Analysis of the Bank and Corporation Franchise Tax Act, Part One of Two

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Analysis of the BANK and FRANCHISE TAX ACT

by Roger J. Traynor

Part One of Two
ANALYSIS
of the
BANK AND CORPORATION FRANCHISE TAX ACT

by
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* * * * *
Submitted
to the
CALIFORNIA TAX RESEARCH BUREAU
in the office of the
STATE BOARD OF EQUALIZATION

January 1933
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AN ANALYSIS OF THE BANK AND CORPORATION FRANCHISE TAX ACT

HISTORY OF STATE TAXATION OF BANKS AND CORPORATIONS

In the Summary Report of the Tax Research Bureau submitted to the People and the Legislature of California on December 1, 1932, the history of bank and corporation taxation by the state was reviewed. It was pointed out that drastic changes in the methods of state taxation of banks and corporations (excepting public utilities and insurance companies) were made in 1929.

Yield Reduced Under 1929 Act

Comparisons of actual yield of state taxes on banks and corporations under the old and new methods of taxation, as made in this report, reveal a marked decrease in these sources of revenue. Allowance was made for the effect of the depression on this yield by drawing further comparisons to determine the effect of the same economic conditions on the gross receipts taxes of utilities and gross premium taxes of insurance companies. The report shows that the revenue from bank and corporation taxes has declined much more sharply than that from the other types of state taxation. The ratio of loss in revenue from bank and corporation taxes appears three times as great as the corresponding ratio for public utility and insurance company taxation.

Bank Tax Shrinkage Major Item

Bank tax shrinkage is shown to be responsible for a major part of this loss in revenue. During the last three years of the operation of the share tax method the total taxes on bank shares were $13,499,374, as contrasted with only $2,292,255 during the first three years of the tax on banks "according to or measured by" their net income substituted for the share tax in 1929. Although it is

1. Cal. Stats. 1929, Ch. 13, p. 19
2. California Tax Research Bureau, Summary Report, pp. 73 et seq.
3. Ibid, p. 75
4. Ibid, p. 77
5. Ibid, p. 75
apparent that the state is restricted in its ability to apportion more equitably the tax burdens imposed upon banks and other taxpayers the report points out that the unsatisfactory condition could be materially alleviated through the elimination of property tax offsets now allowed against the tax computed on net income and the adjustment of bank tax rates so as to impose on banks a burden equivalent in terms of net income to that imposed on other corporations. The nature of the restriction on bank taxation, the validity and economic effect of the property tax offsets, the desirability of the elimination of such offsets and the development of an improved method of bank taxation, outlined in the Summary Report, will be discussed in detail in the following analysis of the Act.

Equalization Primary Objective

As pointed out in the report, the problem is primarily one of equalization of relative tax burdens. Studies have disclosed that under the law now in effect the burdens are apparently not apportioned equitably according to what have generally been regarded as acceptable standards. Moreover, certain administrative weaknesses have developed in the law requiring correction in order that it may be more effectively enforced. It is apparent that these changes, while required principally in the interests of equitable taxation, will also tend to stabilize revenues from bank and corporation taxation materially and to make this Act a more productive source of public funds.

In view of the financial problems which will confront the Legislature at the coming session, a thorough review of the Bank and Corporation Franchise Tax Act seems an essential service to the legislators in their consideration of questions inevitably arising from the general observations made in the Summary Report of this subject.
Analysis Made Of Matters Requiring Change

Accordingly, there follows an analysis of the legal phases of the operation of the Bank and Corporation Franchise Tax Act, together with a discussion of the methods for improvement of the defects believed to exist in the present statute. The reasons why certain suggestions have been made in preference to others are discussed at some length in order that the Legislature may arrive at a considered opinion as to what may best be done to improve the tax both from the standpoint of equity between taxpayers and yield to the state.

Subjects Treated As They Appear In Act

For the sake of clarity in treatment, the various sections of the Act are taken up consecutively in this analysis. As individual consideration has been given only to those sections in which some change is suggested, it will be noted that certain sections have been omitted entirely from the discussion. This does not imply that there are no problems involved in the sections omitted in the discussion but rather that we have no changes in their text to suggest at this time. Because the discussion is arranged in the order that the several subjects are covered in the Act, no attempt has been made to arrange them with reference to their relative importance for that is, after all, a matter of legislative judgment.

Section 1-4.

The Real Estate Tax Offset Is Probably Invalid

Although the constitution provides for the offset of personal property taxes for corporations other than banks, it does not expressly provide any offset whatever for banks. Furthermore, as to the tax on banks, it expressly states that, "The amount of the tax shall be equivalent to 4% of their net income." 6

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The act was passed under this constitutional provision. Section 3 allows banks an offset of 10% of the taxes paid upon their real property with the proviso that the total amount of the offset shall not exceed 75% of the total tax under this section. That this provision violates the constitutional section is arguable on several grounds.

In the first place, if an offset is allowed banks, the tax is obviously not "4% of their net income" but something else, namely, 4% of their net income less the deductions allowed. Thus, the form of taxation is not that contemplated by the wording of subdivision 1 (a) of the constitutional amendment. It must be noted, however, that subdivision 1 (b) of that amendment provides:

"The legislature, two-thirds of all the members elected to each of the two houses voting in favor thereof, in lieu of such tax, may provide by law for any other form of taxation now or hereafter permitted by the Congress of the United States respecting national banking associations; provided, that such form of taxation shall apply to all banks located within the limits of this state."

Although the statute perhaps does not conform with 1 (a) it might still be valid if the tax is one "permitted by the Congress of the United States respecting national banking associations."

The Legislature was apparently attempting to impose the tax permitted by the fourth alternative of Section 5219 of the United States Revised Statutes, namely, a tax upon national banks, "according to or measured by their net income." The validity of the statute, therefore, under 1 (b) and Section 5219 depends on whether or not the statute, with the offset provisions allowing deductions for real property taxes, provides for a tax "according to or measured by net income."

(c) Bank Tax Not Measured By Net Income

A contention that the statute does not provide a tax "according to or measured by net income" may be based upon the argument that to allow such offset is to levy a tax that is not strictly measured by net income but by net income less something else for,
although net income enters into the computation of the tax, the amount of the tax is nevertheless, seriously affected by a deduction the amount of which is independent of income. Although the court might perhaps meet this objection with the proposition that the tax in question comes roughly within the meaning of the phrase, "according to or measured by net income" it is none the less true that net income measures, not the tax, but merely a sum intermediate the determination thereof.

(b) Discriminatory Effect Of Offset

The offset provision may possibly render the statute invalid in that it results not only in a discrimination between banks not contemplated by Section 5219 but in a discrimination that amounts to a denial of equal protection of the laws prohibited by the Fourteenth Amendment to the federal constitution.

An example will clearly bring out the nature of the discrimination effected by the offset provisions of the statute. Let us assume two national banks, Bank A and Bank B, with an equal annual net income of $100,000 so that upon this basis their franchise tax as 4% of that income would be $4,000 each. Bank A has real property upon which it pays $20,000 taxes. Bank B rents its premises, has no real property and therefore pays no real property taxes directly for which it may get an offset. Bank A gets a deduction of 10% of its real property taxes up to 75% of 4% of its net income or in other words, a deduction of $2,000. As a result, Bank A pays a $2,000 tax, while Bank B pays $4,000. According to their net income, these banks should be taxed equally, yet Bank B is required to pay a tax approximately twice as great as that exacted from Bank A. It is no answer to say that Bank B has paid no real estate taxes directly and that this factor should affect the comparison.

Section 5219 contemplates that, in addition to the usual ad valorem taxes upon real estate owned by them, national banks
may be taxed, "according to or measured by" their net income. To inject the element of real estate taxes paid as a direct offset from a tax calculated at a percentage of net income seems not only an unwarranted variation from the method prescribed, but a denial of equal protection of the laws as well.

Discrimination within the meaning of the equal protection of the laws clause is defined as "the act of treating differently two persons or things, under like circumstances." When different treatment is accorded two persons and one invokes the equal protection clause, the question to be decided is whether there is any dissimilarity between their situations of a kind and degree which will justify the unlike treatment complained of. In the case supposed, the unlike treatment consists of unequal franchise-taxes—measured-by-net-income imposed upon two banks whose net income are identical. The dissimilarity of situation, which creates, and must justify the inequality of taxation, is the circumstance that one of the banks owns real property and the other does not. It is submitted that there is no relation whatsoever between the unlike treatment here involved and the dissimilarity of situation upon which it rests. It is questionable whether ownership of real estate or ownership of anything else is a sufficient basis for exemption from franchise taxes imposed upon others of the same class as the favored taxpayer.

(c) No Constitutional Authorization For Offset

Another constitutional problem is raised by the offset of real property taxes under the provisions of Section 4 of the statute. The constitutional provision for a tax offset for financial, mercantile, manufacturing and business corporations specifically mentions personal property taxes but does not mention real property taxes, viz:

"Such tax shall be subject to offset, in a manner to be prescribed by law in the amount of personal property taxes paid by such corporations to the state or political subdivisions thereof, but the offset shall not exceed ninety per cent of such state tax." (Emphasis added)

It should be noted, however, that subdivision 3 of the constitutional provision reads:

"The Legislature, two-thirds of all the members elected to each of the two houses voting in favor thereof, may change by law the rates of tax, or the percentage, amount or nature of offset provided for in paragraphs 1 and 2 hereof." (Emphasis added).

The question immediately arises whether the word "nature" as used in the constitutional provision will be so construed by the courts to justify the offset of real property taxes paid upon the corporations' property as provided in Section 4 of the statute.

It should be noted that besides the provision for offset of a percentage of real property taxes, the statute differs from the amendment in eliminating an offset for personal property taxes paid to the state and allows an offset for taxes paid "upon" the corporations' property.

It might plausibly be argued that eliminating the offset for personal property taxes paid to the state and allowing an offset for taxes paid "upon" the corporations' property, changed the "nature" of the offset within the authority of subdivision 3 of the amendment, but, in providing for an offset of real property taxes, something additional is added which can hardly be considered the "offset provided for." The offset the "nature" of which may be:

8 Cal. Const. Art. XIII Sec. 16.
9 Ibid.
10 The corporate franchise tax assessed under Section 14d of Article XIII would seem clearly to be a personal property tax paid to the state in view of the definition of "property" contained in Section 1 of Article XIII, namely: "The word 'property' as used in this article and section, is hereby declared to include monies, credits, bonds, stocks, dues, franchises, and all other matters and things, real, personal and mixed capable of private ownership...." See also, People v. Alaska Pacific B & B Co. (1920) 162 Cal. 202. To have permitted the franchise tax for 1928 to be offset by the 1928 franchise tax would have reduced the 1929 tax in most instances to a relatively insignificant amount and in many instances to nothing at all. If any substantial revenue was to be expected from the new tax, it was absolutely necessary to eliminate the provision for offset of personal property taxes paid to the state.
changed, is the offset "provided for" in paragraph 2. Real property tax offsets are not mentioned in that paragraph. Is it merely "changing the nature of the offset provided for" to add an entirely new offset? If the word "nature" is broad enough to cover the offset of real property taxes paid in this state, it should be broad enough to cover the offset of taxes paid in any other state, or, in fact, to cover any kind of offset the legislature sees fit to grant.

It may be argued that although the offset for real property taxes is not authorized by subdivision 3 of the amendment, it is authorized by subdivision 2 (b) thereof which provides:

"The Legislature, two-thirds of all the members elected to each of the two houses voting in favor thereof, may provide by law for the taxation by any other method authorized in this constitution of the corporations, or the franchises, subject to be taxed pursuant to subdivision (c) of paragraph 2 of this section or subdivision (d) of section 14 of this article."

In other words, it may be contended that allowing the offset for real property taxes is providing an "other method" of taxing corporations than the method set forth in subdivision 2 (a) of the constitutional provision. This argument, however, renders superfluous subdivision 3 insofar as it provides for a change in the nature of the offset. If providing for a real property tax offset is providing an "other method" of taxing corporations, it would seem that changing the nature of the personal property tax offset provided for in subdivision 2 (c) would likewise be providing an "other method" of taxing corporations. If subdivision (3) was necessary to authorize a change in the personal property tax offset it seems that a similar provision would be necessary to authorize the real property tax offset. It is a well settled rule of constitutional construction that no word or clause should be rejected as superfluous, but that each must be given its due force and appropriate meaning.11

11 Knowlton v. Moore, (1900) 178 U.S. 41; People v. Stephens (1882) 52 Cal. 239; French v. Teschemaker (1866) 24 Cal. 518.
It is submitted that the purpose of subdivision 2(b) is to authorize the Legislature to substitute an entirely different method of taxing corporations for that set forth in subdivision 2(a), i.e., "according to or measured by" net income, and that if the method so set forth is to be retained it may be modified only as authorized in subdivision 3.

The Personal Property Tax Offset Operates Unfairly, Unnecessarily Complicates The Administration Of The Act And Reduces The Productivity Of The Tax

(a) Offset Originated As Temporary Expedient

The commission recommending the personal property tax offset admitted that it was defensible only as a temporary expedient until all personal property taxes should be abolished and a state-wide income tax on all corporations and individuals established. In the words of the commission,

"It was obvious from the beginning that the allowance of the offset would involve certain administrative difficulties and would offer opportunities for abuse through collusion with the local assessors, which would grow more and more serious with the passage of time...... As a permanent feature the offset provision is faulty...."[12] (Emphasis added)

(b) Corporations Have Advantage Not Afforded Other Taxpayers

If all personal property taxes are not abolished and the present offset remains in the Bank and Corporation Franchise Tax Act, the corporations taxable thereunder will be given an advantage not afforded other taxpayers. Prior to the enactment of this act all taxpayers were taxed upon their property, and according to Article XIII, Section 1 of the state constitution:

"All property in the state except as otherwise in this constitution provided not exempt under the laws of the United States shall be taxed in proportion to its value, to be ascertained as provided by law, or as hereinafter provided. The word 'property' as used in this article and section, is hereby declared to include moneys, credits, bonds, stocks, dues, [franchises], and all other matters and things real, personal and mixed, capable of private ownership;......" [Emphasis added]

The gross receipts tax on public utilities is a property tax and is justifiable when imposed upon utilities engaged in interstate commerce only as a property tax. In other words, corporations until 1929 were taxed upon their property the same as other taxpayers in the state. The franchise tax measured by corporate excess was designed to reach property values not touched by the other real and personal property taxes otherwise imposed. The corporate excess, or the difference between the total corporate worth, as determined by the market value of the corporation's outstanding stocks and bonds, the earnings of the company, or otherwise, and the value of its tangible or physical properties was just as much property as any tangible property owned by the corporation and was taxable accordingly.

The present act substitutes a tax measure by net income for the tax on corporate excess. To that extent, it substitutes taxes based on net income for taxes calculated on the value of property owned. If corporations are to be accorded the advantage of such a substitution, it would seem only fair that similar advantages should be accorded other taxpayers. In fact, that was the ultimate objective of the commission when it proposed the offset of personal property taxes as a temporary measure in anticipation of total abolition of all taxes on personal property.

Subsequent events have indicated that attainment of the commission's objective is, at best, a remote possibility.

(c) Elimination of Personal Property Taxes Not Feasible

No steps were taken by either the 1929 or 1931 Legislatures to carry out the recommendation that personal property taxes be abolished. On the contrary, there is every evidence that any move to deprive counties, cities and other local taxing units of this substantial source of revenue would be bitterly opposed. The assessed value of taxable property has diminished sharply within the

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13 Pullman Co. v. Richardson, 185 Cal. 464, 261 U. S. 330.
14 Miller and Lux v. Richardson (1920) 162 Cal. 115.
15 Adams Express Co. v. Ky (1897) 166 U.S. 171; Adams Express Co. v. Ohio State Auditor (1897) 165 U.S. 194.
past two years and there is no indication of early improvement in the conditions responsible for their shrinkage.

At least $28,000,000 were derived from local taxation of tangible personality in 1932.\textsuperscript{16} Removal of this source of revenue from the tax system would add measurably to the fiscal problems now confronting the various political subdivisions of the state. It seems inevitable that real property, already heavily burdened, would be subjected to additional burdens in the effort to balance budgets. The prospect of such a result would act as a strong deterrent to the proposal to do away with direct taxes on personal property.

Moreover, substitution of net income taxes could not be expected to yield commensurate revenues, since estimates made by the Tax Research Bureau show that any feasible personal income tax plan would not be apt to yield more than $17,000,000 annually.\textsuperscript{17} Even assuming that the entire proceeds of such a tax should be devoted entirely to local purposes (an unlikely assumption in view of the shortage in state revenues), it would yield barely half what is now derived from taxes on personality.

A further complication impedes abolition of local personal property taxes. This arises from the fact that substantial portions of operative property values are attributable to tangible personality owned by utilities. If like non-operative property should not be subjected to taxation, some adjustment would doubtless be demanded in the gross receipts tax on operative property. Had the Commission's recommendation for abandonment of the gross receipts tax been adopted, this complication would not arise. However, there has been no legislation designed to make such a change in our revenue system and the fact that the gross receipts tax is still in effect cannot be ignored.

\textsuperscript{16} The total tax on all tangible property taxed locally was $261,052,162 (California Tax Research Bureau Summary Report, p. 16). Tangible personal property represented 10.94\% of the total tangible non-operative property assessed, and so sustained a like proportion of the total tax (Ibid, p. 16).

\textsuperscript{17} California Tax Research Bureau Summary Report, p. 139.
Offset Can No Longer Be Justified As Temporary Expedient

If the Commission could have foreseen the events which have followed its proposals, it is not too much to conclude that the offset would never have been recommended. It is also reasonable to assume that if the same problem were now presented to that body it would urge the Legislature to abolish the property tax offset described by it "as a temporary adjustment, undesirable in itself, which should be eliminated at the earliest practical moment." Again, in the words of the Commission, "If continued for a long period, it is almost certain to be subjected to abuse." 18

For the reasons above stated, there is no basis for assuming that the goal of entire elimination of personal property taxes may soon be achieved. Consequently, the offset, which was expected to disappear upon early attainment of that goal must now be regarded as about to become a permanent feature of the tax, unless definitely abolished in pursuance of the recommendation of those who were responsible for its introduction and who frankly recognized its undesirable features.

Offset Operates Unfairly And Inequitably

Allowance of offset operates unfairly and inequitably between corporations subject to the Act. Corporations that have net income but which pay no real or personal property taxes are required to pay the full amount of the franchise tax, i.e., 4% of their net income. In other words, such corporations do not benefit from the offset allowance. Likewise, corporations that have no net income but which pay real or personal property taxes do not benefit by the offset allowance. Corporations which have not income and which pay real or personal property taxes benefit from allowance of offset but in varying amounts, depending on the relation which their real or personal property taxes bear to their franchise tax prior to offset.

Corporations which pay real or personal property taxes in amounts sufficient that 10% of their real property taxes and 100% of their personal property taxes exactly equal 75% of their franchise tax obtain, and are the only corporations which do obtain, the full advantage of the offset. Such corporations are enabled in all cases to reduce their franchise tax to 1% of their net income. Other corporations which pay real or personal property taxes, subject to offset, in amounts either less or greater than 75% of their net income do not get the full advantage of the offset.

If their real or personal property taxes are less than 75% of their net income, they are not enabled to reduce their franchise tax to 1% of their net income and are consequently actually required to pay franchise taxes at a greater rate than corporations whose real and personal property taxes, subject to offset, amount to 75% of their net income.

On the other hand, if their real and personal property taxes are greater than 75% of their net income, they will not be enabled to offset all of such taxes and consequently their total tax burden will be greater in terms of net income than the tax burden of corporations which pay real and personal property taxes exactly equal to 75% of their net income.

(f) Reduction In Rate Prior Than Allowance Of Offset

It is submitted that the benefits supposed to accrue from the allowance of offset could more fairly and equitably be obtained by disallowing offset and by reducing the franchise tax rate. On the basis of 1931 returns, corporations, other than those subject to minimum and arbitrary assessments not based on net income, actually paid franchise taxes at the average rate of 1.89% of their net income. In other words, if offsets had been abolished, and the rate reduced to 1.89%, the same amount of revenue would have been obtained from corporations subject to the act as was actually obtained. But, if the rate had been reduced to 1.89% and offsets abolished, 9.39% of corporations subject to the act would have paid less taxes than they
actually paid, 78.66% would have paid the same amount of taxes (i.e., minimum and arbitrary assessments, not based on net income), and only 11.96% would have paid greater taxes.

The above data would seem to indicate that only 11.96% of the corporations subject to the Act obtain any benefit from allowance of offset, whereas the remaining corporations, i.e., 88.04% of the corporations either are injured by allowing offset or are unaffected by such allowance.

As was noted above, corporations, except those subject to minimum and arbitrary assessments not based on net income, paid, on the basis of 1931 returns, 1.89% of their net income. There is no assurance that the same amount of revenue would be obtained from corporations in the future by fixing the rate upon them at 1.89% for the reason that it is unknown what the future net income of corporations will be. Furthermore, there is no way of determining what rate should be fixed in advance in order to obtain the same revenue, without offsets that would be obtained with offsets, for the reason that it is uncertain what the property holdings of corporations will be in the future or the amount of local taxes that will be imposed on such holdings.

In fixing the rate to be imposed on corporations the Legislature will have to be guided by a consideration of what it believes constitutes a fair charge to be exacted for the privilege of doing business in California. The actual charge on the basis of 1931 returns (1.89% of net income) as well as the rate under the franchise tax formerly imposed under Article XIII section 14(d) (1.8% of corporate excess) should have some bearing upon the determination of the rate.19

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19 For a more detailed analysis of the effects of the offset allowance, see Summary Report of the California Tax Research Bureau, pages 79 to 82.
ADJUSTMENT OF BANK TAX RATE

Tax Burden On Banks And Corporations Should Be Equal

Whatever rate is fixed for corporations, the rate on banks should be higher because they pay no personal property taxes. The allowance of an offset for personal property taxes to corporations could be justified only upon the assumption that taxes on banks imposed in compliance with the restrictive conditions of the federal statute are in substitution for any taxes on bank personality. On the basis of 1931 returns banks actually paid at the rate of 3.37% of their net income, or a 1.46% higher rate than that imposed on corporations. There is no assurance that this differential will be the same in the future for it is dependent upon the amount of personal property held by corporations and the tax assessments imposed on that property by the local subdivisions of the state.

If the Legislature desired to impose upon banks a tax burden in terms of net income equivalent to that imposed on corporations the rate of tax on banks should be higher than the rate on corporations in an amount equal to the average percentage of net income of corporations paid in personal property taxes. It should be observed, however, that under this proposal a greater burden may be imposed on banks than is now imposed for the reason that corporations are not in all cases enabled to offset the full amount of personal property taxes due to the limitation that the offset must not exceed 75 per cent of the franchise tax (such full amount being used only when it does not exceed 75 per cent of the tax) and due to the fact that some corporations pay personal property taxes but do not have net income and consequently cannot take advantage of the offset provision. In other words, even with the offset provision, corporations are now subjected to a greater total tax burden in terms of net income than banks. It is difficult to see why this discrimination in favor of banks should be continued.

VALIDITY OF PROPOSED BANK TAX

It is proposed now to discuss the validity of the above suggestion that the rate of tax on banks be higher than the rate on corporations if offsets are abolished.

