at least, a state tax in substance upon the bonds. If the court condemned the tax, the result would be federal interference with the power of the state over its creatures. Among the considerations present was the fact that the tax was not a direct tax upon the income from the bonds, but could fairly be said to be rather a tax on the actual net benefits derived from the exercise of the corporate privilege. The court might, as pointed out above, nevertheless have considered that the interference with federal power involved in the tax was more serious than the interference with the state's taxing power which would be involved in its condemnation. The fact is, however, that it chose the contrary alternative and upheld the tax.

In the opposing line of cases, beginning with the Western Union case, the dilemma with which the court had to deal was in substance the same, but the considerations pro and con were not. It seems fair, for example, to characterize the tax condemned in the Western Union case as an attempt by the state to use its power to tax intrastate business as a means of taxing property beyond its taxing powers; property, and this is the point to be observed, which has no connection whatever with the subject taxed, i. e., doing of intrastate business. It is apparent that the court might, so far as logical consistency is concerned, have upheld

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41 In Metcalf v. Mitchell (1926) 269 U. S. 514, 46 Sup. Ct. 172, in which it was decided that an engineer who received compensation for services rendered under a contract with a state, but who was not an officer thereof, was not entitled to exemption from the federal income tax, the court recognized the dilemma that arises in situations like the one discussed in the text: "In a broad sense, the taxing power of either government, even when exercised in a manner admittedly necessary and proper, unavoidably has some effect upon the other. The burden of federal taxation necessarily sets an economic limit to the practical operation of the taxing power of the states, and vice versa. Taxation by either the state or the federal government affects in some measure the cost of operation of the other.

"But neither government may destroy the other nor curtail in any substantial manner the exercise of its power. Hence the limitation upon the taxing power of each, so far as it affects the other, must receive a practical construction which permits both to function with the minimum of interference each with the other; and that limitation cannot be so varied or extended as seriously to impair either the taxing power of the government imposing the tax (South Carolina v. United States, 199 U. S. 437; Flint v. Stone Tracy Co., supra at page 172) or the appropriate exercise of the function of the government affected by it. Railroad Co. v. Peniston, 18 Wall. 31."

42 The foregoing is submitted, not as a statement of the actual grounds of the decision in this case, but as the grounds upon which it rests in the light of the subsequent cases.
this tax if it had chosen to do so, on the ground that since the amount of the tax on intrastate commerce was within the discretion of the state, the measure of that amount was of necessity also within its discretion. This in fact was the contention of Mr. Justice Holmes in his dissent in the Western Union case, and its seems quite probable that it is also the view taken by the court in the Home Insurance case. Obviously, however, the Home Insurance decision did not require so extensive a principle, and whether or not the court adopted it in that case, it was unequivocally repudiated in the Western Union case.

It is proposed to consider now, in the light of the foregoing analysis, certain other cases which have an important bearing upon the problem here discussed.

Horn Silver Mining Co. v. New York is one case clearly inconsistent with the theory advanced above. In that case the court upheld a state franchise tax on the privilege of doing business in the state levied on a foreign corporation engaged only in intrastate business in the state measured by its total capital stock, without regard to what part thereof was employed within the state. In fact only a small proportion was employed in the state. In the course of the court's opinion delivered by Mr. Justice Field, it is said:

"Having the absolute power of excluding the foreign corporation, the State may, of course, impose such conditions upon permitting the corporation to do business within its limits as it may judge expedient; and it may make the grant or privilege dependent upon the payment of a specific license tax, or a sum proportioned to the amount of its capital. No individual member of the corporation, or the corporation itself, can call in question the validity of any exaction which the State may require for the grant of its privileges."44

The measure here imposed bore no relation whatever to the privilege granted. The tax was not measured by the benefits derived from the privilege granted nor by the extent thereof. The case is clearly out of line with the development of the law on this subject, and if not yet overruled is clearly condemned by the reasoning of modern cases.45

Northwestern Mutual Life Insurance Co. v. Wisconsin is one of

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43 Supra n. 40.
44 Ibid. p. 315.
45 In addition to the cases discussed in the text where the taxes were held invalid see Terral v. Burke Construction Co. (1922) 257 U. S. 529, 42 Sup. Ct. 188; Michigan Public Utilities Commission et al. v. Duke (1925) 266 U. S. 570, 45 Sup. Ct. 191; Frost v. R. R. Commission (1926) 271 U. S. 583, 46 Sup. Ct. 605.
the most recent cases involving the measurement theory and a case directly related to the problem of taxing the income from exempt securities. The state of Wisconsin required domestic life insurance companies to pay into the state treasury, as an annual license fee for transacting such business, 3 percent of their gross income from all sources. The payment of such license fee was in lieu of all taxes except taxes on real estate. The law was held invalid so far as it affected the receipt of interest on United States bonds. It was contended by the state that the tax was a privilege or franchise tax exacted for certain privileges, including exemption from personal property taxation and right to do business, and that although measured by total income, including income from United States bonds, it was not a tax on that income. But the court, per Mr. Justice McReynolds, distinguished Flint v. Stone Tracy Co. and the similar cases:

"It cannot be denied (and denial is not attempted) that bonds of the United States are beyond the taxing power of the states. Home Savings Bank v. Des Moines, 205 U. S. 503, 509; Farmers & Mechanics Bank v. Minnesota, 232 U. S. 516; and First National Bank v. Anderson, 269 U. S. 341, 347. Certainly since Gillespie v. Oklahoma, 257 U. S. 501, 505, it has been the settled doctrine here that where the principle is absolutely immune, no valid tax can be laid upon income arising therefrom. To tax this would amount practically to laying a burden on the exempted principal. Accordingly, if the challenged Act, whatever called, really imposes a direct charge upon interest derived from United States bonds, it is pro tanto void.

"The fundamental question, often presented in cases similar to these, is whether by the true construction of the statute the assessment must be regarded as a tax upon property or one on privileges or franchise of the corporation. Society for Savings v. Coite, 6 Wall. 594; Home Insurance Co. v. New York, 134 U. S. 594.

"Section 7634 [Wisconsin Statutes] undertakes to impose a charge not measured by dividends paid, as in Home Insurance Co. v. New York, 134 U. S. 594, nor by net income as in Flint v. Stone Tracy Co., 220 U. S. 107; and those cases are not controlling. The distinction between an imposition the amount of which depends upon dividends or net receipts and one measured by gross returns is clear. U. S. Glue Co. v. Town of Oak Creek, 247 U. S. 321, 328, and earlier opinions there cited. . . .

"Here the statute undertook to impose a charge of 3 per cent upon every dollar of interest received by the Company from United States bonds. So much, in any event, the State took from these very receipts. This amounts, we think, to an imposition upon the bonds themselves and goes beyond the power of the State."47


If franchise taxes measured by total net income are to be upheld as regards income from tax exempt securities it is apparent from a reading of the opinion just quoted that they must be so upheld on the ground that the tax is measured by net rather than by gross income. Regardless of what the tax is called, or the
It will be observed that the court in this case stated something very like the solution above suggested.

Another case which should be mentioned in this connection is Na-

language in which it is framed, it seems certain that if it directly reaches the income from exempt securities it will be held invalid. The problem is thus reduced to a consideration of whether the measurement theory will sustain a tax measured by net income which would admittedly be void if measured by gross income, or in other words, whether a tax measured by net income is or is not a direct tax on that income. There can be no doubt that a tax measured by gross income which reaches "every dollar of interest received from United States bonds" directly and immediately reaches the income from those bonds. On the other hand, a franchise tax measured by net income, i.e., the fruits or benefits of the franchise, is contingent upon the making of profits, that is, losses in the business may swallow up the income from the securities, the holder having the benefit of cancelling some or all of his indebtedness without paying taxes on the receipt of the income.

If, however, the premise should be established that a tax on a good subject cannot be measured by non-taxable property or income (to establish such a premise several cases discussed in the text would have to be overruled), it would be difficult to sustain a distinction holding a franchise tax measured by net income valid and one measured by gross income invalid, since the net income from exempt securities cannot be taxed. The cases emphasizing the distinction between taxes on net and gross income from interstate commerce, or from exports (United States Glue Co. v. Town of Oak Creek (1918) 247 U. S. 321, 328, 38 Sup. Ct. 499, and Peck & Co. v. Lowe (1918) 247 U. S. 165, 38 Sup. Ct. 432) would not be in point because they sanction a direct net income tax and are in no way dependent upon the measurement theory. The tax exempt bond situation is entirely different from the interstate commerce and export situation. The receipt of net income from such bonds cannot be directly taxed. It would seem that a non-discriminatory tax upon net income from federal securities would interfere no more with the federal borrowing power than such a tax on the net income from interstate commerce would burden that commerce. The court, however, in Gillespie v. Oklahoma, supra n. 14 at p. 505-506, refused to follow the reasoning of the Oak Creek case in the matter of taxing the net income of federal instrumentalities. In the Oklahoma case the court held that the state could not tax a lessee of restricted Indian lands upon his net income derived from these leases, as the leases constitute him in effect an instrumentality used by the federal government in fulfilling its duties to the Indians. The state contended that the cases sustaining taxes upon net income from interstate commerce were controlling, but the court, per Mr. Justice Holmes, met this contention as follows:

"The criterion of interference by the States with interstate commerce is one of degree. It is well understood that a certain amount of reaction upon and interference with such commerce cannot be avoided if the States are to exist and make laws. New York, New Haven & Hartford R. R. Co. v. New York, 165 U. S. 628. Diamond Glue Co. v. United States Glue Co., 187 U. S. 611, 616. The rule as to instrumentalities of the United States on the other hand is absolute in form and at least stricter in substance. Williams v. Talladega, 226 U. S. 404, 416, 417, 419. Johnson v. Maryland, 254 U. S. 51, 55. 'A tax upon the leases is a tax upon the power to make them, and could be used to destroy the power to make them.' 240 U. S. 530. The step from this to the invalidity of the tax upon income from the leases is not long.

"In cases where the principal is absolutely immune from interference an inquiry is allowed into the sources from which net income is derived and if a part of it comes from such a source the tax is pro tanto void; Pollock v. Farmers Loan & Trust Co., 157 U. S. 429; 158 U. S. 601; a rule lately illustrated by Evans v.
This case will receive careful and extended examination in the next installment of this article in connection with the recently enacted California bank and corporation tax statute. It is mentioned at this point only to state the considerations that show it does not bear one way or the other upon the measurement theory. The case involved a federal income tax on life insurance companies. In determining the "net income," i.e., the tax base, certain deductions were allowed including the following: (1) The amount of interest from tax exempt securities; (2) A sum equal to 4 per cent of the company's legal reserve less the amount of interest deducted under (1). The court held the statute invalid, so far as it required the deduction of the tax exempt income from the sum of 4 per cent of the reserves. The court was of the opinion that to deny the full 4 per cent deduction to exempt security holders allowed those not holding such securities was in effect a tax upon such securities. In the words of the court, "One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free." Mr. Justice Brandeis wrote a dissenting opinion in which Justices Holmes and Stone concurred. Mr. Justice Stone also wrote a dissenting opinion in which Mr. Justice Brandeis concurred. Mr. Justice Brandeis dissented on the ground that the effect of the decision was to add to the requirement that the bonds should be exempt from taxation, a further requirement that any property or income tax is void unless it is higher with respect to persons not owning exempt securities than it is with respect to persons who do own them. He contended that there was no authority for this decision and that it defeated the proper purpose of Congress which was simply to allow insurance companies deductions equal in any case to 4 per cent of their reserves, but to allow them no more unless the income from federal securities exceeded that sum. He contended that

Gore, 253 U. S. 245; and applied in a case somewhat like the present by the Supreme Court of Hawaii. Oahu Ry. & Land Co. v. Pratt, 14 Hawaii, 126. Whether this property could be taxed in any other form or not, it cannot be reached as profits or income from leases such as those before us. The same considerations that invalidate a tax upon the leases invalidate a tax upon the profits of the leases, and, stopping short of theoretical possibilities, a tax upon such profits is a direct hamper upon the effort of the United States to make the best terms that it can for its wards. Weston v. Charleston, 2 Pet. 449, 468." (Italics added.)

This tax, it is true, was imposed directly upon the net income of a federal instrumentality, but the italicized portion of the opinion offers an opening for the court to distinguish indirect taxes measured by net income, including income from federal securities which it might wish to hold invalid, from cases in which a tax is measured by net income including income from interstate commerce which it might wish to uphold.

49 Ibid. p. 519.
the case was controlled by a principle necessarily implied in the *Home Insurance* and subsequent cases including *Flint v. Stone Tracy Co.*, namely, that a tax is not void merely because it operates to deny an advantage to holders of exempt securities, but is valid unless it also imposes a direct burden thereon. Mr. Justice Stone dissented on the ground that the discrimination occurred only in respect of an act of bounty which Congress could confer, in carrying out its particular purpose, without repugnancy to the Constitution.

It is submitted that this case does not bear upon the validity or invalidity of the measurement theory. It is apparent that the considerations involved in the *National Life Insurance* case have no bearing upon the problems presented by the measurement theory, for the reason, among others, that it was a tax directly upon income. It is interesting to observe that a new measurement theory problem would have been presented if the tax involved in the *National Life Insurance* case had been an excise tax measured by net income and had allowed the same deductions as those which were allowed in fact. If such a tax were declared void the decision would not, it seems, be inconsistent with the cases previously decided in the field, but would simply add a new limitation to the measurement theory, namely, that the denial of an exemption cannot be measured by the value of exempt securities.

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*(To be Concluded)*

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A discussion of the bank tax situation in California, with particular reference to the provisions of the recent California statute, and of the problems raised thereby, will form the third and final installment of this article, which will appear in the next (May) number.