National Banks Not Discriminated Against By Personal Property Tax Offset

The states' power to tax national banks depends entirely upon Section 5239 of the United States Revised Statutes in which the various methods for the state taxation of national banks, consented to by Congress, and the prescribed conditions to which each is subject, are set forth. National banks are exempt from personal property taxes by virtue of the fact that, by not allowing the taxation of such property, Congress has impliedly prohibited it.21 State banks, as a matter of policy, are not taxed upon their personal property for to tax them on such property would subject them to a burdensome discrimination in favor of national banks. Other corporations are taxed on their personal property but the act as it now reads allows them an offset from the franchise tax of all personal property taxes and 10% of real property taxes paid, the total offset being limited to 75% of 4% of their net income.

To allow a deduction of personal property taxes from the franchise tax on such corporations, but to require national banks to pay the full franchise tax (less, of course, 10% of their real property taxes) does not afford national banks the full advantage of their exemption from personal property taxes, but nevertheless tends to equalize the tax burden between banks and other corporations. The effect of the act is not to discriminate against national banks in favor of other corporations but simply to permit the local subdivisions of the state to collect part of the taxes exacted of other corporations, the total tax burden being approximately equivalent to that imposed on banks. (It is in fact higher due to the limitation that the offset shall not exceed 75% of 4% of the net

21 Rosenblatt v. Johnson (1881) 104 U.S. 462
income of such corporations, and due to the fact that some corporations do not make any net income but nevertheless pay personal property taxes.) The division of the tax of these other corporations into a franchise tax less than that imposed on banks and a personal property tax equal to the difference is simply a convenient administrative device for distributing tax revenues between the state and its subdivisions.

It may be argued that the provisions for offset of personal property taxes render the tax on national banks invalid under the rule and reasoning of National Life Insurance Company v. United States. 22 This 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 income from tax exempt securities; (2) a sum equal to 4% of the company's legal reserve less the amount of the first deduction. The effect of the statute was such that insurance companies deriving income from exempt securities amounting to not more than 4% of their reserves, nevertheless, paid an income tax in an amount precisely the same as if they held no exempt securities. The court held the statute invalid so far as it required the deduction of the tax exempt income from the sum of 4% of the reserves. The court was of the opinion that to deny the full 4% deduction to exempt security holders, allowed to those not holding such securities, was in effect unconstitutionally to tax 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."

It is submitted, however, that the rule of the National Life Insurance case is not violated by the California statute. That case involved what was held to be an encroachment upon the exemption

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22 (1928) 277 U.S. 508, 48 Sup. Ct. 591
In First Life Insurance Co., the Court declared:

"Ownership of tax-exempt securities cannot be made the basis of a classification which does not require or is not more burdensome (so that burdens are

In Calip Belfours, other financial corporations are entitled to certain offsets for personal property taxes, but these offsets are

In both Life Insurance Co., the section is completely

In Calip, the banks are exempted from all except the tax-exempt securities, resulting in a total tax burden on their full

In Calip, however, the exemption is not automatically negated, as in the other financial corporates, for 1) a higher tax on its taxable property by virtue of its tax-free holdings.)
from taxation of the income from tax exempt securities, and this exemption is a real exemption; these securities are intended to be actually favored over other property in the matter of taxation.

But the "exemption" of the personal property of national banks from taxation is a different matter. In enacting Section 5219 Congress did not intend that the personal property of national banks should actually be exempt from all taxation; it intended simply that the form of state taxes on national banks should be that prescribed in the statute. In order to insure against discriminatory tax burdens on national banks, Congress prescribed certain alternative methods of taxing them which should be in lieu of all other taxes. The exemption involved in the National Life Insurance case is an exemption from taxation either in form or in effect of the property exempted. The "exemption" from taxation of personal property of national banks on the other hand, was not intended to be an actual exemption from the forms expressly consented to. In this view the California statute is unexceptionable. So far as the present objection is concerned, the tax complies with the form prescribed and its substantial operation in no way violates the purposes of Congress.

To invoke the rule of the National Life case in this situation would be a clear misreading of the intention of Congress end of the California legislature. Congress did not mean that the burden of financial companies would be increased by not allowing a specific deduction for personal property taxes. If, however, the present statute in its attempt to equalize the burden between banks and other corporations by allowing an offset for personal property taxes is invalid, then, of course, the proposal here made that offsets be abolished and banks be taxed at a higher rate equivalent to the additional personal property tax burden borne by other corporations must also be invalid. But if this personal property tax offset provision is constitutional it is difficult to see on what grounds this proposal can be held unconstitutional. Both have the same purpose and effect. So far as
banks are concerned, the difference is purely formal. The tax burden of banks in relation to other corporations would be no different (except that the present 75% limit prevents corporations from being treated exactly on a par with banks; but if the offset is valid up to 75% of the tax surely it is valid up to 100% thereof). In substance and effect there is no difference between equalizing the burden of taxation between banks and other corporations by allowing an offset to the other corporations or by increasing the rate of tax on banks to equal approximately the additional burden sustained by the other corporations. In either case the franchise tax, considered alone, is higher on banks than on other corporations. The important fact in both situations is that the other corporations pay personal property taxes equal to the difference.

Proposed Tax Permitted By Section 5219

It may be contended, however, that to have one rate for financial, mercantile and manufacturing corporations and a higher rate for banks would be an obvious violation of the plain words of Section 5219 providing that if national banks are taxed on their net income or according to or measured by their net income "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." This contention, it is submitted, fails to comprehend the meaning of the words "the rate shall not be higher" and their purpose to prevent discriminatory taxes on national banks.

(a) "Rate" Means Burden

Under the share method of national bank taxation the "tax imposed shall not be at a greater rate than is assessed upon other moneyed capital in the hands of individual citizens." The judicial history of these words demonstrates that the word rate refers not to the arithmetical figure or percentage, but to the actual incidence.
and practical burden of the tax upon the taxpayer. The decisions of
the United States Supreme Court under the share method have per-
mitted the taxation of "other moneyed capital" by different methods
from those employed in the taxation of national bank shares so long
as the ultimate tax burden when translated into the kind of tax im-
posed on national bank shares did not discriminate against national
bank shares. The states have thus been allowed what seems a quite
proper and harmless freedom in the method of taxing other moneyed
capital. The law is quite forcefully stated by Mr. Justice Miller in

"The proposition of counsel seems to be that the
capital of savings banks can be taxed by the State in no
other way than by an assessment upon the shares of that
capital held by individuals, because, under the act of
congress, the capital of the national banks can only be
taxed in that way. It is strongly urged that in no other
mode than by taxing the stockholders of each and all the
banks can a perfect equality of taxation be obtained.
The argument is not conclusive, if the proposition were
sound; for the act of Congress does not require a per-
fected equality of taxation between state and national
banks, but only that the shares of the national banks
shall not be taxed at a higher rate than other moneyed
capital in the hands of individuals. That this does not
mean entire equality is evident from the fact that, if
the capital of the national banks were taxed at a much
lower rate than other moneyed capital in the State, the
banks would have no right to complain, and the law in
that respect would not violate the provisions of the act
of Congress for the protection of national banks.

"It has never been held by this court that the states
should abandon systems of taxation of their own banks,
or of money in the hands of their other corporations,
which they may think the most wise and efficient modes of
taxing their own corporation organizations, in order to
make that taxation conform to the system of taxing the
national banks upon the shares of their stock in the hands
of their owners. All that has ever been held to be
necessary is that the system of state taxation of its own
citizens, of its own banks, and of its own corporations
shall not work a discrimination unfavorable to the hold-
ers of the shares of the national banks. Nor does the
act of Congress require anything more than this; neither
its language nor its purpose can be construed to go any
further. Within these limits, the manner of assessing
and collecting all taxes by the States is uncontrolled
by the act of Congress."
In *San Francisco National Bank v. Dodge*\(^24\) the tax imposed on national bank shares by the statute there involved was held invalid because the ultimate burden on the shares was discriminatory when compared with the burden on "other moneyed capital" in the taxing state. The court admitted, however, at Page 79, that

"As...no conflict necessarily arises between the act of Congress and the state law, solely because the letter provides one method for taxation of state banks and other moneyed corporations and another method for national banks, it follows that the contention that the state law for that reason is repugnant to the act of Congress is without merit."

In *Amoskeag Savings Bank v. Purdy*\(^25\), the court speaking of *People v. Weaver*\(^26\), declared:

"This court held that the clause in section 5219—"that the taxation shall not be at a greater rate than is assessed upon other moneyed capital", etc., meant that the taxation upon shares should not be greater than on other moneyed capital taking into consideration both the rate of assessment and the valuation. In other words, that the restriction contained in the act of Congress had to do with the actual incidence and practical burden of the tax upon the taxpayer."

If the court construes the words of the condition attached to the income tax method of national bank taxation, namely, "The rate shall not be higher" as it has construed the words of the condition attached to the share tax method, "the tax shall not be at a greater rate", and it is difficult to find any reason why it should not, then, if national banks are taxed according to or measured by net income, the tax on the other corporations mentioned need not be in form an income tax so long as the ultimate tax burden when translated into an income tax does not violate the conditions above quoted.

If the state does not desire to impose an income tax on the other corporations specified in Section 5219 and imposes on the other corporations taxes sufficiently high to leave no doubt that if translated into income taxes they would be free of discrimination against national banks, there is no reason why it should not tax these other corporations by any method it chooses. In other words,

\(^{24}\) (1905) 197 U.S. 70

\(^{25}\) (1913) 231 U.S. 373, 386

\(^{26}\) (1899) 100 U.S. 539
Section 5219 does not require that the same method of taxation be used for other corporations that is employed for banks. The restrictions of Section 5219 are met when, all taxes (other than real estate taxes) imposed on corporations are translated into an income tax, the comparison then made with the bank tax is not unfavorable to national banks. Exclusion of real property taxes from the comparison appears proper for the reason that banks and corporations are alike subjected to such taxation without distinction.

If the proposal here suggested is adopted and a higher percentage of tax is imposed upon banks under the bank and corporation franchise tax act than upon other corporations, in comparing the tax on banks with the tax on other corporations it will be insufficient to make the comparison simply with the tax according to net income on other corporations. Suppose that in addition to a tax according to their net income at a rate lower than the rate on banks, corporations were taxed on their gross receipts, and also on their personal property. Surely it could not be said that a discriminatory burden was imposed on banks if the net income tax plus the gross receipts tax plus the personal property tax when translated into a single combined net income tax exceeded the burden on banks. If the according-to-net-income tax plus the personal property tax when translated into a combined single net income tax is not discriminatory, the result should be the same.

(b) Local Taxes May Be Considered in Comparing Tax Burden of Banks and Corporations

It may be contended that Section 5219 in providing that "The several states may (1) tax said shares, or (2) include dividends derived therefrom in the taxable income of an owner or holder thereof, or (3) tax such associations on their net income, or (4) according to or measured by their net income..." means state taxation only and does not permit taxation by the local subdivisions of the state. From this it would be concluded that in comparing the tax burden on
of national banks and other corporations only state and not local taxes can be considered. However, Section 5219 and the cases arising thereunder have long permitted local as well as state taxation of the shares of national banks. It is difficult to see any reason for making a distinction with respect to the income tax methods of taxation. What purpose could be served by such a strict interpretation of the word state? Why should Congress desire to confine the taxation of the income of national banks to the state as a unit to the exclusion of the political subdivisions but permit local taxation of bank shares?

The following cases support the proposition that the word "state" includes counties, cities and other political subdivisions of the state when used in a statute or constitution limiting or permitting state activity.

- **State v. Levy Ct. (1899)** 43, Atl. 522,524
- **George v. City of Portland (1925)** 114 Ore. 418
- **Ex Parte Powers (1904)** 129 Fed. 985,988
- **American Telephone & Telegraph Co. of Alabama v. New Decatur (1919)** 136 Fed. 187,188
- **Des Moines City R. Co. v. Des Moines (1902)** 151 Ia. 875,879
- **San Francisco Gas & Elec. Co. v. City & County of San Francisco (1911)** 189 Fed. 943,949

**Burden of Proving Discrimination Must Be Borne by Taxpayer**

Under the share method of bank taxation a national bank shareholder wishing to escape taxation of his shares has the burden of proving discrimination in favor of other moneyed capital. He must establish that a substantial amount of capital favored by the state tax laws is employed in actual competition with the business of national banks. This burden of proving discrimination must be borne by the taxpayer even though the state employs on the face of the law a different method of taxing bank shares from that used in taxing other moneyed capital. In **Ames v. Ames Savings Bank v. Purdy (1915)**, the court was called upon to determine the validity of a New York Statute

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28 (1915) 231 U.S. 373
which taxed national bank shares at a rate of one per cent on their book value (capital, surplus and undivided profits of the bank divided by the number of outstanding shares) and which left out of consideration other elements such as good will and the like which enter into the determination of the actual market value of such shares. Other personal property, including capital of individual bankers, was taxed directly upon its full value, which presumably meant market value, at a higher rate than that imposed upon national bank shares. From this value, however, the taxpayer was permitted to deduct personal debts. These deductions were not allowed owners of national bank shares, and it was therefore contended, upon the authority of People v. Weaver 29 (holding invalid as regards national bank shares a New York statute allowing debts to be set off against all forms of personal property except national and state bank shares) that national bank shares were discriminated against in violation of Section 5219. The court pointed out the difference in method of taxing bank shares and other personal property as a basis of distinguishing the law in question from the one in the Weaver case.

In the course of its opinion at page 392, the court declared:

"Moreover, we agree with what was said by the Court of Appeals of New York in the Feitner Case, 191 N.Y. 88, 96, that 'The State is not obliged to apply the same system to the taxation of national banks that it uses in the taxation of other property, provided no injustice, inequality or unfriendly discrimination is imposed upon them'. "... As against the owner of bank shares, who, by alleging discrimination, assumes the burden of proving it, and who fails to show that the method of valuation is unfavorable to him, it may be assumed to be advantageous.

Plaintiff in error contends that the statement of the New York court that 'When all things are considered the rate, even without the privilege of deducting debts, is not greater than that applied to other moneyed capital in the hands of individual citizens of the state,' is based upon no facts of experience or investigation, and amounts to a mere surmise. We do not think it is to be so lightly treated; but, if it were, it still remains to be said that it was incumbent upon plaintiff in error to show affirmatively that the New York taxation system discriminates in fact against the holders of shares in national banks before calling upon the courts to overthrow it; and no such showing has been made."

29 (1879) 100 U.S. 539

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It was further held in this case that Section 5219 deals with shareholders as a class and not as individuals so that if the tax is fair to the class the fact that an owner of national bank stock, who is indebted, may sustain a heavier tax than another, likewise indebted, who has invested his money otherwise, will not render the tax invalid. The language of Section 5219 "clearly prohibits discrimination against shareholders in national banks and in favor of the shareholders of competitive institutions, but it does not require that the scheme of taxation shall be so arranged that the burden shall fall upon each and every shareholder alike, without distinction arising from circumstances personal to the individual."

The rule of proof of discrimination is emphatically set forth by the court in its opinion in First National Bank of Garnett v. Ayers.30

"In order to come to a decision in favor of the plaintiff in error it would be necessary for this court to take . . . judicial notice of what is claimed to be a fact, viz., that the amount of moneyed capital in the State of Kansas from which debts may be deducted, as compared with the moneyed capital invested in shares of national banks, was so large and substantial as to amount to an illegal discrimination against national bank shareholders. This we cannot do . . . The relative proportions in which the moneyed capital of the State of Kansas is invested in the various kinds of securities to be therein found, this court cannot judicially know. When proof shall be made regarding that matter, it may then be determined intelligently whether . . . there has been a real discrimination against the holders of national bank shares."

Georgetown National Bank v. McFerrland31, is the latest case in which the Supreme Court refused to invalidate a state tax upon national bank shares because of lack of proof that a substantial amount of capital favored by state tax laws was employed in actual competition with the business of national banks. The state taxed money, notes, bonds and other credits for state purposes at a rate of 40 cents per $100. National and state bank shares were subject to this tax and, in addition to local taxation as well. There was thus a clear case of discrimination on the face of the law and it

30 (1896) 160 U.S. 660, 667
31 (1927) 273 U.S. 566
was contended by plaintiff bank that where all moneyed capital is
exempt from local taxation except bank shares the law is void on
its face without proof. The court rejected this contention and
refused to invalidate it on the ground that the

"evidence with respect to capital invested by
individuals, taken as a whole, falls short of
establishing that the capital thus used is em-
ployed substantially as in the loan and invest-
ment features of banking in making investments
by way of loan or discount, or in notes, bonds
and other securities, with a view to sale or
repayment and reinvestment."

Since the state is not obliged to apply the same system to
national banks that it uses in the taxation of other corporations,
provided no injustice, inequality or discrimination is inflicted
upon national banks, or in other words, since the word "rate" as used
in Section 5219 means tax burden and does not refer simply to the
arithmetical figure or percentage, and since the burden of proving
discrimination must be borne by the taxpayer it seems necessarily to
follow that a complaining bank does not make a case of discrimination
by showing a difference in arithmetical figure or percentage used
but must prove discrimination in fact by showing that the tax burden
on banks exceeds the tax burden on the corporations with regard to
which the bank tax must be compared.

**Burden On Banks Must Not Be Greater Than**

**On Financial Corporations**

It should be noted that in determining the validity of the tax
on national banks under the income tax method, two comparisons must
be made; the bank tax must be compared (1) with the tax on "other
financial corporations", (2) with the tax on mercantile, manufactur-
ing and business corporations, for the tax on national banks (a)
must not be higher than the tax on other financial corporations, nor
(b) higher than the highest of the rates on mercantile, manufacturing
and business corporations doing business within the limits of the
state.
It is regrettable that Section 5219 is not more specific, that it does not state what is meant by a financial corporation or what is meant by a manufacturing, mercantile or business corporation. Until such time as the federal courts define these terms as used in Section 5219 state legislatures must use their own judgment in determining their meaning. The word "other" perhaps gives some clue to the meaning of "financial corporations." When Congress states that in the case of a tax on or according to or measured by net income of a national bank, "the rate shall not be higher than the rate assessed upon other financial corporations" it necessarily states that national banks are financial corporations. Other financial corporations, therefore, are corporations like national banks, but not necessarily banks only for Congress could imply that banks are financial corporations without implying that all financial corporations are banks. Following the court's purposive connotation of the analogous provision that the rate on bank shares must not be greater than the rate on other moneyed capital it would appear that the term "financial corporation" includes all corporations that engage in the same kind of transactions in which national banks engage.

The tax on "other financial corporations" when translated into income taxes must not be at a lower rate than the rate on national banks. In making this comparison the real estate taxes should not be taken into consideration if the real property of national banks is also taxed, for Section 5219 provides that the real property of national banks is taxable "to the same extent, according to its value, as other real property is taxed." If other financial corporations pay real property taxes such taxes have already been used in making the comparison with the tax on the real property of national banks. The income tax on banks is in addition to the tax on their real property and should be compared with the taxes on other financial corporations that are additional to their real property taxes.
In brief, the income tax on national banks should be compared with the tax burden, in terms of income taxation, imposed on other financial corporations, of all taxes other than real property taxes.

**Not Necessary That Burden on All Mercantile, Manufacturing and Business Corporations**

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 a limitation that the rate shall not be "higher" than the rate imposed on such corporations, allows the state a reasonable degree of freedom in classifying corporations of this kind for purposes of taxation.

The words "highest of the rates" necessarily implies that the rates on some of these corporations may be higher than the rates on other corporations for any other interpretation would render meaningless both the word "highest" and the plural form of the word "rates". In other words, some corporations which the state may want to encourage may be taxed 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.

In making the comparison under the second limitation, just as under the first limitation, real estate taxes should not be taken into consideration for they will already be used in determining the validity of the tax on the real estate of national banks. The income tax on national banks should be compared with the tax burden in terms of income taxation imposed on these other corporations by all taxes other than real property taxes.

Some of the mercantile, manufacturing and business corporations
will undoubtedly pay personal property taxes in such amounts that when translated into percentages of net income and added to the percentage of net income exacted as a franchise tax, they will be taxed at a rate either equal to or higher than the rate on national banks. If some mercantile, manufacturing and business corporations are taxed at a rate (considering both personal property taxes and the franchise tax) either equal to or higher than the rate on national banks, the conditions of Section 5219 are met.

**Arithmetical Rate on Banks and Financial Corporations Must Be Identical**

However, Section 5219 provides that the rate on national banks shall not be higher than the rates assessed upon other financial corporations. If the franchise tax rate on other financial corporations is fixed at a lower percentage of net income than the percentage required of national banks, it may happen that some financial corporations will not pay in personal property taxes amounts sufficient, when translated into percentages of net income and added to the percentage of net income exacted as a franchise tax, to make the total combined rate equal to the rate on national banks. It is conceivable that some financial corporations might not pay any personal property taxes and would therefore not be taxed at the same rate as national banks. Hence, to insure compliance with Section 5219, it is advisable to fix the rate on financial corporations at the same percentage of their net income as in the case of national banks.

**Financial Corporations Should Be Allowed Limited Offset**

If financial corporations are taxed on their franchises at the same rate as banks and are also subjected to tax on their personal property, such corporations will obviously be discriminated against as compared to banks and likewise as compared to mercantile, manufacturing and business corporations. In many instances it may happen that their total taxes will represent a greater percentage of their net income than in the case of banks, and mercantile, manufacturing and business corporations.
This difficulty can be met by allowing financial corporations to offset their personal property taxes against their franchise tax. Thus, if a financial corporation pays no personal property taxes, it will pay a franchise tax at the same rate as banks. But if it pays personal property taxes, then its franchise tax will simply be the difference between the personal property taxes and the amount of a tax computed at the same rate as is imposed on banks.

However, financial corporations should not be allowed to offset their personal property taxes up to 100% of their franchise tax, for to allow them to do so would in many instances result in the franchise taxes of financial corporations representing a less percentage of their net income than in the case of mercantile, manufacturing and business corporations. To insure that financial corporations will pay franchise taxes at the same rate as mercantile, manufacturing and business corporations, they should be permitted to offset their personal property taxes only up to that percentage of their net income which is equal to the difference in the (arithmetical) rate of franchise tax imposed upon them and upon mercantile, manufacturing and business corporations.

Offsets on principle, as stated above, are objectionable. In this case, however, there seems to be no other alternative if a valid tax is to be imposed on banks that makes their tax burden correspond fairly with the tax burden on other corporations.

Suggested Amendments

The above suggestions could be carried into effect by amending sections 1, 2, 3, and 4 and by adding a new section, numbered 4½ to the statute as follows:

Sec. 1. Every national banking association located within the limits of this State, shall annually pay to the State a tax according to or measured by its net income, to be computed, in the manner hereinafter provided, upon the basis of its net income for the next preceding fiscal or calendar year, at the rate provided for in section 4½. The State is hereby adopting the
method numbered (4) authorized by the act of March 25, 1926, amending Section 5219 of the Revised Statutes of the United States.

Sec. 2. Every bank, other than a national banking association doing business within the limits of this State, shall annually pay to the State for the privilege of exercising its corporate franchises within this State, a tax according to or measured by its net income, to be computed, in the manner hereinafter provided, upon the basis of its net income for the next preceding fiscal or calendar year at the rate provided for in section 4a.

Sec. 3. The tax referred to in sections 1 and 2 hereof shall be in lieu of all other taxes and licenses, State, county and municipal upon the banks and banking associations therein mentioned, except taxes upon their real property.

Sec. 4. Every financial corporation doing business within the limits of this State of the classes referred to in subdivision 2 (c) of section 16 of article thirteen of the constitution of this State, shall annually pay to the State for the privilege of exercising its corporate franchises within this State, a tax according to or measured by its net income, to be computed, in the manner hereinafter provided, upon the basis of its net income for the next preceding fiscal or calendar year at the rate provided for in section 4a.

Each such financial corporation shall be entitled to an offset against said franchise tax, in the manner hereinafter provided, in the amount of taxes paid upon its personal property to any county, city and county, city, town or other political subdivision of the State; provided, however, that the tax on such financial corporation after the allowance of offset shall not be less than per centum of its net income for the preceding fiscal or calendar year or less than twenty-five dollars.
Every mercantile, manufacturing and business corporation doing business within the limits of this State, of the classes referred to in subdivision 2 (a) of section 16 of article thirteen of the constitution of this State, shall annually pay to the State, for the privilege of exercising its corporate franchises within this State, a tax according to or measured by its net income, to be computed, in the manner hereinafter provided, at the rate of ___ per centum upon the basis of its net income for the next preceding fiscal or calendar year.

In any event, each such corporation shall pay annually to the State for the said privilege a minimum tax of twenty-five dollars.

Taxes under this section and under sections 1 and 2 of this act shall accrue on the first day after the close of the "taxable year" as defined in section 11 hereof.

Sec. 4a. The rate of tax on national banking associations and other banks and financial corporations mentioned in sections 1, 2 and 4 of this act shall be a percentage equal to the average percentage of the net income, allocable to this state, of mercantile, manufacturing and business corporations, taxable hereunder, for the next preceding calendar year or fiscal years ended during such calendar year, required to be paid to this state as franchise taxes according to or measured by such net income, and required to be paid to this state or its political subdivisions as personal property taxes during the preceding calendar year or fiscal years ended in such calendar year. The average percentage of the net income of mercantile, manufacturing and business corporations required to be paid to this state or its political subdivisions in personal property taxes shall be determined by ascertaining the ratio which such personal property taxes bear to the net income of such corporations, allocable to California, increased by the amount of such personal property taxes.

The commissioner shall determine not later than the 31st day
of December of each year the average percentage of net income above specified, and shall forthwith mail notice of his determination and the amount of tax payable on the basis of such determination to all banks and financial corporations affected thereby, but such determination shall not be considered a deficiency assessment within the meaning of Section 25.

If it be judicially determined that the rate of tax on any bank or corporation is higher than is authorized by law such bank or corporation shall be relieved of liability for any tax imposed by this act only to the extent of the excess beyond that legally authorized.
If offsets are abolished, or the rates increased, the basic date for determining gain or loss changed, or deductions allowed that were not allowed under the old act, or any other advantages or disadvantages given to or imposed upon, banks or corporations, an adjustment will have to be made for fiscal year corporations and the tax increased or decreased accordingly.

The reason for this adjustment is to prevent discrimination. For example, if the amendments become operative before March 15, 1933, the date returns are due, and the rates are increased, calendar year corporations will pay the increased rates for the privilege of doing business the entire year 1933, whereas the new rates, unless an adjustment were made, would apply to fiscal year corporations only for the months of 1933 following the close of their fiscal years ending in 1933.

Suppose a corporation with a fiscal year ending June 30, 1933. Unless an adjustment were made, its tax for the months January 1 to July 1, 1933, would be at the old rates, whereas a calendar year corporation would pay a tax for these same months at the higher rates. On the other hand, if the amendments do not become operative until after March 15, 1933, and the rates are increased, calendar year corporations would not pay the increased rates for any part of the year 1933, whereas the new rates, unless an adjustment were made, would apply to fiscal year corporations, whose returns are not due until after the amendments become operative, for the months of the year 1933 following the close of their fiscal years. For example, suppose the rates were increased by an amendment operative on August 14, 1933, and a corporation had a fiscal year ending June 30, 1933. Its return would not be due until September 15, 1933, consequently, unless an adjustment were
made, its tax for the privilege of doing business for the months from June 30 to December 31, 1933, would be at the new rates, whereas a calendar year corporation would pay a tax for those same months at the lower rates.

Suggested Amendment

It is submitted that the following, based upon Section 105 of the Federal Revenue Act of 1928, should be added to Section 4:

The tax on any bank or corporation for a period beginning in one calendar year (hereinafter in this section called "first calendar year") and ending in the following calendar year (hereinafter in this section called "second calendar year") where the law applicable to the computation of taxes for calendar year banks or corporations for the second calendar year is different from the law applicable to computation of taxes for calendar year banks or corporations for the first calendar year, shall be the sum of:

(1) the same proportion of a tax for the entire period, determined under the law applicable to the first calendar year and at the rates for such year, which the portion of such period falling within the first year is of the entire period; and (2) the same proportion of a tax for the entire period, determined under the law applicable to the second calendar year and at the rates for such year, which the portion of such period falling within the second calendar year is of the entire period.

Any tax that has been paid under the law applicable to the first calendar year if in excess of the tax imposed by this section shall be refunded or credited to the bank or corporation as provided in Section 27. Any tax in addition to that paid under the law applicable to the first calendar year made necessary by this section shall be immediately due and payable upon notice and demand from the commissioner.
Illustrations:

(1) The Amendments Become Operative as of January 1, 1933:

Suppose a corporation with fiscal year ending June 30, 1933. The income earned from July 1, 1931 to June 30, 1932, was the basis for the tax for the period July 1, 1932 to June 30, 1933. Suppose that under the law applicable in 1932 the tax on this corporation amounted to $1,000. The proportion of such tax which the portion of the period falling within 1932 is of the entire period is $\frac{6}{12}$ or $\frac{1}{2}$. One-half of $1,000$ is $500$. Suppose that under the law applicable in 1933, the tax on this corporation would have been $1,500. The proportion of such tax which the portion of the period falling within 1933 is of the entire period is $\frac{6}{12}$ or $\frac{1}{2}$. One-half of $1,500$ is $750$. Suppose that under the law applicable to calendar year corporations in 1933, the tax on this corporation would have been $1,000. The proportion of such tax which the portion of the period falling within 1933 is of the entire period is $\frac{6}{12}$ or $\frac{1}{2}$. One-half of $1,000$ is $500$. Suppose that under the law applicable to calendar year corporations in 1933, the tax on this corporation would have been $1,500. The proportion of such tax which the portion of the period falling within 1933 is of the entire period is $\frac{6}{12}$ or $\frac{1}{2}$. One-half of $1,500$ is $750$. The corporation, of course, should already have paid the $1,000 due under the old law. In other words, it will be required to pay an additional amount of $250.

(2) If the Amendments Become Operative After March 15, 1933 and Do Not Apply to Calendar Year Corporations until 1934.

Suppose a corporation with a fiscal year ending June 30, 1933. The income earned from July 1, 1932 to June 30, 1933, will be the basis for the tax for the period from July 1, 1933 to June 30, 1934. Suppose, under the amended law, the tax on this corporation would amount to $1,500. The proportion of such tax which the portion of the period falling within 1934 is of the entire period is $\frac{6}{12}$ or $\frac{1}{2}$. One-half of $1,500$ is $750$. Suppose that under the law applicable to calendar year corporations in 1933, the tax on this corporation would have been $1,000. The proportion of such tax which the portion of the period falling within 1933 is of the entire period is $\frac{6}{12}$ or $\frac{1}{2}$. One-half of $1,000$ is $500$. Suppose that under the law applicable to calendar year corporations in 1933, the tax on this corporation would have been $1,500. The proportion of such tax which the portion of the period falling within 1933 is of the entire period is $\frac{6}{12}$ or $\frac{1}{2}$. One-half of $1,500$ is $750$. The corporation has already paid the tax under the law as amended, it will be allowed either a credit or a refund of $250.
MASSACHUSETTS OR BUSINESS TRUSTS

These Associations Are Not Taxable Under the Act

The words of Section 4 of the Act "for the privilege of exercising its corporate franchises" probably prohibit the levying of the tax upon Massachusetts or business trusts, joint stock associations and limited partnerships. Section 16 of Article XIII of the constitution is responsible for this provision. That section states that the tax is on "corporations" and is "for the privilege of exercising their corporate franchises" so that even if the statute omitted the language quoted it might be held that the constitutional section limited the tax to formally created corporations.

These Associations Should Be Taxed as Corporations

There is no reason why business trusts should be exempt from this tax and perhaps the same is true of joint stock associations and limited partnerships. For most business and financial purposes, organizations of this kind are indistinguishable from corporations. The State Board of Equalization in its report for 1923-24 stated that business trusts are becoming quite common in this state and that since they come directly into competition with, as well as frequently take the place of, California business corporations which are required to pay a franchise tax in this state, it would be quite proper to put such organizations on the same or similar basis and require a business tax from them also. They are taxable as corporations under the federal revenue act.

This loophole in the law should be closed. In view of the recent decision of the California Supreme Court in Goldwater v.

32 At p. 9.
33 Hocht v. Molloy (1924) 265 U.S. 144.
Oltman, holding that members of a business trust may gain the advantage of immunity from partnership liability (heretofore afforded only by incorporation or the formation of limited partnerships) if the declaration of trust is so drawn as to give shareholders or associates no substantial control over the trustee, it is quite likely that the number of such organizations in this state will greatly increase.

**Separate Act Required**

Can these associations be taxed under the act by defining the word "corporation" in such manner as to include them? Congress has so defined corporations in section 701 of the Federal Revenue Act of 1928. Congress, however, was not limited by a constitutional provision similar to section 16 expressly stating that "corporations" were to pay the tax, and that the tax was "for the privilege of exercising their corporate franchises".

Section 16, however, provides that the Legislature shall define "corporations". To define "corporations" to include organizations that for most business and financial purposes are indistinguishable from formally created corporations, that enjoy the same privileges and advantages, that come directly into competition with and take the place of corporations subject to the tax, could hardly be said to be an abuse of the power granted to define this term. It would seem therefore, that the Legislature may include these organizations in its definition of "corporations." It is doubtful, however, whether this power is sufficient to enable the Legislature to subject them to the tax under the act in view of the language of Section 16 not only that the tax is for the "privilege of exercising their corporate franchises" but is upon "corporations subject to be taxed pursuant to subdivision (d) of this article."

34 (1930) 210 Cal. 408. -38-
It is thus not enough that they may be considered corporations—they must also have been taxable under section 14(d). It would seem that associations of this kind operating simply by agreement between the members without any franchises are not exercising a "corporate franchise" within the meaning of Section 16 and that they did not have any franchises taxable under 14 (d).

If it were not for the provisions of Article IV, Section 24, of the state constitution providing that "Every act shall embrace but one subject, which subject shall be expressed in its title" it might be possible to impose in one and the same statute a franchise tax on banks and corporations pursuant to Section 16 and under the reserved powers of the Legislature, an excise or license tax on the associations in question measured by net income. There can be little doubt that the state has power independently of Section 16 to tax those associations, but inasmuch as such tax would not be passed in pursuance of Section 16, it probably cannot be included in a statute whose title states that it is passed under that section, nor can it have two titles for it would then be embracing more than one subject.

In view therefore of the probable invalidity of an attempt to reach these associations under the Bank and Corporation Franchise Tax Act, it would seem advisable to enact a separate statute subjecting them to the tax. The separate statute, if the Legislature desires to tax them according to net income, could repeat or incorporate by reference the applicable provisions of the bank and corporation franchise tax act.

35 Although the California Constitution does not in express terms authorize such a tax, express authority is unnecessary in view of the well established rule that the constitution is a restriction rather than a grant of power to the Legislature, and in view of the rule that that body has unlimited power with regard to taxation except as restricted by the constitution itself or by the United States Constitution. In re Modoc Irr. Dist. (1891) 93 Cal. 296; Beals v. Amador County Supervisors (1868) 35 Cal. 624.
Registration of Business Trusts Should Be Required

It is submitted that it would be desirable for the legislature to provide for the registration of business trusts with the Secretary of State and with the county clerk of any county in which they do business. Those who administer the tax could obtain the lists of such associations and require returns disclosing their taxable values and such other information that may be necessary to determine the tax that should be assessed upon them.

Section 5

CORPORATIONS TAXABLE UNDER ACT

The constitutional provision in pursuance of which the Act was passed contemplates a tax "according to or measured by" net income on:

(1) Banks, including national banking associations, located within the limits of this state.

(2) All financial, mercantile, manufacturing and business corporations which are:

(a) doing business within the limits of this state, and

(b) subject to be taxed pursuant to subdivision (d) of Section 14 of Article XIII.

It will be observed that the only constitutional requirement for the taxability of banks is that they be "located within the limits of this state." This language is repeated in the Act insofar as national banks are concerned but is modified with reference to state banks which are described as taxable if "doing business within the limits of this state."

36 Cal. Const. Art. XIII, Sec. 16
37 See Section 1 of the Act.
38 See Section 2 of the Act.
It will be further observed that two requirements are imposed by the constitution with reference to the taxability of corporations. The first of these requirements, i.e. that of "doing business", appears to have lost virtually all significance because of the broad definition given to this term by the 1931 amendment to the act discussed below. The second requirement precludes extension of the act to public utilities and insurance companies for the taxation of which special provisions are made elsewhere in the constitution.39

Because of the enumeration of "financial, mercantile, manufacturing and business corporations" in the act, the tax imposed thereunder is apparently not applicable to all corporations heretofore taxable under section 14(d) of Article XIII of the constitution. If it had been the intention to tax every corporation subject to assessment under section 14(d), that purpose could have been easily expressed. The fact that certain classes of corporations "subject to be taxed pursuant to subdivision (d) of section 14" are enumerated must be regarded as evincing an intent to exclude all other corporations subject to taxation pursuant to that constitutional provision.40

To be taxable under section 14(d) a corporation must be possessed of a franchise of assessable value, for it must be observed that no specific mention is made of corporations in that part of the constitution which simply provides that:

"All franchises, other than those expressly provided for in this section, shall be assessed at their actual cash value. * * * and shall be taxed * * * each year, and the taxes collected thereon shall be exclusively for the benefit of the state."

The excluded franchises are, of course, those of the public utilities, banks and insurance companies subject to special taxation under other provisions of the same section. Reference to these provisions has already been made.

39 Cal. Const. Art. XIII, section 14, subdivisions (a), (aa), (ab), (c); section 15 and section 16.
Every domestic corporation, by the very fact of its existence, is possessed of a franchise the situs of which is in this state. Theoretically, at least, each such corporation is "subject to be taxed pursuant to subdivision (c) of section 14" in account of its general corporate franchise, i.e., right to be a corporation. However, it is conceivable, of course, that the franchise may have no "actual cash value." Consequently, in its actual operation such a law does not necessarily exact an annual state tax from every domestic corporation.

So far as a foreign corporation is concerned, there has been a judicial determination that any company which owes its existence to some other state is not taxable here for its general corporate franchise unless it actually engages in intrastate business in California. Therefore, the extent of section 14(c) appears to be fairly well defined, and, potentially, includes every domestic corporation (with the exception of any whose franchises are otherwise taxed) and every foreign corporation qualified to do business here (except such as may be doing no intrastate business in this state).

However, as now worded the Act is restricted in its application to certain enumerated types of corporations that are "doing business within the limits of this state." Apparently, a corporation which may be described as a "financial," "mercantile," or "manufacturing," corporation comes also within the broader classification of "business" corporation. So for all practical purposes, the Act may be regarded as providing for taxation, under certain conditions, of all business corporations and as excluding from taxation all non-business corporations.

The term "business corporation" is vague, and before an exact line of demarcation can be drawn between "business" and "non-business" corporations, judicial guidance will probably be required.

41 See San Joaquin & Kings River Canal & Irrigation Co. v. Merced County (1906) 2 Cal. App. 593.

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Meaning of the Term: "Business Corporation"

In view of the fact that the wording of the statute incorporates the wording of Section 5219, it would seem that judicial determination of the term "business corporation" as used in that section would fix the definition of the term as used in the California statute. However, since there has been no decision upon this point under Section 5219, we must turn to other decisions for assistance in determining the nature of a business corporation. We find numerous cases supporting the view that any corporation whose purpose is that of personal material gain of a pecuniary nature to its members is a business corporation. Some of the principal ones are summarized as follows:

Malood v. Lincoln Medical College of Cotner University

"The character of a corporation is determined from its articles of incorporation and the statute authorizing its formation. In this case, it is apparent from both the articles of incorporation and the provisions of section 15, chapter 16, compiled Statutes, that this organization is an educational and not a 'business' or 'trading' corporation for the pecuniary profit of its members."

Greenough v. Board of Police Commissioners of Town of Tiverton

"Is it or 'business' within the provisions of 'Class I--Business Corporations'? The definition of the noun 'business' according to Webster's Int. Dict. is: (3) 'Financial dealings; buying and selling; traffic in general; mercantile transactions.' A corporation organized for such purposes is therefore a business corporation."

Flint v. Stone Tracy Co.

"A 'business is that which occupies the time, attention, or labor of men for the purpose of livelihood or profit."

People v. Board of Trade of Chicago

"This organization is not maintained for the transaction of business or for pecuniary gain, but simply to promulgate and enforce among its members correct and high moral principles in the transaction of business. It is not engaged in business but only prescribes rules for the transaction of business."

43 (1903) 69 Neb. 550, 553.
45 (1911) 280 U. S. 107, 171.
46 (1975) 86 Ill. 1, 134, 156.
Dairy Marketing Association of Ft. Wayne

"...a corporation transacting business for gain as its chief and ultimate purpose is a business corporation."

Under the rule enunciated in the foregoing decisions, it seems clear that corporations which are organized purely for religious, charitable, social, fraternal, or civic purposes, and from the operation of which the stockholders or members gain no pecuniary benefit, are not "business corporations." Hence, as "non-business corporations" such organizations are not taxable under the Act.

Are Holding Companies "Business Corporations"?

There are probably other types of corporations, not so clearly of a non-business character, which, non-the-less, are excluded from classification as "business corporations" as a result of judicial interpretation of that term. Thus, serious question has already arisen under the Act as to whether holding companies are business corporations subject to taxation in pursuance of its provisions.

Is the purpose of a holding company personal material gain of pecuniary nature to its members? The federal court decisions under the Federal Capital Stock Act of 1909 may have some bearing upon an answer to this question. In Dole Norto Company v. Wilkinson involving a corporation whose activities were limited to the holding of stock in another company and protecting its capital investment, the court held:

"There is not a suggestion that during any of these years its capital was in any sense 'employed' or, as we may put it, 'worked' for the purpose of the pursuit of profit or gain in any fair sense, or that any income, revenue, or profit in a true sense has been realized."

See also Rose v. Junnally Investment Company in which the court stated:

"The capital invested and reinvested, and not the activities of plaintiff, earned the profits. In

47 (1926) 9 Fed. (2d) 626, 628.
48 (1926) 26 Fed. (2d) 978.
49 (1927) 22 Fed. (2d) 103.

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maintaining its old investments, and in making new investments, plaintiff was only enjoying the fruits of its ownership, and neither those old nor new investments were used to further business opportunity or standing..." (Italics added).

"If the only substantial corporate activity is the ownership and preservation of real and personal property, the receipt of its ordinary income, which arises from the property itself rather than from the active use and management of it, and the distribution of such income to the stockholders with only such corporate organization and activity as is necessary thereto, there is not such a going of business as is required by the Act. While such activity is "business" in a broad sense, a tax upon such business would be in substance one of the mere ownership of property, becoming thus a direct tax..."

If the California courts follow the theory underlying these cases, and other federal cases arising under the Federal Capital Stock Act of 1909, that the use of its corporate powers and the working of its capital to secure a profit is the test of whether a holding company is a business corporation, the conclusion will be reached that holding companies that simply hold stock and collect the income therefrom are not taxable under the act. On the other hand, it may be argued that from the organization of these corporations certain advantages arise to the members thereof, that if no

50 Emery Bird Thayer Realty Co. v. U.S. (1912) 199 Fed. 242, 250; Sellar v. United States (1927) 54 F. (2d) 944; Zeno v. Miners' Alliance Syndicate (1911) 55 L. Ed. 428; Van Brough v. Shattuck Iron Co. (1919) 61 L. Ed. 460; U.S. Nissin Mines Co. (1913) 205 Fed. 431; Arapahoe Casualty Min Co. v. Anderson (1930) 42 F. (2d) 219, 221; Automatic Fire Alarm Co. v. Delaware & Bowrs (1931) 51 Fed. (2d) 118,120. These cases hold that corporations whose activities consist simply in holding, stock and distributing dividends therefrom are not doing "business." If these cases are sound it is difficult to see how corporations organized to do something that is not business can be business corporations. It may also be argued that these decisions are binding upon the California courts since the legislation in adapting the federal classification of corporations and the terms "business corporations" and "doing business" as used in Section 5219, has necessarily adopted the definitions of these terms established by decisions defining those terms as used in Section 5219. Where a word or expression has acquired a judicially settled meaning, in subsequent legislative enactment such word or expression will be presumed to have that meaning in the statute. United States v. Herron (1925) 68 L. Ed. 240.244; Nieser v. United States (1931) 49 L. Ed. 114,122.
gain or benefits were derived therefrom, they would not be created, and that if the members thereof desire these benefits they should pay the price in the form of a franchise tax exacted by the state for the privilege of having such corporations.

**Should Holding Companies be Taxed Under Act?**

The statute as it now reads creates a situation of doubt that can be settled only by court decision. It is submitted that the Act itself should definitely state whether or not such corporations are taxable thereunder, particularly in view of the fact that whether or not holding companies are taxable under the Act is the controlling factor in determining whether corporations which receive dividends from holding companies are taxable on those dividends.

Section 8 (h) allows a deduction for dividends declared out of income from business done in this state. If holding companies are taxable on the theory that they are business corporations doing business in this state, other corporations are entitled to deduct dividends received from holding companies. If, however, holding companies are not taxable because they are not business corporations doing business in this state, corporations receiving dividends from holding companies are taxable on such dividends.

If holding companies are taxed under the act, the tax will fall practically entirely on dividends declared out of earnings from non-California business. Since other corporations which are taxable under the act are taxed on dividends received by them, if such dividends are declared out of earnings from non-California business (whether or not such corporations engage in activities other than the holding of stock, or whether they simply have the right to do business and actually engage in no activities other than the holding of stock) it is arguable that holding companies should likewise be taxed on dividends declared out of earnings from non-California business.

However, to tax holding companies under the act would lead either to discrimination against domestic holding companies or to
the abandonment by them of their California charters. It is doubtful whether foreign holding companies holding stock in this state would be held to be doing intra-state business in the state and even if they were, stock could easily be held outside the state and the dividends distributed therefrom. If the tax can easily be avoided by becoming a foreign corporation and holding stock outside the state, it would seem that the taxing of holding companies under the act would result in driving such companies out of the state. Thus, the problem with respect to holding companies resolves itself into a determination of whether California does or does not want holding companies.

The Present Definition of "Doing Business" is Unsatisfactory

The problem of what corporations are taxable under the Act is further complicated by the question what constitutes "doing business." As previously shown, "doing business" is a prerequisite to taxable status of any corporation.

When the Act was first passed in 1929, "doing business" was defined as "any transaction or transactions in the course of its business by a corporation created under the laws of this state or by a foreign corporation qualified to do or doing intrastate business in this state." In 1931 the Act was amended by adding to the definition just given the following: "and shall include the right to do business through such incorporation or qualification."

Even though there are no "transactions in the course of its business by a corporation created under the laws of this state or by a foreign corporation qualified to do business in this state" such corporations are, under the latest definition, by legislative fiat, "doing business" if they merely enjoy the "right to do business." It is difficult to understand how, having the "right to do" something can sensibly be "doing" that thing.

The tax on corporations expressly provided for in paragraph 2(a) of Section 18 of Article XIII of the state constitution is
limited to corporations doing business in this state. Hence it appears that that paragraph contemplates the imposition of an excise tax on doing business as a corporation. The Legislature as a result of the amendment, has, in effect, while seemingly defining terms, provided for the imposition on some corporations, not previously subjected to the tax contemplated by the constitutional section, of a license tax on the right to do business rather than an excise tax on the doing of business.

The 1929 act and the 1931 amendment were enacted pursuant to the provisions of Section 16 of Article XIII of the state constitution. Although that section, in furtherance of a plan for an excise tax on the doing of business as a corporation, authorizes the Legislature to define various terms, including "doing business," it is doubtful whether that body, in pursuance of such authorization, can provide constitutionally for a license tax on the right to do business as a corporation merely by defining the possession of that right as "doing business."

However, it should be observed that subdivision (b) of paragraph 2 of Section 16 empowers the Legislature to provide for taxation by any other method authorized in this constitution of the corporations, or the franchises, subject to be taxed pursuant to subdivision (a) of paragraph 2 of this section or subdivision (b) of Section 14 of this article."

The validity of the 1931 amendment, assuming that it provides a different method of taxing corporations from that expressly set forth in paragraph 2 (a) of Section 16, and assuming that paragraph 2(b) implicitly limits the Legislature and makes Section 16 the sole source of legislative authority to impose taxes on the kind of corporations referred to therein, will depend upon:

(1) Whether a corporation which would be taxed under the amendment was taxable under Article XIII, Section 14;

(2) Whether this different method is "provided by law" when done under the guise of defining the terms of the old method; and
Whether this new method is "authorized in" the State Constitution.

If the source of legislative authority to impose this tax is Section 16, the amendment as regards foreign corporations fails to meet the first requirement and as regards such corporations it is therefore unnecessary to consider the other two requirements.

The case of People v. Alaska S. S. Co. definitely held that foreign corporations qualified to do intrastate business in this state but not exercising such right were not taxable under Section 14d, and, as noted, above, taxability under Section 14d is a condition precedent to taxability under Section 16.

Foreign corporations doing exclusively interstate business in the state are, of course, not subject to a franchise tax. As to domestic corporations the amendment complies with the first requirement, for the theory of the old franchise tax as set forth in the cases seems to support the contention that such corporations were taxable under Section 14d although not actually doing business.

Assuming that by changing the definition of terms the Legislature is providing by law for a new method of taxing corporate franchises, the question presented by the third requirement is whether this new method is authorized in the Constitution. What is meant by "any other method authorized in this constitution?" Do these words mean that the other method must be expressly set forth in the constitution, or do they refer to any method that is constitutional? The only methods expressly authorized in the constitution for the taxation of corporate franchises which were taxable under Section 14d are the methods set forth in Section 16 and in Section 14d. The tax expressly set forth in Section 16 is upon corporations only that are "doing business." The tax provided in

51 (1926) 162 Cal. 262.
52 Alpha Portland Cement Co. v. Massachusetts (1925) 268 U.S. 268.

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Section 14 is a property tax and franchises taxable thereunder must be taxed at their full cash value.

The tax imposed under the 1931 amendment does not appear to meet either of the conditions applicable to taxes imposed under the express terms of Section 16 or Section 14(c). Unless by the mere device of definition the Legislature has metamorphosed the possession of the right to do business into doing business, the tax is not confined to corporations that are "doing business." A license imposed directly on the right to do business, measured either by the net income of the owner of the right or by a flat minimum charge, cannot be regarded as taxation of that right at "its full cash value." Consequently, if "any other method authorized by this constitution" means expressly set forth therein, the 1931 amendment is of doubtful validity.

If the words "authorized in this constitution" mean "constitutional" the method employed need not be expressly authorized in the constitution and the amendment is within the authority of the legislature, for a license tax on the right to do business is apparently constitutional. It may be argued, however, that this interpretation would render superfluous the words "authorized in this constitution" for obviously any method of taxation must be constitutional regardless of express conditions so stating. On the other hand, if these words had been omitted, paragraph 2(b) might be construed as granting to the legislature power to impose without restriction any other method of taxation upon the corporations mentioned, or their franchises, regardless of other provisions in the constitution. It was probably intended to grant to the legislature a reasonable degree of freedom with respect to the taxation of such corporations subject to the restriction that the method adopted should conform with any limitations in the constitution not set forth in Section 16. The words in question were probably inserted to achieve this purpose.
It is submitted that instead of defining the term "doing business" as including the "right to do business" the Act should be amended to contain a definition of "doing business" which more nearly comports with legal significance of that term as defined by the courts. This would eliminate much confusion and uncertainty now existing as to the scope of the Act.

If the Legislature desires to impose a $25 annual tax on corporations having the right to do business in this state but not actually exercising that right, direct language may be used to effectuate such a tax. While some question as to implied limitation on the power to impose this tax may arise from the language of Section 16, the better view seems to be that the power has not been impaired and that the language of paragraph 2(b) of that section is intended merely to make clear that the method for taxing corporations as provided in paragraph 2(a) was not necessarily exclusive.

There does not appear to be any desire to exact more than the minimum tax from inactive corporations. When the definition of "doing business" was revised with the apparent result of making such corporations taxable, Section 13 of the Act was amended to prevent imposition of a greater tax on them than the minimum. However, such corporations are not protected from a tax of more than $25 in all cases for reasons stated in the discussion of Section 13 below. Moreover, there still remains the question of the taxability of holding corporations which should be definitely settled for reasons already stated.

As appears from the earlier discussion, any attempt to tax holding companies on the full amount of their net income arising from out-of-state sources will eventually prove futile. On the other hand, some private advantage accrues from the continued existence of these companies, and it seems only fair that they should contribute something to the state for the enjoyment of that privilege. Definite exclusion of holding companies from the category of
business corporations, and their taxation at the $25 minimum would appear a reasonable solution.

In providing for a $25 annual license tax on inactive and holding corporations, it might be advisable to exclude from the terms of the Act religious, charitable, social fraternal and civic organizations. Such corporations are not regarded commonly as possessing general corporate franchises of assessable value, and thus have not been required to pay franchise taxes to the state under 14(d). With this exclusion the scope of the tax under the Act would be substantially identical with the scope of corporate franchise taxation under 14(d) which is in apparent conformity with the intent of the constitution.

Suggested Amendments

Add the following to Section 4:

Every corporation subject to be taxed pursuant to subdivision (d) of Section 14 of article thirteen of the constitution of this state, and not otherwise taxed in pursuance of this section, shall pay annually to the state a tax of twenty-five dollars in lieu of the tax on its general corporate franchise under the provisions of said subdivision (d).

The provisions of this section shall not apply to corporations organized to operate as public utilities or insurance companies, subject to special in lieu taxation under article thirteen of the constitution of this state, if such corporations engage in no other business, nor to corporations organized for religious, charitable, social, fraternal or civic purposes if their organization or activities result in no financial or pecuniary gain or profit to the stockholders or members thereof.
Any corporation organized to hold the stock or bonds of any other corporation or corporations, and not trading in such stock or bonds or other securities held, and engaging in no other activities than the receipt and disbursement of dividends from such stock or interest from such bonds, shall not be considered a financial, mercantile, manufacturing or business corporation or a corporation doing business in this state for the purposes of this act.

Add the following to the definition of "corporation" in Section 5:

And every corporation subject to be taxed pursuant to Section 4 hereof.

Substitute the following for the definition of "doing business" in Section 5:

The term "doing business," as herein used, means actively engaging in any transaction for the purpose of financial or pecuniary gain or profit.
EXCLUSIONS FROM GROSS INCOME

Section 6:

Receipts from Life Insurance

The California act should follow the federal act in making
an exception for the deduction of amounts received under a life in-
surance contract paid by reason of the death of the insured where
the beneficiary is a transferee of the policy for a valuable con-
sideration.

The California statute should also have a provision that if
amounts paid by reason of the death of the insured are held by the
insurer under an agreement to pay interest, interest payments should
be included in gross income.

Suggested Amendment

Add to section 6, paragraph (a):
but if such amounts are held by the insurer under an
agreement to pay interest thereon, the interest payments
shall be included in gross income.

Add to section 6, paragraph (b):
In the case of a transfer for a valuable consideration,
by assignment or otherwise, of a life insurance, endowment,
or annuity contract or any interest therein, only the actual
value of such consideration and the amount of the premiums
and other sums subsequently paid by the transferee shall be
excluded from gross income under paragraph (c) of this
section.

Stock Dividends; Subscription Rights

The act makes no specific provision for stock dividends or sub-
scription rights. They are not taxable under the federal act. 53

53 Fed. Rev. Act of 1928; Sec. 115f; Miles v. F.D. Deposit and
Trust Co. of Baltimore (1922) 259 U.S. 247
It is uncertain whether they are taxable under the California act. Section 6 of the statute includes among the items that must be included in gross income "except as hereinafter otherwise provided... all dividends received on stocks." The exception refers to dividends declared out of earnings from California business (see section 68) and has no bearing upon the present question.

Section 16 of Article XIII of the constitution and section 4 of the act contemplate a tax measured by "net income." California courts might follow the opinion of the United States Supreme Court in Eisner v. Macomber, that stock dividends for the purpose of income taxation are capital and not income and thus not within the contemplation of the constitutional section or statute. Although this is believed to be the better view the California courts might follow the contrary rule of Trefry v. Putnam. This problem should be definitely settled by the statute and not left to conjecture.

**Liquidating Dividends**

A somewhat similar question, due to the same ambiguity of the statute and its failure specifically to cover the point, may arise in the case of dividends which represent a distribution of capital, e.g., "liquidating" dividends and dividends from depreciation and depletion reserves. However, there should not be the same doubt on this problem regardless of whether stock dividends are or are not "income" for surely a return of capital, admitted to be such, is not income. The statute, however, should set at rest all doubts on questions of this kind.

**Suggested amendment:**

Add to Section 6:

Stock dividends or subscription rights; but gain may be derived or loss sustained by the shareholders from the sale of such stock or the sale of such rights. The amount of gain derived or loss sustained from the sale of such stock or rights or the sale of the stock or rights in

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54 (1920) 252 U.S. 189
55 (1917) 227 Mass. 522
respect to which the stock or rights are issued or the sale of the stock acquired with such rights shall be determined as provided in section 19.

See discussion of section 19 below for treatment of liquidating dividends.

Section 8:

DEDUCTIONS FROM GROSS INCOME

Salaries

The act provides that from gross income there may be deducted a reasonable allowance for salaries or other compensation for personal service actually rendered. Difficulty has been experienced in determining what constitutes a "reasonable allowance". A number of closely held corporations have avoided taxes by distributing all or practically all of the profits to officers in the form of salaries or additional compensation. It is conceivable that many more corporations may follow a similar procedure in the future.

The problem could be more adequately taken care of than at present, by an amendment based largely upon section 314, subdivision 10, of the New York Corporate Franchise Tax law as amended in 1930.56

Suggested amendment:

Amend subdivision 8 (a) to read as follows:

(a) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and rentals or other payments required to be made as a condition to the continued use or possession for business pur-

poses of the property to which the taxpayer has not taken or is not taking title or in which it has no equity; provided however that the tax imposed under this act shall not be less than it would be by applying the tax rate to a base found by using the following formula: From the sum of the entire net income and salaries and other compensation paid to all elected or appointed officers, and/or any stockholder owning in excess of five per centum of the issued capital stock of the corporation deduct as a specific exemption the sum of $5000 and any net loss for the reported year; from the sum so found, an exemption of seventy per centum thereof shall be granted and the remainder shall be used as the basis of the tax.

**Federal Income Tax**

It is questionable whether a deduction should be allowed from gross income for federal income taxes. It is difficult to see why the fact that the federal government also taxes such net income should induce the state, before levying its own tax, to deduct the amount of the federal tax from the tax base. Income taxes of other states are not allowed as a deduction. Why should the federal income tax be treated differently? If the federal government taxed real property would it be necessary or desirable to deduct the amount of the federal tax from the value of such property for the purposes of state taxation? Should the state make an allowance for the amount of the federal tax on sales of gasoline before imposing its own gasoline tax?

It is submitted that there is no rule of law that requires the legislature to make an allowance or deduction for federal taxes before it may levy its own tax on a subject that is also taxed by the federal government. It would seem that the powers of the state and nation in regard to the taxation of income from business carried on in the state are coextensive, that both assess their taxes...
according to the same measure, and that it lies simply within the discretion of either whether a deduction should be allowed for the other's taxes.

**Franchise Taxes of Other States**

Under the present wording of subdivision (c) franchise taxes of other states measured by net income are probably deductible. That subdivision provides that taxes on income or profits paid or accrued within the taxable year imposed by the authority of any state, etc., are not deductible. The theory of franchise taxes measured by net income, and this is particularly true of the California tax, is that the subject taxed is the corporate franchise and not the income or profits by which the tax is measured. For that reason such taxes do not come within the wording of section 8 (c). It is submitted that there is no greater reason for allowing a deduction for such taxes than if they were imposed in some directly upon net income.

**Suggested Amendments:**

The legislature could remove the deduction for federal income taxes by inserting the following after Section 8 (c) (1) "the government of the United States or" and by omitting the specific provisions of 8 (c) relating to the amount of deduction allowable.

The statute could easily be changed to close the loophole permitting deductions of franchise taxes measured by income by inserting in subdivision (c) between the words "on" and "income" the words, "according to or measured by".

**Depreciation**

Subdivision (f) of Section 8 now reads as follows:

Exhaustion, wear and tear and obsolescence of property to be allowed upon the basis provided in sections 113 and 114 of that certain act of the Congress of the United States known as the "Revenue Act of 1928" which is hereby referred to and incorporated with the same force and effect as though fully set forth herein, or upon the basis provided in Section 19 hereof. (Italics added).
An ambiguity arises from the use of the word "is" in this subsection. According to a strict grammatical construction the whole Revenue Act of 1928 is incorporated in the California Statute. Obviously this was not the intention of the legislature, for if it were, any of the provisions of the California Act would be rendered meaningless or superfluous and others would conflict with the provisions of the federal Act. The legislature undoubtedly intended to incorporate only Sections 113 and 114 of the federal Act. To make the grammar of the section conform to that intention the word "is" should be changed to "are".

A further problem arises whether Sections 113 and 114 are incorporated only for the purpose of determining the allowance for exhaustion, wear and tear and obsolescence or for all purposes covered by these sections. Section 113 sets forth the federal scheme for determining the gain or loss from the sale or other disposition of property. This scheme is not consistent entirely with the plan set forth in Sections 19 to 21 in the California Act for determining such gain or loss. If both plans are incorporated in the statute a hopelessly confused situation results. The Act should provide that these sections of the federal Act are incorporated only for the purpose of the subsection.

Suggested amendment:

Amend Section 3 (f) to read as follows:

(f) Exhaustion, wear and tear and obsolescence of property to be allowed upon the basis provided in Sections 113 and 114 of that certain Act of the Congress of the United States known as the "Revenue Act of 1928" which are for the purposes of this subsection hereby referred to and incorporated with the same force and effect as though fully set forth herein, or upon the basis provided in Section 19 hereof;

Provided, however, that in the case of property acquired pursuant to an exchange of the kind mentioned in Section 21 here-
of, the basis shall be as provided in that section.

**Depletion Of Oil Wells**

The act clearly discriminates against oil and gas companies since they are the only corporations clearly deprived of the opportunity of basing depletion deductions on January 1, 1928 values. It may be contended that this discrimination amounts to a denial of equal protection of the laws. In view, however, of the extensive power of the state to classify various callings, trades and businesses for purposes of taxation it is very unlikely that such contention will be upheld.

A more serious objection, perhaps, may be raised by oil and gas companies whose tax accrued prior to February 27, 1931, the effective date of the amendment. Section 4 of the act provides that taxes accrue under the act on the first day after the close of the taxable year. Corporations whose tax accrued prior to February 27, 1931, computed their tax under the provisions of the statute which allowed a deduction for depletion based on January 1, 1928 values. The tax on such corporation, it may be argued, became a determined and accrued liability before the amendment became effective and the statute cannot be applied retroactively to change it. It is submitted, however, that the retroactivity is more apparent than real. The tax is not a tax on the income earned by such corporations during the taxable year prior to February 27, 1931, but is a tax on the privilege of doing business during the succeeding taxable year. In other words, the privilege taxed is a present and continuing privilege, the amount of the tax being measured by the transactions in a prior period. The tax imposed in 1931 is not a retroactive tax but a tax for the current taxable year. It is difficult to see on what basis a taxpayer can claim that, regardless of legislative action, current taxes must be figured on the same basis on which past taxes have been assessed, or in fact on what grounds he can complain if the rates of current taxes were increased or if, indeed, additional taxes were imposed during the same year on the same subject.
Although it is believed that the 1931 amendment regarding oil and gas wells is valid it is difficult to see the justification for the discrimination against these companies. In other words why should not the same provision apply to all corporations taxable under the act? Applying the provision to all taxable corporations raises no more or different legal problems from those raised in the case of oil and gas companies. This problem will be fairly adequately taken care of it either of the suggestions made below under the discussion of Section 19 regarding a change in the basis of determining depletion and gain or loss on sale or exchange of property is adopted.
Section 12:

CHANGE OF ACCOUNTING PERIOD

The Franchise Tax Commissioner probably has authority to permit changes from one taxable year to another but the question is by no means free from doubt. It is submitted that the statute should settle the doubt and provide for returns for a period of less than twelve months resulting from a change of accounting period.

Suggested Amendment

Add the following to Section 12:

(a) If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income, shall, with the approval of the Commissioner be computed on the basis of such new accounting period subject to the following provisions.

(b) If a taxpayer, with the approval of the Commissioner, changes the basis of computing net income from fiscal year to calendar year a separate return shall be made for the period between the close of the last fiscal year for which return was made and the following December 31. If the change is from calendar year to fiscal year, a separate return shall be made for the period between the close of the last calendar year for which return was made and the date designated as the beginning of the fiscal year. If the change is from one fiscal year to another fiscal year a separate return shall be made for the period between the close of the former fiscal year and the date designated as the beginning of the new fiscal year.

(c) Where a separate return is made under paragraph (b) on account of a change in the accounting period then the income shall be computed on the basis of the
period for which separate return is made. The due date of the separate return for such period is the fifteenth day of the third month following the close of that period.

(2) If a separate return is made under paragraph (b) on account of a change in the accounting period, the net income, computed on the basis of the period for which separate return is made, shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in the period for which separate return is made. The Commissioner shall compute the amount of a tax on the income placed on such annual basis, and shall allow the offset provided for in Section 26 from such tax. The tax due under this section (which shall not be subject to offset) shall be such part of the tax (less the offset allowed) computed on such annual basis as the number of months in such period is of twelve months.

Illustration:

Suppose A Corporation reporting on a fiscal year basis, its fiscal year ending June 30, wishes, in the latter part of 1933, to change its accounting period from a fiscal to a calendar year basis. If the Commissioner approves, A will, after December 31, 1933, no longer report on a fiscal year basis but will thereafter report on a calendar year basis. As a fiscal year corporation, it will have been required to file a return within two months and fifteen days after June 30, 1933, the close of its last fiscal year, showing its net income for the period from June 30, 1932, to and including June 30, 1933, and will be required to pay a tax computed on the basis of such net income for the privilege of doing business from June 30, 1933 up to and including June 30, 1934. As a calendar year
corporation it will be required to file a return within two months and fifteen days after December 31, 1934, i.e. March 15, 1935, showing the net income for 1934, and to pay a tax computed on such net income for the privilege of doing business during the year 1935. If it were not for the separate return required by the suggested amendments, then neither as a fiscal year corporation nor as a calendar year corporation would A be required to file a return covering the six months period between the close of its last fiscal year and the beginning of its calendar year, i.e. the period between June 30, 1933 to and including December 31, 1933. Likewise, it would not be required to pay a tax for the privilege of doing business during the six months period from June 30, 1934 to and including December 31, 1934.

However, under subdivision (b) of the proposed amendment, A will be required to file a return covering the period between the close of its last fiscal year (June 30, 1933) and the beginning of its calendar year (January 1, 1934). Under subdivision (c) this return will be due on the fifteenth day of the third month following the close of the period for which the return is made (i.e. March 15, 1934). The net income for this period as disclosed by the return will be used as the basis for computing a tax under subdivision (d). This tax may be regarded as a tax for the privilege of doing business during the six months period from June 30, 1934 to and including December 31, 1934.

It would seem that the tax for this period should be half the amount of what the tax would have been for twelve months if a change in A's accounting period had not been effected. The only feasible way of determining what A's tax would have been for a twelve month period is to place the income for the period covered by the separate return on an annual basis (i.e. multiply by twelve and divide by the number of months in the period covered by the separate return, in this case six months) and then compute a tax on such income.
Provision for doing this is made in subdivision (d). Under this provision, if A in its separate return reported a net income of $20,000 then $40,000 will be used for determining the amount of a tax for a twelve month period (12 times $20,000 equals $240,000). This sum divided by six equals $40,000. Four per cent of $40,000 is $1,600. Now suppose A is entitled to an offset of $400 on account of real and personal property taxes paid during the period covered by the separate return. $400 from $1,600 leaves $1,200. To this must be added four per cent of the offset, (Section 25) resulting in a total of $1,216, which represents the amount of a tax which would have been due if computed on a twelve month income.

The tax for the period from June 30, 1934 to and including December 31, 1934 should be one-half of the above amount or $608, since there are but six months in this period. This is the amount of the tax which will be due under subdivision (d) since the tax, less the offset allowed, computed on the basis of the income for the period covered by the separate return after such income has been placed on an annual basis is $1,216 and since there are six months in the period covered by the separate return.

It is to be noted that if the tax had been computed on the basis of the income disclosed by the separate return without placing such income on an annual basis, the tax after allowance of offset, would have amounted to but $416 (4% of $20,000 equals $800, less $400, the amount of the offset, equals $400, plus 4% of the offset equals $416) or considerably less than one half of the amount of a tax for a twelve month period.

The period covered by the separate return can be regarded as a taxable year within the definition of that term set forth in Section 11. The tax disclosed by the return will be subject to revision by the Commissioner and will be payable in installments as in the case of other taxes provided for in the Act, the first installment of which will be due at the time the return is due.
on the fifteenth day of the third month following the close
of the period for which the separate return is made, and the second
installment six months later. The tax will become delinquent and
penalties will attach for non-payment of it the same as in the case
of other taxes provided for in the Act.

COMMENCING CORPORATIONS, CORPORATE
REORGANIZATIONS, DISSOLUTIONS, WITH-
DRAWALS, CESSATION OF BUSINESS.

Section 13:

Corporations Whose First Taxable Year is a Period of Less
than Twelve Months Are Not Properly Provided For

The treatment of a corporation that commences to do business
after the effective date of the statute and chooses as its first
taxable year a period less than twelve months (which will often be
the case as most corporations keep their books either on a calendar
year basis or on the basis of a fiscal year ending June 30, and few
corporations commence business on either January 1, or July 1) is
different under the 1931 amendment from under the provisions of the
1929 act.

Under the 1929 provisions of the act the tax for the succeeding
taxable year was based upon the same net income on which the tax for
the first taxable year was based, or in other words the tax for the
entire succeeding year of such a corporation was figured upon the
income of only part of a year.

Under the statute as amended in 1931, the tax for the fraction-
cal part of the year is computed in the same manner as formerly but
"the net income to be used as the measure of the tax for the second
taxable year shall be in the same proportion to the net income for
the first taxable year as the number of months in the second taxable
year bears to the number of months covered by the return for the
first taxable year" but in no case may the term "doing business" as
defined in the act be so construed as to enable a corporation to
pay a less amount than the minimum tax of $25.00, nor shall a period
during which the corporate powers have not been exercised be con-
sidered as a base for the computation of the tax.

In other words, the tax for the succeeding year is based partly upon fictitious income, i. e. upon an estimate of what the income for the whole year would have been computed upon the assumption that the income for each of the remaining corresponding fractions of the year would have been the same as the income for the fraction of the year in which the corporation actually did business. For example, suppose that during the first taxable year the corporation did business from October 1, to December 31, or one quarter of a year and that its net income for this period was $500. The estimated income for four quarters, or the whole year, is four times $500 or $2,000 which is the base upon which the tax for the second taxable year is computed.

It is obvious that this method may work unfairly upon those corporations whose income is largely seasonal. Suppose that in the example given the last quarter is primarily the only portion of the year in which income is earned. An arbitrary assumption that the corporation would have earned as much income in each of the other three quarters seems clearly unjustified.

The constitutional provision in pursuance of which the act was passed authorizes a tax according to the "net income". It is doubtful whether fictitious income is "net income" within the meaning of the constitutional provision. Furthermore, to tax some corporations according to actual net income and others by fictitious net income, it might be contended, raises a very serious question as to denial of equal protection of the law. However, since this results from the election by the corporation of its first tax date a period less than twelve months, the contention does not have much force.

Suggested Amendment

Amend the second paragraph of Section 13 to read as follows:

"A bank or corporation which commences to do business within the limits of this state after the effective date of this
not shall prepay the minimum tax hereunder which prepayment must be made before the bank or corporation files with the Secretary of State its articles of incorporation or duly certified copy thereof as the case may be. Upon the filing of its tax return within two months and fifteen days after the close of its first taxable year its tax for that year shall be adjusted upon the basis of the net income received during that taxable year, a credit being allowed for the prepayment of the minimum tax. Said return shall also, in accordance with sections 23 to 26 inclusive be the basis for the tax of said bank or corporation for its second taxable year, if its first taxable year is a period of twelve months. In every case in which the first taxable year of a bank or corporation constitutes a period of less than twelve months said bank or corporation shall pay as a prepayment of the tax for its second taxable year an amount equal to the tax (after the offset allowance has been computed) for its first taxable year, the same to be due and payable at the same time and in the same manner as if that amount were the entire amount of its tax, (after the offset allowance has been computed) for that year; and upon the filing of its tax return two months and fifteen days after the close of its second year it shall pay a tax for said year based on its net income received during that year, allowing a credit for the prepayment; but in no event shall the tax for the second taxable year be less than the amount, not subject to offset, of the prepayment for that year, and said return for its second taxable year shall also, in accordance with sections 23 to 26 inclusive be the basis for the tax of said bank or corporation for its third taxable year.

Illustration:

Suppose a corporation elects to do business in this state July 1, 1932, electing to report on a calendar year basis, its
taxable year ending December 31. It pays the minimum tax upon the commencement of business and on March 15, 1933, files a return reporting its income for the period July 1, -December 31, 1932. Suppose the tax amounted to $500 on the basis of its net income for that period; it will be given a credit for the propyment of the $25 minimum tax and will pay $475 for the privilege of having done business from July 1 - Dec. 31, 1932. The sum of $500 will be due as a propyment of the tax for the second taxable year and will be payable in installments, etc., i.e., $250 on March 15, 1933 and $250 on Sept. 15, 1933, just as if that were the total tax for that year. Suppose that the return for the second taxable year discloses a tax liability of $1000; a credit of $500.00, or the amount of the propyment, will be given, and $500 will then be due and payable. The return for the second taxable year will also be the basis for the third taxable year, in other words $1000 will be the tax for the third taxable year.

If the corporation chooses a twelve months period for its first taxable year, the income returned for such period will be the basis for the tax for both its first and second taxable years.

Refund of Tax on Dissolution or Withdrawal

The statute is very liberal in the third paragraph of Section 13 in allowing a reduction in the tax in cases where the corporation withdraws from business before the end of its fiscal year. The tax is imposed for the privilege of doing business during a particular taxable year and is not on net income but "measured by net income." The corporation pays a tax for the privilege of doing business for a twelve month period. The fact that it does not see fit to exercise its privilege for the full period is not of itself sufficient justification to apportion the tax and give a refund for the period the privilege is not exercised.

Furthermore, it is to be noted that no refund was allowed under the franchise tax formerly imposed Article XII Section 14 (c) in
case the corporation withdrew from business after the first Monday in March of any year. Likewise, corporations taxable on their gross receipts or gross premiums are given no refund if they withdraw from business after the tax date, nor does a taxpayer get a refund of property taxes when he leaves his personality out of the state shortly after the tax date. It is difficult to see why a different result should obtain in the case of corporations taxable under the Bank and Corporation Franchise Tax Act.

Suggested Amendment

If the legislature desired to remove this liberal provision the following could be inserted in the place of the third paragraph of Section 13:

‘Taxes levied under this act shall not be subject to abatement or refund because of the cessation of the business or corporate existence of any bank or corporation.

If the provision for reduction in the tax in cases where a bank or corporation dissolves or withdraws from the state during any year and the provision for offset of taxes in Sections 3, 4 and 26 are allowed to remain, a change should be made in the method of determining the tax liability for the months prior to dissolution or withdrawal.

Under the present provisions of the Act, it would seem that a bank or a corporation dissolving or withdrawing during the year would be entitled to the full offset provided in Sections 3, 4 and 26 from its tax for the months preceding such dissolution or withdrawal, notwithstanding the fact that only a portion of the net income for the previous year is used in computing said tax.

This result follows from the language of Section 26 which provides:

‘Offset for local taxes. A corporation subject to the tax herein provided for shall receive an offset against said tax, subject to the limitations provided in section

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4 hereof, for real and personal property taxes paid upon its property to any county, city and county, city, town or other political subdivision of the State during the taxable year. Every bank and banking association subject to the tax herein provided for shall receive an offset against said tax, subject to the limitations provided in section 3 hereof, for taxes paid upon its real property during the taxable year to any county, city and county, city, town, or other political subdivision of the State."

It is to be observed that the offset is allowed against the tax without regard to the section under which the tax is computed. In the case of a bank or corporation which dissolves or withdraws during any year the "tax" provided for in the Act is the tax provided for in the third paragraph of Section 13.

The full offset is undoubtedly allowed against the "tax" provided for in sections 1, 2 and 4, and, as no exception is made for a partial offset from the "tax" provided for in section 13, the full offset granted by Section 26 must be allowed from this "tax" also.

The following example will illustrate how the present system operates. Suppose a corporation has a net income during one taxable year of $100,000 and dissolves six months after the close of said taxable year. The tax for the six months prior to dissolution is computed by taking one half of $100,000, that is $50,000 and multiplying this amount by 4%, the amount thus obtained being $2,000.

Suppose further that the corporation has an offset allowance of $1,500 for real and personal property taxes paid in the preceding year. The full amount of such allowance under the terms of the act is offset from the $2,000 calculated above. The result is that the corporation's tax for half a year is but $500 plus 4% of the offset (last paragraph of section 26) or $560 whereas if it had exercised its corporate franchise during the entire year, its tax would have been $2,500 plus 4% of the offset, $100,000 x 4% or $4,000 less $1,500 plus 4% thereof or $2,560. Thus, for exercising its corporate franchise for half a year, the corporation pays approximately only 1/5 of the amount it would have paid had it exercised its franchise during the entire year.
It would seem reasonable that for the months prior to dissolution or withdrawal, a bank or corporation should pay a tax at least in an amount not less than that proportion of the tax it would have paid had it exercised its franchise during the entire year which the number of months prior to dissolution or withdrawal bears to the entire year. To meet this condition the corporation in the example above would have had to pay one half of $2,560 or $1,280 rather than $560.

**Suggested Amendment.**

If the suggestions heretofore made with regard to the treatment of banks and corporations that dissolve or withdraw during any year are not followed, the third paragraph of section 13 should be amended to read as follows:

Any bank or corporation which is dissolved and any foreign corporation which withdraws from the State during any year shall pay a tax hereunder for the months of its fiscal year which precede such dissolution or withdrawal, according to or measured by such proportionate part of the net income of the preceding taxable year as the number of months of the year prior to such dissolution or withdrawal bears to the number of months of the preceding taxable year. Provided, however, that in the case of any bank or corporation which is dissolved, or which withdraws from the State during any year, the offset from the tax for the months prior to such dissolution or withdrawal shall not exceed that proportion of the offset computed under section 26 which the number of still months prior to such dissolution or withdrawal bears to the number of months of the preceding taxable year. In any event, each such corporation shall pay a minimum tax not subject to offset of $25 for such period.
Corporate Reorganizations, Consolidations and Mergers

The present provisions of section 13 relating to the computation of the taxes of banks or corporations which dissolve or withdraw from the state or which commence to do business in the state make no exception in the case of corporate reorganizations, consolidations or mergers. Hence, simply because of a change in the corporate structure by which a business is operated, the taxes due the state for the privilege of operating that business in a corporate form will vary in amount from what they would have been had such change not occurred.

For example, suppose "A", a corporation reporting on a calendar year basis, operates a business which yields a net income of $500,000 in 1932, and a net income of $200,000 in 1933, half, or $100,000, of which is produced in the last six months of 1933. Its tax for the year 1933 computed at the rate of 4% of the net income for the year 1932 will be $20,000. Its tax for the year 1934 computed at the same rate on the basis of the net income for the year 1933 will be $8,000. Its total tax for the years 1933 and 1934 will be $28,000.

Now suppose a reorganization occurs in 1933 pursuant to which "A" dissolves or withdraws from the state, and "B" corporation is organized and takes over the business on June 30, 1933. "A's" tax for the first six months of the year 1933, computed at the rate of 4% of that proportion of the "net income of the preceding taxable year as the number of months of the year prior to such dissolution or withdrawal bears to the entire preceding taxable year" will be $10,000. If "B" reports on a calendar year basis, its tax for its first taxable year, i.e., the last six months of 1933, computed at the rate of 4% of the net income for said year, i.e., $100,000, will be $4,000. Its tax for its second taxable year, i.e., 1934, computed at the rate of 4% of "net income" which is in the "same proportion to the net income for the first taxable year as the
number of months in the second taxable year bears to the number of
months covered by the return for the first taxable year" will be
$8,000. Thus the total tax for the years 1933 and 1934 will be but
$22,000 as compared to $28,000; the amount it would have been, had
a reorganization not been effected in 1933.

Now suppose the business yields a net income of $200,000 in
the year 1932, and a net income of $500,000 in the year 1933,
half or $250,000 of which is produced in the last six months of
1933. If "A" is not reorganized, its tax will be $8,000 for the
year 1933, and $20,000 for the year 1934, or a total of $28,000
for the two years. If, however, a reorganization similar to the
one mentioned in the above example occurs, "A"'s tax for the first
six months of 1933 will be $4,000, "B"'s tax for the last six
months of 1933 will be $10,000, and for the year 1934 will be
$20,000. In other words, the tax for the two years 1933 and 1934
will be $34,000 or $6,000 greater than it would have been had no
reorganization occurred.

In case of a consolidation of two or more corporations pur-
suant to which the consolidating corporations dissolve or withdraw
from the state and a new consolidated corporation comes into exis-
tence, the taxes of the consolidating corporations for the months
of the year prior to dissolution or withdrawal will be computed in
the same manner as the tax of a corporation which dissolves or
withdraws from the state pursuant to a reorganization is computed
for the months of the year prior to dissolution or withdrawal.
Likewise, the taxes of the consolidated corporation for its first
and second taxable years will be computed in the same manner as
the taxes of a corporation which comes into existence pursuant to
a reorganization are computed for its first and second taxable
years. Hence, a similar variation in taxes will result in case of
a consolidation as will result in case of a reorganization.
Where a corporation merges with an existing corporation and thereinupon dissolves or withdraws from the state, its tax for the months of the year prior to dissolution or withdrawal will be measured by a portion only of the net income of the preceding taxable year. The balance of the net income for the preceding year, and the entire net income for the months of the year prior to dissolution or withdrawal will not be used as a measure of any franchise tax. The surviving corporation's tax for the taxable year in which the merger occurs will be measured only by the net income of the taxable year preceding the year in which the merger occurs, which obviously will not include any of the net income of the business of the merged corporation. Its tax for the taxable year succeeding the year in which the merger occurs will be measured by the net income of the year in which the merger occurs, including the net income of the business of the merged corporation for such year which is earned subsequent to the merger. But even if the merger had not occurred, this income would have been used as a measure of a tax either on the surviving corporation or on the merged corporation. Consequently, whenever a merger occurs, the taxes due the state will be less, because of the merger, than they would have been had the merger not occurred.

**Suggested Amendment**

It is submitted that the taxes due the state for the privilege of operating a business under corporate form should not vary because of a change by way of reorganization, consolidation, or merger in the corporate structure by which that business is operated, but should be measured by the same income had a reorganization, consolidation or merger not occurred. If the recommendation heretofore made to the effect that taxes levied under the act should not be subject to abatement or refund because of the cessation of business or corporate existence of any bank or corporation during any taxable year is followed, this result can be effected by adding to the

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seconde paragraph of Section 13, whether or not it is rendered as here-
before recommended, the following provision:

This paragraph shall not apply to a bank or corpora-
tion which continues to do business in this state pursuant
to a reorganization or pursuant to a consolidation of two
or more banks or corporations,
and by inserting the following between the second and third para-
graphs of Section 13.

Where a bank or corporation continues to do business
in this state pursuant to a reorganization of a bank or
corporation it shall pay no tax for its first taxable year,
but its tax for its second taxable year shall be computed
upon the basis of its net income for its first taxable year,
and the net income of the reorganized bank or corporation
for the months of the taxable year prior to the reorganiza-
tion. Every such bank or corporation in its return filed
for its first taxable year shall specify all such facts
with respect to the reorganized bank or corporation for
the months of its taxable year prior to the reorganiza-
tion as the commissioner may require in order to carry out the
provisions of this paragraph. The term 'reorganization'
as herein used shall include (1) a transfer by a corpora-
tion of all or a part of its assets to another corporation
if immediately after the transfer the transferor or its
stockholders or both are in control of the corporation to
which the assets are transferred; or (2) a recapitaliza-
tion; or (3) a mere change in identity, form or place of
organization, however effected.

Where a bank or corporation continues to do busi-
ness in this state pursuant to a consolidation of two,
or more banks or corporations, it shall pay no tax for its
first taxable year, but its tax for its second taxable year
shall be computed upon the basis of its net income for its first taxable year and the net income of the consolidated banks or corporations for the months of their taxable years prior to the consolidation. Every such bank or corporation in its return filed for its first taxable year shall specify all such facts with respect to the consolidated banks or corporations for the months of their taxable years prior to the consolidation as the commissioner may require in order to carry out the provisions of this paragraph.

Where a bank or corporation, or two or more banks or corporations, merge with another bank or corporation, the tax of the surviving bank or corporation for its taxable year succeeding its taxable year in which the merger occurs shall be computed upon the basis of its net income for its preceding taxable year and the net income of the merged banks or corporations for the months of their taxable years prior to the merger. Every such surviving bank or corporation in its return for its taxable year in which the merger occurs, shall specify all such facts with respect to the merged banks or corporations for the months of their taxable years prior to the merger as the commissioner may require in order to carry out the provisions of this paragraph.

In order to insure that the same amount of offset will be allowed in the case of a reorganization, consolidation or merger as would have been allowed if a reorganization, consolidation or merger had not occurred, the following provision should be adopted, if offsets are limited to financial corporations.

The tax for the second taxable year of a bank or corporation doing business in this state pursuant to a reorganization or consolidation, and the tax of a surviving bank or
corporation in case of a merger for its first taxable year succeeding the merger, shall, in addition to any other offset allowed by this Act, be subject to offset in the amount of real and personal property taxes paid by such of the reorganized, consolidated, or merged banks or corporations as are financial corporations upon their property to any county, city and county, city, town or other political subdivision of the state during the taxable year in which the reorganization, consolidation or merger occurred; provided, however, that the offset herein provided for shall be allowed subject to the conditions and limitations set forth in sections three, four and twenty-six of this act.

Instead of the above provision, the following provision should be adopted if offsets are not limited to financial corporations:

The tax for the second taxable year of a bank or corporation doing business in this state pursuant to a reorganization or consolidation, and the tax of a surviving bank or corporation in case of a merger for its first taxable year succeeding the merger, shall, in addition to any other offset allowed by this act, be subject to offset in the amount of real and personal property taxes paid by each of the reorganized, consolidated, or merged banks or corporations, as the case may be, upon its property to any county, city and county, city, town or other political subdivision of the state during the taxable year in which the reorganization, consolidation or merger occurred; provided, however, that the offset herein provided for shall be allowed subject to the conditions and limitations set forth in sections three, four and twenty-six of this act.
Explanation:

The following examples may be helpful in understanding how the above recommendation would operate, provided, of course, that the recommendation heretofore made with respect to the abatement or refund of taxes in case of the cessation of business or corporate existence of any bank or corporation during any taxable year is adopted.

(1) Suppose "A" Corporation reporting on a calendar year basis has $500,000 net income for 1932 and $200,000 net income for 1933, half or $100,000 of which is earned in the first six months of 1933. Its tax for 1933 calculated on the basis of its net income for 1932 will be $20,000. Its tax for 1934 computed on the basis of its net income for 1933 will be $8,000. Now suppose a reorganization occurs on June 30, 1933, pursuant to which "X" corporation is organized and all of the assets of "A" are transferred to "X". Even though "A" ceases doing business in the state or dissolves or withdraws from the state during the year 1933 its tax for 1933 will not be subject to abatement or refund. Consequently its tax for 1933 will be $20,000. "X" will not pay any tax for its first taxable year, but its tax for its second taxable year, the year 1934, if it reports on a calendar year basis, will be measured by its net income for the first taxable year, $100,000, and also by the $100,000 net income of "A" for the months of the year 1933 prior to the reorganization. Its tax for the year 1934 so computed will be $3,000. Thus the taxes of the two corporations for the two years 1933 and 1934 will be $28,000, the amount "A"'s taxes would have been had the reorganization not occurred.

(2) Suppose "B" Corporation reporting on a calendar year basis, has a net income of $200,000 for 1932, and a net income of $400,000 for 1933, half of $200,000 of which is earned during the first six months of 1933. "B"'s tax for 1933 will be $8,000, (4% of $200,000 the income earned during 1932) and for 1934 will be $16,000 (4% of
the income earned during 1933. Suppose "A" in example (1) above, consolidates with "B" on June 30, 1933, forming "Y" Corporation, and thereupon A and B dissolve or withdraw from the state prior to the close of the year 1933. The taxes of "A" and "B" for the year 1933 will be the same as they would have been had the consolidation not occurred, i.e., $20,000 and $8,000 respectively, or a total of $28,000. "Y" will pay no tax for its first taxable year, but its tax for its second taxable year, the year 1934, if it reports on a calendar year basis, will be measured by its not income for the first taxable year in the amount of $300,000 ($100,000 from "A"'s business for the last six months of 1933 and $200,000 from "B"'s business for the last six months of 1933) and also by the $100,000 not income of "A" and the $200,000 not income of "B" for the months of the year 1933 prior to the consolidation or $600,000 in all. Thus, its taxes for the year 1934 will be $24,000. The total of the taxes of the three corporations for the two years 1933 and 1934 will be $52,000. The taxes of "A" and "B" for the two years also would have been $52,000 if the consolidation had not occurred. ($28,000, A's taxes plus $24,000, B's taxes).

(3) Suppose "A" merges into "B" on June 30, 1933 instead of consolidating with "B" and thereupon dissolves or withdraws from the state prior to the close of the year 1933. "A"'s tax for the year 1933 will be $20,000, and "B"'s tax for the year 1933 will be $8,000. "B"'s tax for the year 1934 will be measured by its not income for the preceding year which will amount to $500,000 ($100,000 of which is attributable to the business of "A" for the last six months of the year 1933, and $400,000 of which represents the amount of not income "B" would have earned during the year 1933 had the merger not occurred) and also by the $100,000 not income of "A" for the months of the year 1933 prior to the merger. As so measured, its tax for the year 1934 will amount to $24,000. Thus the taxes of the two corporations for the two years 1933 and 1934 will amount to $52,000,
which is the same amount they would have been had the merger not occurred.

If the recommendation heretofore made with respect to the abatement or refund of taxes in case of the cessation of business or corporate existence of any bank or corporation during any taxable year is not followed, then the following should be added to the first sentence of the third paragraph of section 13:

Provided, however, that the taxes levied under this Act shall not be subject to abatement or refund because of the cessation of business or corporate existence of any bank or corporation pursuant to a reorganization, consolidation, or merger.

Tax on Resumption of Operations

The fourth paragraph of Section 13 provides that if any bank or corporation discontinues actual operations within the state in any year and thereafter has no net income but does not dissolve or withdraw from the state, it shall in the succeeding year and thereafter until dissolution, withdrawal or resumption of operations pay an annual tax to the state of $25.

Apparently, it was the purpose of this paragraph to mollify the effect of the statutory definition of "doing business" as amended in 1931, to include the "right to do business". Prior to the 1931 amendment to the definition of doing business, if a bank or corporation discontinued actual operations in any year and did not resume operations thereafter, it paid no tax for the year succeeding such discontinuance, regardless of whether it dissolved or withdrew from the state, and regardless of whether it realized a net income in the year in which it discontinued operations, for the reason that as it did not do business during such succeeding year, it was no longer taxable under the act. For example, suppose a corporation did business from January 1, 1929 to November 31, 1929, and then discontinued all operations. Suppose further that during this period,
it received, let us say, a net income of $100,000. No return of this income was required.

Since the 1931 amendment defining doing business to include the right to do business, a corporation that discontinues business during a year and does not dissolve during that year remains subject to the Act and is required to file a return for that year and for all succeeding years until it is dissolved. For example, a corporation engages in business transactions from January 1, 1932 to November 31, 1932, at which time it discontinues actual operations. During this period it receives $100,000 net income. If the corporation does not dissolve during the year 1932, it must make a return in 1933 of the $100,000 earned during the year 1932, and, unless a different result is required by the fourth paragraph of section 13, it will have to pay a tax for the year 1933 based on the $100,000 earned during the year 1932 for the privilege of "doing business" in the statutory sense during the year 1933 even though its place of business is closed down, all of its employees discharged, and no business transactions of any kind entered into.

Apparently, it was the purpose of the fourth paragraph of Section 13 to require only a $25 tax from this kind of bank or corporation and to exempt it from a tax computed on the basis of the net income received during the year 1932. If this was the purpose of the provision, that purpose is not adequately provided for in view of the language used. To obtain the benefit of the exemption certain conditions are prescribed: (1) The bank or corporation must discontinue operations; (2) it must thereafter have no net income; (3) it must not dissolve or withdraw from the state.

In other words, if after such discontinuance, it receives some net income no matter how small the amount thereof may be, or if it dissolves in the year succeeding such discontinuance of operations, a tax based on the preceding year's income must be paid. It is difficult to see any reason why the presence of these facts should sub-
ject the bank or corporation to a greater tax than would be exacted if no net income were thereafter received, or if it did not dissolve or withdraw.

Although it is probable that the fourth paragraph of Section 13 was designed to require simply a $25 tax from banks or corporations for the year succeeding the year in which they discontinue actual operations rather than a tax measured by the net income of the preceding year, it has the effect of requiring a $25 tax from banks or corporations for each of the years intervening between the year in which they discontinue actual operations and the year in which they either dissolve or withdraw from the state or resume operations. Insofar as this paragraph operates to require a $25 tax in cases where a bank or corporation does not have any net income it is subject to various objections.

As applied to foreign corporations this provision is of doubtful constitutionality. The case of People v. Alaska Pacific S. S. Co., 57 held that a foreign corporation not doing business here was not subject to taxation on its corporate franchise under subdivision (d) of section 14 of Article XIII of the Constitution, although it had the right to do business here. Taxability under subdivision (d) of Section 14 is a condition necessary to taxability under section 16 of Article XIII of the Constitution. It is true that under the 1931 amendment to the definition of doing business, a corporation having the right to do business in this state is to be considered as doing business here, but it is questionable whether the Legislature can avoid the effect of the rule of People v. Alaska Pacific S. S. Co. under the guise of defining terms.

As applied to banks this provision is probably not constitutional because not in pursuance of the constitutional provision

57 (1920) 182 Cal. 262.
(Section 16 of Article XIII of the state constitution) under which the act was passed which makes no provision for a minimum tax with regard to banks but which contemplates a tax on banks according to or measured by net income. A minimum tax when there is no net income obviously would not be measured by net income. Furthermore, as applied to national banks it is probably unconstitutional for a similar reason because not in pursuance of the provisions of Section 5219 of the Revised Statutes of the United States that such banks may be taxed "according to or measured by their net income".

It may be argued that although this provision is unconstitutional with respect to national banks it is valid as regards state banks under paragraph 1 (b) of Section 16 of Article XIII which gives the legislature power to provide for a tax on banks in lieu of a tax measured by net income. The answer to this argument, however, is contained in the proviso to paragraph 1 (b) that "such form of taxation shall apply to all banks located within the limits of this state". In other words, a minimum tax to be valid under paragraph 1 (b) must apply to all banks in the state. It cannot apply to national banks in view of the restrictions in Section 5219, consequently it cannot apply to state banks.

Furthermore, it should be observed that if a bank continues operations and has some net income, although not in an amount sufficient to give rise to a tax of $25, the paragraph of section 13 here discussed would not be applicable for the reason that it applies only if the bank or corporation "discontinues actual operation" and "thereafter has no net income". It is rather difficult to explain why a bank that discontinues operations and has no net income should pay a greater tax than a bank that continues operations and has net income.

Insofar as domestic corporations are concerned, it would seem that this paragraph of section 13 is superfluous since corporations are subjected to a minimum tax of $25 per year under...
Section 4 of the Act.

Furthermore, if a corporation resumes operations in some subsequent year, its tax for the year in which it resumes operations will be but $25 (unless, of course, despite the fact that it did no business during the preceding year it received a net income in the preceding year in an amount sufficient to give rise to a greater tax that $25). Thus, a corporation which discontinues operations in one year and which resumes operations after an interval of an entire taxable year or more, will be required to pay a tax of but $25 for the year in which it resumes operations although it may earn a large net income during such year and although it paid no tax measured by the income for the year in which it discontinued operations. For example, suppose "A" corporation, reporting on a calendar year basis, earns a net income of $100,000 in 1932 and discontinues operations on November 1, 1932, but does not dissolve or withdraw from the state. Under the fourth paragraph of Section 13, its tax for 1933 will be $25, provided it does not have any net income during 1933 and provided it does not dissolve or withdraw from the state and does not resume operations during 1933. Suppose "A" resumes operations on January 1, 1934 and earns a net income during 1934 of $100,000. Under the present provisions of the Act, "A"'s tax for 1934 is to be measured by its net income for 1933. Since "A" had no net income in 1933, the provision in Section 4 for a minimum tax will apply and "A"'s tax for 1934 will be but $25. It is to be noticed that if "A" had commenced doing business in this state for the first time in 1934 instead of resuming operations, its tax for its first taxable year would have been measured by the income earned during such year (second paragraph of Section 13) and as so measured would have amounted to $4,000 (4% of $100,000).

It is suggested that when a corporation discontinues operation in one year and is not in the succeeding year subjected to a tax
measured by the income of the year in which it discontinued operations, its tax for the year in which it resumes operations should be measured by the net income of the year in which it discontinued operations.

Suggested Amendment

If the amendment to the definition of "doing business", suggested above, is adopted, substitute the following for the fourth paragraph of Section 13:

When a bank or corporation discontinues business during any fiscal or calendar year, as the case may be, and does not dissolve or withdraw from the state during that year and does not resume doing business during the succeeding fiscal or calendar year its tax for the year in which it resumes doing business shall be computed upon the basis of the net income for the year in which it discontinued doing business. Said tax shall be immediately due and payable when said bank or corporation resumes doing business.

If the present definition of "doing business" is retained, amend the fourth paragraph of section 13 to read as follows:

When a bank or corporation discontinues operations during any fiscal or calendar year, as the case may be, and does not dissolve or withdraw from the state during that year and does not resume operations during the succeeding fiscal or calendar year, its tax for the succeeding fiscal or calendar year shall not exceed the sum of twenty-five dollars. When such bank or corporation resumes operations it shall pay a tax, in addition to any other tax required under this act, for the year in which it resumes operations computed on the basis
of the net income for the year in which it dis-
continued operations. Said tax shall be immed-
istically due and payable when said bank or
corporation resumes operations.
Section 14.

CONSOLIDATED RETURNS

The Consolidated Returns Provision is Ambiguous and Probably Invalid.

The apparent purpose of permitting consolidated returns is to tax as a business unit what in reality is a business unit. The California statute, however, is seriously defective in not clearly providing for the computation of the tax in case consolidated returns are filed.

Sections 1, 2 and 4 of the act specifically provide that "every" bank and "every" taxable corporation shall pay a tax according to or measured by "its" net income. Section 13 sets forth the method of computing the tax on corporations commencing to do business in the state after the effective date of the act and choosing as a taxable year a period less than twelve months.

Section 14 provides that in the case of a bank or corporation which is a member of the affiliated group for a fractional part of the year the consolidated return shall include the income of such bank or corporation for such part of the year as it is a member of the affiliated group.

If a corporation commences business as a member of the affiliated group and also commences business during a fractional part of the taxable year of the group will it escape taxation for its first taxable year? Will its tax be computed according to Section 13 without regard to the net income of the affiliated group or will that section be superseded and the new corporation's income and losses be merged in the income and losses of the old members of the group including losses incurred before the new member joined the group and its tax for its first taxable year incorporated in the tax on the group as a unit with the result that in some instances it will pay no tax in excess of the minimum although it realized a considerable income during its first taxable year whereas in
other instances it will pay tax considerably in excess of the minimum although it sustained a loss during its first taxable year? Will losses incurred by some of the corporations before the new corporation joined the group offset the income of the new member?

Section 14 simply permits the filing of consolidated returns but omits to provide for computing the tax when such returns are filed. Such failure, it may be argued, leaves Sections 1, 2, 4 and 13 in full force and effect so that although consolidated returns are filed the tax is nevertheless to be computed upon the net income of each corporation in compliance with those sections. In other words by failing to provide that the tax shall be computed upon the consolidated net income of the group the provisions for consolidated returns is rendered meaningless and it would seem the property tax offsets and losses of one corporation may not offset the net income or reduce the tax on the other corporations.

It may be contended that the words "consolidated returns" as used in Section 14 necessarily involve consolidating the net income and taxing such income as a unit as if the affiliated group were a single corporation. Some support for this contention may be found in Section 26 of the act which states that,

"Where a consolidated return has been made under Section 14 hereof the offset allowable against the tax liability of the consolidated group may include said property taxes paid during said period by all corporations which are included in the consolidated group subject to the limitations of Section 4 hereof."

But if this contention is sound other difficulties must be met. Upon whom is the tax assessed when consolidated returns are filed? Is it assessed against the parent corporation, against each corporation in proportion to the net income properly assignable to each, is the tax apportioned among the corporations as directed by the parent corporation or as they may agree among themselves or are the members severally liable for the tax assessed upon the group? Sections 1, 2, 4, and 13, perhaps afford the only direct answers to these questions.
Is the parent corporation the only one liable for the tax and is it the only one that may be sued, does the lion apply only to its property and is it the only one subject to the suspension provision of Section 32? The act fails specifically to answer these questions.

Even if it be determined that the statute authorizes the computation of the tax on the consolidated net income of the group, thereby permitting the losses and property tax offsets of one corporation to offset the net income and reduce the tax of other corporations, a very serious constitutional question must be met. The constitutional section in pursuance of which the act was passed makes no provision for consolidated returns but provides that taxable corporations shall be taxed according to or measured by "their net income." Corporations that are allowed to offset their net income by the losses of other corporations are obviously not being taxed according to "their net income." If it be held that the statute does not impose the tax set forth in the constitutional section the problem will then arise whether levying such a tax is providing by law for another method of taxing franchises "authorized in this constitution" according to paragraph 2b of Section 16 or is within the legislative authority independently of that section.

The Consolidated Returns Provision is Probably Invalid as Applied to National Banks

If Section 14 permits affiliated groups to be taxed as if they were a single corporation, an interesting problem is presented by the 1931 amendment to that section withdrawing the right of banks to file a consolidated return with non-banking corporate members of the affiliation. The effect of the amendment is to prevent banks from writing off against their net income the losses of their non-banking corporate associates, from eliminating intercompany profits through consolidated returns, and from reducing their taxes by the offsets of local taxes paid by such associates.
Section 5219 of the United States Revised Statutes provides that the rate of tax on national banks "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 word "rate" as used in Section 5219 under the share method of taxation authorized thereby has been held to apply not only to the arithmetical measure or percentage of tax but also the basis of assessment, discrimination as to either being a violation of that section. There is no reason to doubt that the same interpretation will be given the word "rate" as used in the income tax methods authorized by that section. Inasmuch as not only other financial corporations but in fact all taxable corporations other than banks are allowed deductions and offsets not allowed national banks, there seems to be a clear violation of the conditions of the federal statute.

Section 5219 also presents another question if the consolidated returns provision is interpreted to permit losses of members of the banking group to offset income of other members and to permit the real property tax offsets of members to reduce the tax on other members, Section 5219 authorizes a tax on national banks according to or measured by "their" net income. If national banks are permitted to offset their net income by losses of other banks, national or state, or to reduce their tax by the real property tax offsets of other banks a plausible argument can be made that they are not being taxed according to or measured by "their" net income and that the provisions of Section 5219 are being violated.

Desirability of Consolidated Returns

The act imposes a franchise tax on the privilege of going business as a corporation. Yet some corporations may avoid entirely or greatly reduce the tax on their franchise if they are permit-
ted to offset losses and deductions of other corporations. This privilege consequently reduces to a great extent the revenue which would otherwise be obtained under the act. Consolidated returns may perhaps be justified under a direct net income tax but it is difficult to see their place under a franchise tax imposed for the privilege of doing business as a corporation. The consolidated returns provision encourages the multiplication of corporations and the segregation or separate incorporation of activities which would normally be carried on as branches of one concern. If a corporation or the group in control thereof wish to avail themselves of the privilege of incorporating the various departments of their business why should they not pay the price for such privilege?

Corporations Commencing Business as Members of a Consolidated Group

Notwithstanding the provision for a consolidated return, it would seem that Section 13 should be followed insofar as it relates to the computation of the tax for the first taxable year of a corporation commencing to do business in the state after the effective date of the act, inasmuch as the tax for the first taxable year is to be computed upon the basis of the income earned during that year, whereas all the other taxes provided for in the act are to be computed upon the basis of a preceding year's income. But if Section 13 is to be followed in computing the tax for the first taxable year, why should it not be followed in computing the tax for the second taxable year? Furthermore, if the net income of an affiliated group as shown by a consolidated return can be disregarded in one instance and the tax of one of the members of the group computed in accordance with other provisions of the act, it would seem that the same procedure should be followed in all instances.

Suggested Amendment

If the Legislature desires to continue to allow the privilege of filing consolidated returns it is recommended that the following,
for purposes of clarity and definiteness, be added to Section 14:

If a consolidated return is made subject to the provisions of this section the tax imposed under this act shall be computed as a unit upon the consolidated net income of the group. Except as hereinafter provided the parent corporation and each subsidiary, a member of the group during any part of a consolidated period shall be severally liable for the tax (including any deficiency in respect thereof) computed upon the consolidated net income of the group. If a subsidiary by reason of a bona fide sale of stock for fair value has ceased to be a member of the affiliated group its liability shall remain unchanged, except that if such cessation occurred prior to the date upon which any such deficiency is assessed such deficiency in the case of such former subsidiary shall be reduced to an amount equal to such part as may be allocable to it upon the basis of the consolidated net income properly assignable to it. In no case, however, shall any demand for the payment of any deficiency be made, or any proceeding in court for the collection thereof be begun against such former subsidiary prior to the determination by the commissioner that the amount of the deficiency cannot be collected from the parent corporation and the corporations (if any) remaining members of the affiliated group.

Where a member of an affiliated group filing a consolidated return is a bank or corporation commencing to do business in this state for the first time after the effective date of this act, its tax for its first and second taxable years shall be computed without regard to this section but in accordance with the provisions of Section 13 of this act.
The commissioner shall prescribe such regulations as he may deem necessary in order that the tax liability of an affiliated group of corporations making a consolidated return and of each corporation in the group during, before and after the period of affiliation may be determined, computed, assessed, collected, and adjusted in such manner as clearly to reflect the income and to prevent avoidance of tax liability.

Corporations Owned by "Same Interests"

Corporations are allowed to make consolidated returns in cases that would not be allowed under the federal act, namely, in cases in which "at least ninety-five per centum of the stock of each of the banks in the banking group, or of each of the corporations in the corporate group is owned by the same interests or by the same stockholders." The former federal revenue acts contained a provision corresponding to the one just quoted but so many difficult and complicated problems arose thereunder that beginning with the taxable year 1929 it was abolished. If it was too complicated for the federal government it is probably too complicated for California and should be abolished in this state. The fewer the departures from the federal practice the fewer are the adjustments that have to be made in the administration of the state tax.

Suggested Amendment

Repeal the following sentence toward the close of the second paragraph of Section 14:

"or if at least ninety-five per centum of the stock of each of the banks in the banking group, or of each of the corporations in the corporate group is owned by the same interests or by the same stockholders."
Under Section 19 the basis of property acquired on or after January 1, 1928, is the cost or inventory value thereof, and the basis of property acquired prior to January 1, 1928, and disposed of thereafter is the fair market value as of January 1, 1928.

Inclusion Of Items As Gain Where There Has Been No Gain

An interesting problem is presented by the Californian statute in instances in which the original cost of the property, less depreciation actually sustained before January 1, 1928, is greater than its January 1, 1928, value and greater than the selling price, but the January 1, 1928, value is less than the selling price. The difference between the January 1, 1928, value and the selling price represents a gain for that period, although on the transaction as a whole there is no gain but in fact a loss. To include this difference between the January 1, 1928, value and the selling price in the tax base as gain or income when as a matter of fact no gain or income was realized on the investment seems unjust. Section 16 of Article XIII, in pursuance of which the statute was passed, and Section 4 of the statute, contemplate a tax measured by "net income".

These constitutional and statutory provisions may be interpreted to modify Section 19 of the statute and prevent the inclusion of items in the measure of the tax which really do not represent income. The Supreme Court of the United States was confronted with substantially an identical problem arising under the Federal Revenue Act of 1918. That act contained a provision corresponding to Section 19 of the Californian act, to the effect that the basis for the determination of gain or loss of property acquired before March 1, 1913, was "the fair market price or value of such property as of March first, nineteen hundred and thirteen". In Goodrich v. Edwards the taxpayer acquired property in 1912, having a value of $291,600.

58 (1921) 255 U.S. 257
Its March 1, 1913, value was $148,635.50. It was sold in 1916 for $269,346.25, obviously at a loss to its owner. The court held that although the selling price was greater than the March 1, 1913, value there was no taxable gain to the taxpayer. After stating that the act provided that net income should include "gains, profits and income," and after quoting the definition of "income" approved by the court in *Eisner v. Johnson*, the court declared:

"It is thus very plain that the statute imposes the income tax on the proceeds of the sale of personal property to the extent only that gains are derived therefrom by the vendor, and we therefore agree with the solicitor general that since no gain was realized on this investment by the plaintiff in error no tax should have been assessed against him."

**Deductions Allowed As Losses When There Has Been No Loss**

Just as the statute, using as it does without exception January 1, 1928, as the basic date, raises a question regarding the inclusion of items as gains when there has actually been no gain, so also it raises a question regarding the deduction of losses when there has actually been no loss. If the selling price was less than the January 1, 1928, value but equal to or greater than the cost, the difference between the January 1, 1928, value and the selling price would represent a loss for that period, but on the transaction as a whole there would be no loss, and in fact if the selling price were greater than cost there would actually be a gain, which accrued, however, prior to January 1, 1928. The Supreme Court of the United States was also presented with this problem. In *United States v. Flannery*, *61* James Flannery bought, prior to March 1, 1915, certain

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59 (1920) 258 U.S. 169, 207
60 *Welsh v. Decker* (1921) 255 U.S. 536, in which the sale price exceeded both the cost and the 1913 value, but the 1913 value was less than the cost, but the court approved of a tax only on the actual gain.
61 (1925) 268 U.S. 95
corporate stock for less than $95,175. Its market value on March 1, 1913, was $116,325 and he sold it in 1919 for $95,175, that is, for more than cost. Flannery died in March 1920, and his executors in returning his income for the year 1919 deducted as a loss the difference between the sale price and the March 1, 1913, value. The Supreme Court upheld the commissioner of internal revenue in disallowing the loss claimed. The 1918 Federal Revenue Act, which was applicable to this situation, contained substantially the same basic date clause as the 1916 act quoted above. In the course of its opinion the court said:

"It is clear, in the first place, that the provisions of the act in reference to the gains derived and the losses sustained from the sale of property acquired before March 1, 1913, were correlative and that whatever effect was intended to be given to the market value of property on that date in determining taxable gains, a corresponding effect was intended to be given to such market value in determining deductible losses. This conclusion is unavoidable under the specific language of Section 202 (a) establishing one and the same basis for ascertaining both gains and losses."

And further on, after referring to Goodrich v. Edwards and Walsh v. Brewster, the court continued:

"So we think it should be held that the Act of 1918 imposed a tax and allowed a deduction to the extent only that an actual gain was derived or an actual loss sustained from the investment, and the provision in reference to the market value on March 1, 1913, was applicable only where there was such an actual gain or loss, that is, that this provision was merely a limitation upon the amount of the actual gain or loss that would otherwise have been taxable or deductible."

These cases seem to stand for the proposition that if there is a gain after February 28, 1913, it will be taxable only to the extent that it represents actual gain over the whole transaction; and if there is a loss after February 28, 1913, that portion thereof which represents actual loss over the whole transaction will be deductible.

If California should follow these cases in interpreting the basic date provision of the California statute the results reached would be just but the plain meaning of Section 19 of the statute would be altered. So far as that section is concerned nothing is said
about actual gains or actual losses and it is arguable whether the
court should add such precepts to the statute, particularly in view
of the theory that the statute and constitutional section do not pur-
purt to impose a tax on actual net income but impose a tax on cor-
porate franchises "measured by" the net income of fixed accounting
periods. If California follows the case just cited, and an item
represents net income within the fixed accounting period, it will be
included in the base regardless of whether or not there was actually
a loss rather than a gain on the particular transaction. If that be
true there should be no great objection to equating gain or loss
on the sale of capital on the basis of a fixed period (January 1,
1928, to date of sale) regardless of actual gain or actual loss.

It is submitted that if the January 1, 1928, basis date is re-
tained, the fairest rule in this situation, from the standpoint of
both the state and the taxpayer, would provide that if there is a
gain after January 1, 1928 the taxability of that gain will be
limited to the portion of the gain which represents actual gain
accruing to the taxpayer over the whole transaction beginning with
the purchase of the property; and if there is a loss after January
1, 1928, that portion of such loss will be deductible which
represents actual loss sustained over the whole transaction.

Suggested amendment if January 1, 1928 basic date is retained:

Amend Section 19 to read as follows:

"For the purpose of ascertaining the gain derived or
loss sustained from the sale or other disposition of property
real, personal or mixed, acquired on or after January 1,
1928, the basis shall be the cost thereof, or the inventoried
value if the inventory is made in accordance with this act.
In the case of property acquired prior to January 1, 1928,

63 See Roger J. Traynor, The Bank and Corporation Franchise Tax
Act, Ch. XX Ballantine, California Corporation Laws, p. 730, note 120.
and disposed of thereafter the basis shall be the fair
market value thereof as of said date; provided, however,
(1) that if its cost is greater than such basis, the gain,
if any, to be included in gross income shall be the excess
of the amount realized therefrom over the cost thereof;
(2) if the cost is less than such basis the deductible
loss, if any, shall be the excess of the cost over the
amount realized therefrom.

Curt the second paragraph of Section 19 as the situation covered
thereby is taken care of in the additional amendment to Section 19
discussed below.

Illustration:

<table>
<thead>
<tr>
<th>Cost</th>
<th>Value January 1, 1928</th>
<th>Selling Price</th>
<th>Taxable gain or deductible loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>$10,000</td>
<td>$15,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>2.</td>
<td>$10,000</td>
<td>$5,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>3.</td>
<td>$10,000</td>
<td>$30,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>4.</td>
<td>$10,000</td>
<td>$3,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>5.</td>
<td>$10,000</td>
<td>$5,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>6.</td>
<td>$10,000</td>
<td>$15,000</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

Desirability of January 1, 1928 as Basic Date

In view of the recent great depression in property values a
serious question arises whether January 1, 1928 as a basic date
should be retained in the act. If gains accrue from now on to
property acquired by a corporation before January 1, 1928, and that
property is subsequently sold and such gain realized it will not be
taxed by the state unless the selling price exceeds the January 1,
1928 value of such property. The state will never obtain a tax on
such gains if the present basic date is retained and if January 1,
1928 values represent a peak which will not again be reached. If
gains accrue after January 1, 1928 and are realized and there has
actually been a gain over the whole transaction, that is, if the
selling price exceeds the cost of the property, why should not the
state tax such gain?
For example, suppose A Corporation purchased property in 1920, for $100,000, and that its value on January 1, 1926 was $200,000, and that its value on January 1, 1932 was $100,000. Suppose, further, that B Corporation purchased identical property on January 1, 1932 for $100,000. Assume that the property in each case rises in value in 1935 to $200,000. If the present basic date is retained and both corporations sell their property in 1938, B Corporation will be taxed on a gain of $100,000, whereas A Corporation will pay no tax on the gain which it realized. It is difficult to see why the fact that A purchased its property prior to January 1, 1926 should justify the difference in treatment accorded these two corporations. The principal reason for employing a basic date is to prevent the taxation of gains or the deduction for losses that occurred prior to the enactment of the taxing act. However, where there has actually been a gain over the whole transaction and that gain occurred after the enactment of the taxing act, it is submitted that there is no reason why such gain when realized should not be taxed. Such gains could be reached by changing the basic date to January 1, 1932.

Desirability of January 1, 1932 As Basic Date

If the basic date is changed to January 1, 1932, and gains accruing thereafter are taxed, an argument may be made that an undesirable discrimination against certain corporations would arise. Corporations that did not sell such property until after the new date became effective, for example, July, 1932, would be subject to tax on such gains but corporations that sold such property before the new date, for example, December 31, 1931, would not be taxed therein. In other words, why penalize corporations that held such property until after the new date? The answer to this question may be that the January 1, 1932 date should have been abandoned earlier and if said corporations escaped a tax that perhaps should have been imposed upon them that is no reason all other corporations should
likewise be relieved from such tax. This argument against a new basic date proves too much. It would apply to any change in a statute that increased the burden upon those affected by it, and accordingly no loophole in a taxing statute should ever be closed for to close it will always discriminate against those who were not alert enough or able to take advantage of it.

Of course, if there is a gain from now on in property values, and a corporation realizes such gain, that fact alone is not sufficient justification for taxing it. Not only must there be a gain after January 1, 1932, but there must also be a gain over the whole transaction, the selling price must also exceed the cost. In other words, the problem raised by Goodrich v. Edwards discussed above must be provided for if any change is made in the basic date.

Elimination Of Basic Date

It is believed, however, that the state should, if possible, avoid employing any basic date. An adequate determination of property values as of a certain date, particularly when that determination must be made several years after such date, is virtually impossible without the expenditure of tremendous sums of money in making an effective check upon the values as fixed by the taxpayer. It is suggested that the basis should be cost less depreciation actually sustained. If such basis were used, the administration of the act would be greatly simplified and the opportunity for evading taxation by means of excessive evaluations that are difficult to discredit, would be eliminated. The taxpayer would be taxed only when it has actually made a gain and would be allowed deductions for losses when there have actually been losses.

Not only does the present act entail all the shortcomings, from the standpoint of an effective administration thereof, but has, it is believed, adopted an unfortunate basic date, a date when property values were at their peak.

It should be observed that if the basis is changed as here suggested, the result will be that in the case of property acquired
prior to the effective date of the act, the state will be taxing
gains which arose prior to that date or will be allowing a deduction
for losses which occurred prior thereto. The deduction for losses
occurring prior to the effective date of the act will be allowed
only in the case of property the cost of which was greater than its
1928 value and greater than the price for which it is sold. If
gains which accrued prior to the effective date of the act are taxed,
it seems reasonable that deductions should be allowed for losses that
occurred prior thereto.

It is arguable that gains which accrued prior to the adoption
of the act constitute capital and that an attempt to tax such
gains as income in the year in which realized would be unconstitutions.
However, it has been held that since the gains are not realized
until after the effective date of the act they constitute income in
the year of realization. Furthermore, it is to be noted that
probably most of the gains accruing to property prior to the
enactment of the act have been wiped out by depreciation in property
values occurring since 1928. Consequently even though it were deter-
mined that gains accruing prior to the effective date of the act
could not be included in the base as income, such determination
would not materially affect the operation of the act. All gains
accruing after the passage of the act would nevertheless be taxed if
the selling price exceeded the cost.

Suggested Amendment If January 1, 1932 Is
Adopted As A Basic Date

"For the purpose of ascertaining the gain derived or
loss sustained from the sale or other disposition of
property, real, personal or mixed, acquired on or after
January 1, 1932, the basis shall be the cost thereof, or
the inventoried value if the inventory is made in accord-
ance with this act.

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64 20 Cal: Law Rev. 640
65 See Supra; Note 63.
"In the case of property acquired prior to January 1, 1932, and disposed of thereafter, the basis shall be the fair market value thereof as of said date; provided, however, (1) that if the cost is greater than such basis, the gain, if any, to be included in gross income shall be the excess of the amount realized therefrom over the cost thereof; (2) if its cost is less than such basis, the deductible loss, if any, shall be the excess of the cost over the amount realized therefrom."

**Suggested Amendment If Basis Is Changed To Cost Less Depreciation:**

"For the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal or mixed, the basis shall be the cost thereof or the inventoried value if the inventory is made in accordance with this act.

"The basis shall be diminished by the amount of exhaustion, wear and tear, obsolescence and depletion actually sustained in respect to such property subsequent to the acquisition thereof."

**Illustration Comparing The Suggested Alternatives With The Present Basis:**

<table>
<thead>
<tr>
<th>Cost loss depreciation Jan. 1, 1928</th>
<th>Jan. 1, 1932</th>
<th>Selling Price</th>
<th>Taxable Gain Or Loss</th>
<th>Cost less depreciation Jan. 1, 1928</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000</td>
<td>$20,000</td>
<td>$10,000</td>
<td>Neither $10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>$10,000</td>
<td>15,000</td>
<td>15,000</td>
<td>Neither 5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>$10,000</td>
<td>5,000</td>
<td>5,000</td>
<td>Neither 5,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

**Inadequate Provision For Gains And Losses On Sale Of Capital Assets:**

(1) The amount to be compared with the basis for the purpose of ascertaining gain or loss is not defined. Of course this figure must be the amount received but such a fundamental fact should be stated in the act.
(2) No provision is made for adjustments on account of expenditures properly chargeable to capital account which in fairness to corporations should be allowed.

(3) There is no provision for the diminution in the basis of stock on account of capital distributions.

Suggested Amendment:

It is suggested that the following provision, based upon Sections 111 and 115 of the federal act should be added to whichever of the amendments to Section 19 submitted above is adopted:

(a) Computation of gain or loss -- Except as otherwise provided in this section the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis herein provided and the loss shall be the excess of such basis over the amount realized.

(b) Adjustment of basis -- In computing the amount of gain or loss under subsection (a)--

(1) Proper adjustment shall be made for any expenditure, receipt, loss or other item, properly chargeable to capital account, and

(2) The basis (if fair market price or value as of January 1, 1928, or January 1, 1932, if that date is adopted) shall be diminished by the amount of the deductions for exhaustion, wear and tear, obsolescence and depletion which have since January 1, 1928 (or January 1, 1932) been allowable in respect of such property under this act.

(c) Amount realized -- The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market price or value of the property (other than money) received.

(d) Recognition of gain or loss -- In the case of a sale or exchange, the extent to which the gain or loss deter-
mined under this section shall be recognized shall be
determined under the provisions of Section 20.

(e) **Installment sales** -- Nothing in this section
shall be construed to prevent (in the case of property
sold under contract providing for payments in install-
ments) the inclusion in gross income of that portion of
any installment payment representing gain or profit in the
year in which such payment is received.

(f) **Distributions in liquidation** -- Amounts distrib-
uted in complete liquidation of a corporation shall be
treated as in full payment in exchange for the stock, and
amounts distributed in partial liquidation of a corporation
shall be treated as in part or full payment in exchange for
the stock. The gain or loss to the distributee resulting
from such exchange shall be determined under this Section
but shall be recognized only to the extent provided in
Section 20.

(g) **Other distributions from capital** -- If any distrib-
ution (not in partial or complete liquidation) made by a
corporation to its shareholders is not out of earnings or
profits, then the amount of such distribution shall be
applied against and reduce the basis of the stock and if in
excess of such basis, such excess shall be included in gross
income in the same manner as a gain from the sale or ex-
change of property. The provisions of this subsection shall
also apply to distributions from depletion reserves based on
the discovery value of mines.

**Section 21**

Present Provisions Ambiguous

Section 21 provides that when property is exchanged for other
property and no gain or loss is recognized under the preceding
section, the property received shall be treated as taking the place
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of the property exchanged therefor. Under the preceding section (Section 20) the entire amount of gain or loss resulting from an exchange is recognized with the exceptions provided for in Section 112 of the Federal Revenue Act of 1928.

One of the exceptions provided for in Section 112 applies to the situation where property is transferred to a corporation in return for stock of the corporation and immediately thereafter the transferee is in control of the corporation. No gain or loss resulting from the exchange is recognized, under the federal act. The same is true under the State act by virtue of Section 20. Consequently, under Section 21 of the State act the property transferred to the corporation is to be treated as acquiring the same basis as the stock exchanged therefor. This provision is ambiguous for the reason that it is difficult to understand how stock of a corporation prior to its being issued for the first time can be regarded as having any basis. Even if it can be regarded as having a basis, considerable doubt exists as to what the basis should be inasmuch as it might be the par value, the fair market value, or the value of the property obtained in exchange for it.

Certain Gain Not Taxed

Furthermore, it is to be noted that this section literally construed is applicable only when no gain or loss is recognized under the preceding section. Hence, when an exchange occurs and gain resulting from the exchange is recognized under the preceding section, the basis of the property received will be the basis provided for in Section 19 of the Act which is the cost of the property. The result of this is that when some of the gain, but not the entire gain, resulting from an exchange is recognized under the preceding section, the balance of the gain which is not recognized at the time of the exchange will never be recognized. For example, suppose "X", a corporation, exchanges productive property which cost $50,000 and which has increased in value to $100,000 for like property worth
$70,000 and $30,000 in cash. Under Section 112 of the Federal Revenue Act, and consequently under Section 20 of the State Act, gain to "X" only in the amount of $30,000 will be recognized. If "X" subsequently sells the property received for $70,000 no further gain will be recognized under the State Act since the basis of the property is the cost thereof, i.e., $70,000. Consequently, gain only in the amount of $30,000 is recognized although gain in the amount of $50,000 was realized by "X" from the transaction.

Federal Rule With Certain Differences Suggested

It is to be noticed that Section 113 of the Federal Revenue Act contains detailed provisions regarding the basis of property received pursuant to an exchange with respect to which either no gain or loss or with respect to which some, but not the entire amount of gain resulting from the exchange, is recognized under Section 112 of that Act. In incorporating the provisions of the federal act relating to this problem, the legislature failed to incorporate all the relevant provisions of that act necessary adequately to meet the problem. Inasmuch as Section 20 of the State Act provides that gain or loss resulting from an exchange is to be recognized only to the extent it would be recognized under Section 112 of the Federal Revenue Act, it seems reasonable and necessary that some of the provisions at least of Section 113 of the Federal Revenue Act relating to the basis of the property received pursuant to an exchange with respect to which the provisions of Section 112 of the Federal Revenue Act are applicable should be incorporated into the State Act.

However, a provision different from that contained in Section 113 of the Federal Act should be made respecting the basis of property transferred to a corporation in exchange for stock, or in exchange for stock and money or property other than stock, where the transferor immediately after the exchange is in control of the corporation.
Section 113 (a) (8) provides that in such a transfer the property transferred shall retain the same basis it had in the hands of the transferor (with certain adjustments on account of any gain or loss to the transferor which was recognized at the time of the exchange). Since Section 113 (a) (8) provides that the basis of the property received by the transferor shall acquire the same basis as the property surrendered (with adjustments on account of any gain or loss to the transferor which was recognized at the time of the exchange), the effect of Section 113 (a) (8) is to provide that the property transferred and the property received shall have the same basis, namely, the basis that the property transferred had in the hands of the transferor.

Because of this rule, double taxation will result in certain instances, and double deductions for loss will be permitted in other instances. For example, suppose "A" Corporation, transfers property which has a basis of $50,000 and which has increased in value to $100,000 to "B" Corporation in exchange for $100,000 of stock of "B" Corporation and immediately thereafter is in control of "B" Corporation. The gain resulting to "A" is not recognized. Hence, under Section 113 (a) (6) the property received by "A" acquires a basis of $50,000 the basis of the property transferred. The property transferred, in accordance with Section 113 (a) (8) retains the basis it had, i.e., $50,000. If "B" sells the property transferred for $100,000, it will be taxed on a gain of $50,000. If "A" sells the stock, received by it in exchange for the property transferred, for $100,000, it also will be taxed on a gain of $50,000. Thus, $100,000 is taxed although a gain of but $50,000 was realized from the transaction.

Suppose on the other hand that the property transferred had a basis of $100,000 and was transferred to "B" in exchange for $50,000 of "B"'s stock. If "B" sells the property for $50,000, it will be allowed to deduct a loss of $50,000. If "A" sells the stock,
received by it in exchange for the property transferred, for
$50,000, it also will be allowed to deduct $50,000 as a loss. Thus,
deductions totalling $100,000 will be allowed although a loss of
but $50,000 was sustained from the transaction.

Instead of providing, as is provided in Section 113 of the
Federal Revenue Act, that the basis of the property transferred shall
be the same as in the hands of the transferor, it would seem better
to provide that the basis of the property transferred should be the
value of the property at the time of the transfer. Under this pro-
vision, if the property transferred is sold by the transferee for an
amount equal to the value of the property at the time of the transfer,
neither gain nor loss will result to the transferee. Consequently,
there will be no double taxation, nor will double deductions for loss
be permitted, regardless of the amount for which the stock received
by the transferor is sold.

However, an objection to such a provision can be made on the
grounds that it will permit deductions for loss when loss has not in
fact been sustained. For example, suppose property which cost
$50,000 is transferred when it has increased in value to $100,000.
If the transferee sells the property for $50,000, a deduction of
$50,000 will be allowed although over the entire transaction no loss
has been sustained. This objection can be met by providing that
whenever the basis of the property in the hands of the transferor is
less than the value of the property at time of the transfer, the
basis of the property transferred for all purposes other than deter-
mining gain to the transferee shall be the same as in the hands of
the transferor. Thus, if the property transferred is sold by the
transferee for as much or more than it cost the transferor, no
deduction for loss will be allowed.

If this modification is made, then a further modification
should be made to take care of the situation where property is trans-
ferred to a corporation, in exchange for stock of the corporation,
and for money or property in addition to stock, for otherwise the
transferee in some instances, may not be allowed to deduct the full amount of loss which is actually sustained. For example, suppose property having a basis of $50,000 is transferred to a corporation in exchange for stock of the transferee and for money and property other than stock in the amount of $60,000. If the property transferred is sold by the transferee for $50,000, no loss will be allowed if the basis is the same as in the hands of the transferor although the transferee receives from the property less than the value of the money and property it actually surrendered in exchange for the property.

It would seem that the basis of the property transferred for all purposes other than for the determination of gain should be the basis of the property in the hands of the transferor increased by the amount of money and the value of the property other than stock given in exchange thereof. Obviously, however, the basis so computed should not exceed the value at the time of transfer of the property transferred.

A simple way of effecting this result would be to provide that if the basis in the hands of the transferor is less than the value of the stock given in exchange for the property transferred, the basis for all purposes other than determining gain, shall be the same as in the hands of the transferor increased by the amount of money and the value of property other than stock given in exchange thereof.

If the above solution is followed, it will be necessary to define the term "basis in the hands of the transferor". The term can be defined to mean the basis provided for in Section 19 of the Act. It will also be necessary to define the term "control". Section 112 of the Federal Revenue Act contains a definition of the term as used in said Section. Inasmuch as the above solution applies only to exchanges covered by Section 112, it would seem proper to define the term "control" as meaning the same as it is defined to mean in that
Amend Section 21 to read as follows:

When property is exchanged for other property and no gain or loss, or some gain but not the entire amount of gain, is recognized under the preceding section, the basis of the property received, except as hereinafter provided, shall be determined in accordance with the provisions of Section 113 of the Federal Revenue Act of 1928 which are hereby referred to and incorporated for the purpose of this section with the same force and effect as though fully set forth herein.

When property is transferred to a bank or corporation of the classes taxable under this act, in exchange for stock of such bank or corporation, or in exchange for stock and money or property other than stock, and immediately thereafter the transferor is in control of such bank or corporation, the basis of the property transferred shall be the fair market value thereof at the time of the transfer except that if the basis in the hands of the transferor of the property transferred is less than the fair market value, at the time of the transfer of the stock of such bank or corporation given in exchange therefor, then the basis of the property transferred shall be, for all purposes other than determining gain resulting to such bank or corporation from the subsequent disposition of the property transferred, the same as the basis in the hands of the transferor increased by the amount of money and the fair market value of property other than stock of such bank or corporation given in exchange therefor.

The phrase "basis in the hands of the transferor" as herein used is hereby defined to mean the basis provided for
in Section 19 hereof.

The term "control" as herein used is hereby defined to mean the same as the term is defined to mean in Section 112 of the Federal Revenue Act of 1928.

Section 23: INSTALLMENT PAYMENTS

If the method for computing the rate of tax on banks and financial corporations as above proposed, is adopted, it is suggested that at the time of filing their returns, banks and financial corporations be required to pay as the first installment of their tax a percentage of their net income equal to the rate imposed on manufacturing, mercantile and business corporations, and that the balance of the tax be due after the commissioner has made the calculation necessary to determine the rate on banks and financial corporations.

Suggested Amendment:

Amend Section 23 to read as follows

Sec. 23. On or before the fifteenth day of the third month following the close of the taxable year, as defined in Section 11 hereof, there shall be due and payable, from every national banking association, every other bank or financial corporation of the classes mentioned in sections 1, 2 and 4 of this act as a first installment of the tax on such banks and financial corporations, a percentage of their net income as disclosed by the return, which is equal to that percentage of the net income of manufacturing, mercantile and business corporations which is required to be paid to the state as a franchise tax according to or measured by net income.

On or before the fifteenth day following the mailing of notice of the Commissioner's determination of the average percentage of net income of manufacturing, mercantile and business corporations required to be paid to the state or its political subdivisions in franchise, or personal property taxes as provided in Section 4 (a) of this act, or on or before the fifteenth day of the ninth month following the close of the taxable year as defined in Section 11 hereof whichever is later, there shall be due and payable
from every such banking association, bank and financial corporation, as a second installment of the tax on such banks and financial corporations, a percentage of their net income as disclosed by the return which is equal to the percentage of the net income of manufacturing, mercantile and business corporations required to be paid to the state or its political subdivisions as personal property taxes as determined by the Commissioner. The offset herein provided for shall be applied to such second installment.

In the case of manufacturing, mercantile and business corporations one half the amount of tax disclosed by the return shall be due and payable, as a first installment of the tax on such corporations, on or before the fifteenth day of the third month following the close of the taxable year as defined in Section 11 thereof. The balance of the tax shall be due and payable, as a second installment, on or before the fifteenth day of the ninth month following the close of the taxable year. A tax imposed by this act or any installment thereof may be paid at the election of the taxpayer, prior to the date prescribed for its payment.

Where an extension of time for filing returns has been granted by the commissioner under the provisions of Section 15 of this act, the first installment shall be paid prior to the expiration of such extension.

If the first installment of the tax is not paid on or before its due date, or the due date as extended by the commissioner, it shall be delinquent and a penalty of fifteen per centum added thereto. If the second installment is not paid at the time it is due and payable, it shall be delinquent and a penalty of five per centum added thereto. At the time of the delinquency of the second installment an additional
penalty of five per centum shall be added to the first installment unless that installment has theretofore been paid.

All taxes and interest imposed under this act must be paid to the commissioner at Sacramento in the form of remittances payable to the Treasurer of the State of California, and he shall transmit said payments daily to the State Treasurer.

All moneys received by the State Treasurer shall be deposited by him in a special fund in the State treasury to be designated the bank and corporation franchise tax fund, and moneys in said fund shall, upon the order of the State Controller, be transferred into the general fund of the State, or drawn therefrom for the purpose of refunding to taxpayers hereunder.

Section 25: DECIENCY ASSESSMENTS

One year limitation on additional assessments is entirely too short. It renders practically impossible the making of adjustments on the audit of the federal return and thus enables the taxpayer to escape the payment of taxes rightfully due the state which the commissioner could not reasonably be expected to assess within one year. The limitation is two years in the federal act (Federal Revenue Act of 1938, sec. 275a) but should be somewhat longer in the state act to permit adjustments on the audit of the federal return.

For further proposed amendments to Section 25, see discussion under Section 30, below.

Section 26: CREDITATION OF OFFSET

If offsets for all real and personal property taxes, except personal property taxes paid by financial corporations, are abolished as suggested above, this section should be amended so as to be applicable only to the offset of personal property taxes paid by...
financial corporations.

**Suggested Amendment**

Substitute the following for the present provisions of Section 26:

A financial corporation subject to the tax herein provided for shall receive an offset against said tax, subject to the limitations provided in Section 4 hereof, for personal property taxes paid upon its property to any county, city and county, city, town or other political subdivision of the state during the taxable year. At the time of payment of the first installment of tax under the provisions of Section 23 of this act, each taxpayer claiming an offset against the tax shall submit to the commissioner evidence in such form as he shall prescribe in support of such claims.

(Where a consolidated return has been made under Section 14 hereof the offset allowable against the tax liability of the consolidated group may include said personal property taxes paid during said period by all financial corporations which are included in the consolidated group, subject to the limitations of Section 4 hereof.)

If a financial corporation in paying the tax provided for in this act desires to claim an offset in the computation of its tax, the rate provided in Section 4 hereof for financial corporations shall be applied to such offset and the amount so computed shall be added to and included in the tax of such corporation.

If all offsets are abolished, including the offset of personal property taxes paid by financial corporations, this section as it now reads should be repealed.

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66 Words in parenthesis to be added if provision for consolidated returns not repealed.

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Whether offsets are or are not abolished, or whether they are abolished only to the extent suggested, there is one change in the interests of fairness to the state and to corporations generally that should be made. If a corporation is allowed an offset for real or personal property taxes against the franchise tax and subsequently a local subdivision makes a refund of real or personal property taxes to such corporation, and if it is too late, in view of the period of limitations, for the commissioner to assess a deficiency to recover the offset allowed on account of such refunded real or personal property taxes, such corporation escapes a tax that in equity and justice it should pay, and enjoys a benefit not enjoyed by other corporations taxable under the act. If offsets are abolished, an amendment should nevertheless be adopted providing for the recovery of offsets previously allowed on such refunded taxes.

Suggested Amendment

Substitute the following for Section 26 if all offsets are abolished, and add it to Section 26 if all offsets are not abolished regardless of whether or not it is amended as above suggested:

If any real or personal property taxes are at any time refunded to any bank or corporation taxable under this act, and said bank or corporation has been allowed an offset for such taxes against any tax imposed under this act, said bank or corporation shall report that fact to the commissioner and shall pay a tax (not subject to offset) in an amount equivalent to any offset which has been allowed against any tax at any time imposed under this act on account of such refunded real or personal property taxes.

Section 27

REFUNDS

The one year period in which to file a refund claim is unreasonably short. Just as the period in the case of the assessment

67 Words in parenthesis to be inserted if offsets retained.
of deficiencies should be extended to allow the state to obtain the benefit of the federal audit so that period should be extended to allow corporations to obtain the benefit of such audit.

Provision should be made requiring refund claims to be filed in duplicate so that the Commissioner may retain one copy for his files, and forward another copy to the Board of Control if the claim is approved, so that the Board may know the nature of and grounds for filing the claim.

Neither this section nor any other section of the Act authorizes the crediting of an over payment of taxes on any taxes which are due under the Act but which have not been paid. It seems reasonable that an overpayment should not be refunded until the taxpayer’s tax liability to the state under the Act has been discharged in full.

Suggested Amendment

These suggestions could be carried into effect by amending the first and second paragraphs of Section 27 to read as follows:

If in the opinion of the commissioner, or said board, as the case may be, a tax has been computed in a manner contrary to law or has been erroneously computed by reason of a clerical mistake on the part of the commissioner or said board, such fact shall be set forth in the records of the commissioner, and the amount of the illegal levy shall be credited on any taxes then due from the taxpayer under this Act, and the balance shall be refunded to the taxpayer or its successor through reorganization, merger, or consolidation, or to stockholders upon dissolution.

If any tax or penalty has been paid more than once, or has been erroneously or illegally collected, or has been erroneously or illegally computed, the commissioner shall certify to the state board of control the amount collected in excess of what was legally due, from whom it was collected, or by whom paid, and if approved by that board, the
same shall be credited on any taxes then due from the taxpayer under this act and the balance shall be refunded to the taxpayer, but no such credit or refund shall be made in the case of overpayments made before June 1, 1932, unless duplicate copies of a claim for refund are filed by the taxpayer with the commissioner within one year from the date of overpayment, and in the case of overpayments made on or after June 1, 1932 unless duplicate copies of a claim for refund are filed within three years from the date of overpayment. Every claim for refund must be in writing under oath and must state the specific grounds upon which the claim is found."

**Interest on Overpayments:**

If the Act is amended to allow the crediting of overpayments on taxes due thereunder, the provisions for the allowance of interest on overpayments should be amended to allow interest on overpayments which are credited on taxes due under the Act as well as on overpayments which are refunded, as the taxpayer is deprived of the use of his money in both instances.

The Federal Revenue Act provides for the allowance of interest on credits (Section 614), but limits interest to the period between which the date of the overpayment and the date on which the taxes against which the credit is allowed became due. In support of following the Federal provision, it may be argued that after the taxes against which the credit is allowed became due, the taxpayer owes the state an amount at least equal to the amount of the credit, and consequently the state should not be required to pay interest on the credit thereafter. But under Section 24 of the Act, interest will accrue at the rate of one per cent per month on the amount the taxpayer owes the state. Hence, it would seem fair for the state to allow the taxpayer interest on the amount it owes the taxpayer from the date of the overpayment up to the date the overpayment is credited on taxes due the state.

It is submitted that the provisions for allowance of interest on overpayments should also be amended to prevent the allowance of interest on overpayments which are made due to an error or mistake
on the part of the taxpayer. Where the overpayment is made because of a mistake on the part of the commissioner, it is fair and proper that the taxpayer should be allowed interest on the overpayment, but it does not seem fair or proper that the taxpayer should obtain interest on an overpayment which was made because of his own mistake or error.

Recovery Of Refunds Erroneously Made

It would seem some provision should be made in the Act for the recovery of refunds erroneously made. It is quite possible that a refund may be made which information subsequently obtained, from the federal audit or otherwise, will show should not have been made. Unless provision is made for the recovery of such erroneous refunds, they will be lost to the state. It is suggested that the period within which actions can be instituted to recover an erroneous refund should be three years from the date the refund was made so as to allow the commissioner ample time in which to determine whether or not the refund was properly made. Provision should also be made for the recovery of credits erroneously allowed. Even without some such provision, it is probable that the state could bring an action under Section 31, provided the time for bringing such action has not elapsed, to recover the taxes against which the erroneous credit was applied on the theory that the allowance of such a credit did not effect a payment of the taxes and consequently that they are still due and collectible. But the period within which actions can be brought to collect delinquent taxes commences to run from the date the taxes were due. Credits will always be allowed against taxes already due. Consequently, it may very well happen that a credit will be allowed which information shortly thereafter obtained will show to have been erroneously allowed, but the state will be powerless to collect the taxes against which the credit was applied because the period within which an action can be brought to collect them will have elapsed. Such a contingency can be avoided by providing for the
recovery of erroneously allowed credits within three years from the
time the credits were allowed. Such provision will also have the
advantage of placing erroneously allowed credits on the same basis
as erroneously allowed refunds.

Suggested Amendments

These suggestions could be carried into effect by amending
Section 27 as indicated below:

Amend the third paragraph of Section 27 to read as follows:

Interest shall be allowed and paid upon any over-
payment of any tax, if the overpayment was not made because
of an error or mistake on the part of the taxpayer, at the
rate of six per centum per annum as follows:

(1) In the case of a credit, from the date of the
overpayment to a date preceding the date of the allow-
ance of the credit by not more than thirty days, such
date to be determined by the commissioner. Any interest
allowed on any credit shall first be credited on any taxes
then due from the taxpayer under this Act.

(2) In the case of a refund, from the date of the
overpayment to a date preceding the date of the refund
warrant by not more than thirty days, such date to be
determined by the Commissioner.

Add the following to Section 27:

Any refund or any portion thereof which is erron-
eously made, and any credit or any portion thereof which
is erroneously allowed, may be recovered, together with
interest at the rate of six percentum per annum from the
date the refund was made or the credit allowed, in an
action brought by the controller of the state in a court
of competent jurisdiction in the county of Sacramento in
the name of the people of the State of California, and
such actions shall be tried in the county of Sacramento
unless the court with the consent of the attorney general order a change of place of trial.  

The attorney general must prosecute such action, and the provisions of the Code of Civil Procedure, relating to service of summons, pleadings, proofs, trials, and appeals are applicable to the proceedings herein provided for.

Appeal To State Board Of Equalization From Commissioner's Denial Of Claim For Refund

Under the present provisions of the act, if the commissioner denies or disallows a claim for refund of any tax, the taxpayer's only remedy is to bring an action in the Superior Court. It is submitted that there is just as much reason for allowing an appeal to the State Board of Equalization from the commissioner's action in denying or disallowing a claim for refund as there is for allowing such an appeal from the commissioner's action in overruling a taxpayer's protest to a proposed deficiency assessment.

Suggested Amendment

Insert the following, between the second and third paragraphs of Section 27:

If the commissioner disallows any claim for refund, he shall notify the taxpayer accordingly. Within thirty days after the mailing of such notice, or if the commissioner does not act upon any claim for a refund within six months from the time the claim is filed, then within thirty days after the expiration of said six months, the commissioner's action upon the claim shall be final, unless within such thirty day period the taxpayer appeals in writing from the action of the commissioner to the state board of equalization. The appeal must be addressed and mailed to the state board of equalization.

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68 The reason for this provision is explained in the discussion on Section 31, below.
zation at Sacramento, and a copy of the appeal addressed and mailed at the same time to the commissioner at Sacramento. Said board shall hear and determine the same and thereafter shall forthwith notify the taxpayer and the commissioner of its determination. If the board sustains the commissioner, the commissioner's action in disallowing the claim shall thereupon be final.
Section 29: LIEN OF TAX

The Lien Provisions of the Constitution and the Statute Create a Very Confused and Undesirable Situation.

It was apparently intended by the constitutional section that the new tax should accrue upon a fixed date which, if in accord with the general tax system set up in the constitutional article of which it is a part, would be the first Monday in March of that year. Apparently with this in mind the framers of the constitutional section provided that "Said taxes shall become a lien upon the first Monday of March of 1929 and of each year thereafter," thus establishing a lien date in accord with the lien date of other taxes provided for by Article XIII. One of the outstanding characteristics of the tax system set up by Article XIII is the fact that the accrual of the tax and the attachment of its lien are coincident. Thus, under that article, the fixing of the tax obligation on the subject of the tax and the creation of the tax lien must be regarded as occurring simultaneously, although, of course, the amount of the tax may not be ascertained until later, in which case there is a relation back to the date when the tax first accrued and became a lien. The attachment of the lien at the date of the accrual of the tax is an essential feature of a sound tax system, for it is somewhat burdensome on taxpayers to have the lien attach before any tax has accrued, and unwise for the state to have the lien attach at a date after the tax has accrued.

Notwithstanding these basic propositions, the Bank and Corporation Franchise Tax Act provides in section 11 for an accrual

69 Estate of Backesto (1923) 63 Cal. App. 265.
date which shall be "the first date after the close of the taxable year", and defines "taxable year" as the "calendar year or the fiscal year . . . upon the basis of which the net income is computed." As a result, instead of providing for one accrual day, the act establishes January 1 as the accrual date for calendar year corporations and the first day of any of the other eleven months as the date for fiscal year corporations. By reason of the constitutional provision, the act could not provide that the lien should attach at the varying date of accrual, and instead was forced to provide for a single fixed lien date. The provision is found in Section 29 of the act:

"The taxes levied under this act shall constitute a lien upon all property of the taxpayer, which lien shall attach on the first Monday of each year. Every tax herein provided for has the effect of a judgment against the taxpayer and every lien has the effect of a judgment duly levied against all property of the delinquent . . . ."

The language of this section is ambiguous. If the tax is to be a lien on the first Monday in March the provision that every tax has the effect of a judgment is superfluous if it means no more than that every tax is to have the effect of a lien. The provision that every tax is to have the effect of a judgment might be read as providing that every tax should have the effect of a lien upon accrual; however, this interpretation is precluded by reason of the constitutional stipulation that the lien attach on the first Monday in March.

Section 29 apparently, therefore, provides that the lien shall only attach on the first Monday in March. Since taxes accrue before and after the lien date, it is pertinent to ask, on what March does the lien attach if the tax accrues after the first Monday in March? Does the lien relate back to the preceding March, or must the attachment of the lien be delayed until the March following? The provision must operate in one way or the other and the act leaves this important question in doubt.

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Insofar as the language of the act is concerned, the view that the lien relates back to the preceding March is as tenable as the view that the lien attaches the March following. Objections may be made to either view. If the lien is considered as attaching on the March following the accrual an undesirable situation results, for it means that after a corporation becomes liable for the tax a period intervenes before the lien will attach. The corporation may sell its property within that period free from any lien for the tax due against it. For example, suppose a fiscal year corporation ended its taxable year on June 30, 1931; on the next day its tax for the next fiscal year accrued; however, the lien for that tax will not attach until the following March, i.e., March 1932. Thus, the corporation has a period within which it may sell its property free of a lien for the accrued taxes. Such procedure is fundamentally contrary to sound tax policy.

The other possibility is to have the lien relate back to the prior March. For example, if a corporation's taxable year ended June 30, 1931, its tax accrued on July 1, 1931, and the lien for the tax attached on March 4, 1931, four months before the tax accrued. Thus, if the lien always related back to the preceding March, the objection that the tax might be avoided could not be raised. However, the effect of such procedure upon the securing of a clear marketable title from a corporation selling its property would be extremely important, for a purchaser might find his property subject to a lien for taxes subsequently accruing against the corporation, of which he could have no knowledge without examining the accounting system of the corporation in question. A purchaser in April might subsequently find that a lien had attached the month before for taxes, accruing against the corporation, perhaps as late as December following his purchase.

From the foregoing, it is evident that the lien provisions of the act create a situation of doubt, with a choice between undesir-
able alternatives.

**Lien Should Attach on Date Tax Accrues**

A fixed lien date is a workable provision only if the accrual date is also fixed. The situation created by the statute can only be remedied satisfactorily by a change of the lien provision in Section 16 of Art. XIII state constitution, allowing the lien to attach upon the date the tax accrues. Changing the article to provide for a uniform accrual date coincident with the first Monday in March, is not feasible if the corporation is allowed to make returns on the basis of taxable years as defined in section 11. To require all returns to be made on the same basis would be extremely inconvenient, both to the corporation and the Commissioner and would greatly complicate the administration of the tax.

Although the problem cannot adequately be solved without constitutional amendment much can be done to remove the present situation of doubt and confusion. Title insurance companies, purchasers of property and other persons dealing with corporations should be able to learn definitely from the statute the time that the lien attaches even though the definite time therein set forth might not be the most desirable time viewed from the standpoint of a legislature not impeded by constitutional limitations.

**Present Uncertainty Should Be Removed**

Under the present act there is little difficulty insofar as calendar year corporations are concerned except that the lien does not attach until the third month after the tax accrues. In other words such corporations have a two month period in which to dispose of their property free and clear of the lien. As regards fiscal year corporations, whose taxes accrue after the first Monday in March, a choice must be made between the first Monday in March before the tax accrues or the first Monday in March following the accrual of the tax. It is submitted that to settle the question one way or the other is better than to leave it in its present

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state of uncertainty.

**Lion Should Attach on First Monday in March of Year in Which Tax Acrues**

The state must choose between allowing a loophole which may be used to escape payment of the tax on the one hand, and on the other hand, burdening corporations with a somewhat premature lien. It is believed that the interests of the state outweigh the inconvenience to the taxpayer (particularly in view of the fact that the corporation voluntarily chooses a taxable year that closes after the first Monday in March) and that the lien should attach on the first Monday in March of the calendar year in which the tax accrues.

It may be urged in objection to such a choice of lien dates that the lien will attach before any taxes are due. That situation is not now in California for a similar objection can be made to most of the liens for taxes in this state. In the case of local taxes the lien attaches in March, whereas the tax may not be computed until the following September. In the case of other state taxes, e.g. taxes on gross receipts and gross premiums the taxes may not be computed until July. This system has been sustained as it has been held that "in this state the time when taxes shall attach as a lien upon property is fixed by statute as of a certain day in the year, and when the amount is ascertained it relates back to the time so fixed."

A more serious objection may be made by corporations commencing business in the state after the first Monday in March and whose first taxable year ends in the same calendar year in which they commence business. The lien on the property of such corporations,

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70 Cal. Pol Code, Sections 3717, 3718.
71 Cal. Pol Code Sec. 3714
72 Cal. Pol Code Sec. 3668b.
73 Estate of Bucksteo (1925) 63 Cal. App. 265.
under a provision making the lien attach on the first Monday in March of the year in which the tax accrues, would attach before the corporation had any property or was even in existence.

**Exception for Certain Commencing Corporations**

The following language from the case of *West Bay Municipal Utility District v. Garrison* has an important bearing on the problem:

"In order, therefore, for the lien of taxes to be legally imposed upon property as of the first Monday in March of any particular year it is essential to the fixation of such tax lien upon such property as of said date not only that the property itself should be in existence at the time of the attachment of such lien but also that there should be at such time an existing obligation to pay the particular tax which the lien thus imposed is to secure. Otherwise the lien would have no foundation upon which to rest and would, by the imposition of an encumbrance having no obligation to support it, amount to the taking to the extent of such encumbrance of the property of the citizen without due process of law."

In the light of this case it would seem that an exception would have to be made for corporations commencing business in the state after the first Monday in March and whose first taxable year ends in the same calendar year in which they commence business. Except for the lien for the minimum tax of $.25 due on the commencement of business it is not likely that there will be many instances in which the exception will operate. All but 8% of the corporations taxable under the act do business on a calendar year basis. The first taxable year of commencing corporations that elect a calendar year basis will close December 31 and the tax for such period will accrue January 1 of the following year, under the provision suggested, the lien therefore will attach the following March. It is quite likely also that the first taxable year of many fiscal year corporations will end in the calendar year following that in which they commence business.

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74 (1923) 191 Cal. 680, 692, 113. -129-
Suggested Amendment

The suggestions here made could be carried out by amending the first sentence of Section 29 to read as follows:

The taxes levied under this act shall constitute a lien upon all property of the taxpayer which lien shall attach on the first Monday in March of the year in which the taxes accrue; provided, however, that in the case of a bank or corporation commencing to do business in this state for the first time after the effective date of this act, the lien of the taxes for the first and second taxable years of such bank or corporation shall attach on the first Monday in March subsequent to the time the bank or corporation commenced to do business.

Section 30:

RECOVERY OF OVERPAYMENTS

Overpayments Should First Be Credited Against Taxes Due

Section 30 provides that a taxpayer may bring an action against the state treasurer to recover an overpayment of any tax. Provision is made authorizing the court in any such action to render judgment in favor of the plaintiff, but the section is deficient in not providing for the payment of the judgment. It should be provided that the judgment should first be credited against any taxes due under the Act, as was suggested in the case of overpayments under the provisions of section 27, and the balance refunded to the taxpayer.

Suggested Amendments

Amend the first line of the second paragraph of Section 30 to read as follows:

When a claim for refund has been filed, etc.

Add to the third paragraph of Section 30, the following:

The amount of the judgment shall first be credited on any taxes due from the plaintiff under this act, and the balance of the judgment shall be refunded to the plaintiff or its successor through reorganization, merger, or consolidation, or to its stockholders upon dissolution.

Amend the last paragraph of Section 30 to read as follows:

In any judgment of any court rendered for any overpayment in respect of any tax imposed by this Act,
interest shall be allowed at the rate of six percentum per annum upon the amount of the overpayment, from the date of the payment or collection thereof to a date preceding the date of the refund warrant or the date of allowance of credit on account of such judgment by not more than thirty days, such date to be determined by the commissioner.

Appeal From State Board of Equalization to Supreme Court

If the commissioner overrules a taxpayer's protest to a proposed deficiency assessment, the taxpayer may either appeal to the State Board of Equalization, or he may pay the tax and bring an action in the Superior Court for the recovery of the amount paid. If the taxpayer appeals to the Board and the Board sustains the Commissioner, the taxpayer may then pay the tax and bring an action in the Superior Court to recover the same. If the Board reverses the Commissioner, the Commissioner may likewise bring an action in the Superior Court to determine the taxpayer's liability. If an action is brought in the Superior Court, either by the Commissioner or the taxpayer, after an appeal has been taken to the Board, the action is tried de novo. Thus the hearings, findings, and determination of the Board are rendered meaningless. After an appeal to the Board, the situation is substantially the same as if an appeal had never been taken to the Board. In other words, the question of the taxpayer's liability for a deficiency assessment is not advanced one step toward a final determination by an appeal to and a hearing and determination by, the Board.

Instead of providing for the bringing of a new action in the Superior Court after an appeal to and determination by the Board, it is suggested that it would be better to provide for the taking of an appeal, either by the Commissioner or the taxpayer, directly to the Supreme Court from the Board's decision. Providing for such a procedure would not only give some real significance to the Board's
action in appeals from the Commissioner, but would have the advantage of saving both to the state and the taxpayer the time and expense incident to the trial of an action in the Superior Court and would tend to reduce congestion in the Superior Courts. The adoption of such a provision might be objected to on the grounds that it would give too large a discretion or authority to an administrative board since the Board's action would be final subject only to a review by the Supreme Court. However, it is to be noted that the authority of the Board with respect to appeals from the Commissioner would be no greater than is the authority of the Railroad Commission or the Industrial Accident Commission with respect to matters over which they have jurisdiction.

Furthermore, if any bank or corporation subject to the act should at any time prefer that the question of its liability for a proposed deficiency assessment not be finally determined by the Board subject only to a review by the Supreme Court, it could avoid such a contingency by not appealing to the Board, and in lieu thereof, could pay the tax and bring an action in the Superior Court to recover the same. It is to be noted that the suggested procedure is similar to the procedure provided for in the Federal Revenue Act. With respect to deficiency assessments under that act, a taxpayer may either appeal to the Board of Tax Appeals from whose decision an appeal lies directly to the Circuit Court of Appeals, or he may pay the assessment and bring an action in the District Court to recover the same.

If this suggestion is followed, and if the suggestion above made respecting appeals to the Board from the action of the commissioner in disallowing claims for refund is also followed, provision should be made for appeals to the Supreme Court from the decision of the Board in cases involving claims for refund as well as in cases involving deficiency assessments.
Suggested Amendment

The above suggestions can be carried into effect by making the following changes in the Act:

Amend the third paragraph of Section 25 to read as follows:

If no such protest is so filed the amount of the tax shall be final upon the expiration of said sixty-day period. If a protest is so filed it shall be the duty of the commissioner to reconsider the computation and levy of the tax complained of, and if the taxpayer has so requested in its protest it shall be the duty of the commissioner to grant said taxpayer, or its authorized representatives, an oral hearing. After consideration of the protest and the evidence adduced in the event of such oral hearing, the commissioner's action upon the protest shall be final upon the expiration of thirty days from the date when he mails to the taxpayer notice of his action, unless within that thirty-day period the taxpayer appeals in writing from the action of the commissioner to the State Board of Equalization. The appeal must be addressed and mailed to the State Board of Equalization at Sacramento, and a copy of the appeal addressed and mailed at the same time to the commissioner at Sacramento. Said board shall hear and determine the same and thereafter shall forthwith notify the taxpayer and the commissioner of its determination, and the reasons therefor, which shall be final upon the expiration of sixty days from the time of such determination, unless within such sixty-day period the commissioner shall apply to the supreme court of the
state for a writ of certiorari or review for the purpose of having the lawfulness of the decision of the State Board of Equalization inquired into and determined.

Add the following to the first paragraph of Section 30:

and provided, further, that no such action shall be filed to recover any deficiency assessment, or any part thereof, if the taxpayer has at any time appealed to the State Board of Equalization from the action of the commissioner in overruling the taxpayer's protest to the commissioner's proposal of the said deficiency assessment.

Add the following to the second paragraph of Section 30:

provided, that no action shall be filed if the taxpayer has appealed to the State Board of Equalization from the action of the commissioner with respect to any claim for a (credit or) refund.

Add the following between the third and fourth paragraphs of Section 30:

Within sixty days after the determination of the State Board of Equalization of any appeal from the action of the commissioner either the commissioner or the appellant may apply to the supreme court of the state for a writ of certiorari or review for the purpose of having the lawfulness of the decision or order

75 Words in parenthesis to be added if the suggestion regarding crediting of overpayments on taxes due under the act is followed.

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of the board inquired into and determined. Such writ shall be made returnable not later than thirty days after the date of the issuance thereof, and shall direct the board to certify its record in the case to the court. On the return day, the cause shall be heard by the supreme court, unless for a good reason shown the same be continued. No new or additional evidence may be introduced in the supreme court, but the cause shall be heard on the record of the board as certified to by it. The review shall not be extended further than to determine whether the board has regularly pursued its authority, including a determination of whether the decision or order under review violates any provision of the constitution of the United States or of the State of California. The findings and conclusions of the board on questions of fact shall be final and shall not be subject to review. The board and each party to the proceedings before the board shall have the right to appear in the review proceeding. Upon the hearing, the supreme court shall enter judgment either affirming or setting aside the order or decision of the board. The provisions of the Code of Civil Procedure of this state relating to the writs of review shall, so far as applicable and not in conflict with the provisions of this act, apply to proceedings instituted in the supreme court under the provisions of this section.

Section 21:

COLLECTION OF TAX

CHANGE IN PLACE IN TRIAL

Section 31 provides that actions for the collection of delinquent taxes shall be commenced in the county of Sacramento. But
unless some contrary provision is made, the defendant will be able to secure a change of place of trial to the county of its residence. Why provide for commencing actions in Sacramento County if the place of trial of actions can be changed at any time? It is to be noticed that in 1931 Section 3668 (c) of the Political Code was amended to provide that the place of trial of actions for the collection of other delinquent state taxes could not be changed from Sacramento County except with the consent of the court and the attorney general. It is suggested that a similar amendment should be made to this section.

Suggested Amendment

Amend the first sentence of Section 21 to read as follows:

"At any time within one year after the delinquency of any tax, or any installment thereof, the controller of the state may bring an action in a court of competent jurisdiction in the county of Sacramento in the name of the people of the State of California to collect the amount delinquent, together with penalties, and such actions shall be tried in the county of Sacramento unless the court, with the consent of the attorney general, order a change of place of trial."

Period of Limitation Too Short

The one year period of limitation contained in this section is entirely too short for it imposes an unreasonable burden upon the controller and attorney general, who last year alone had to institute approximately 5,000 suits. It is suggested that the period for the assessment of deficiency taxes, refund of taxes, and collection of taxes should be uniform.

Provision Suggested for Summary Collection of Tax

The act as it now reads provides that the tax has the effect of a judgment against the taxpayer. In view of this provision, it would seem unreasonable to require the state to bring an action to collect the tax and thus obtain another judgment against the taxpayer. Furthermore, to require such action needlessly delays, and

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76 People v. Fincham (1931) 22 Cal. Dec. 529, 664.
77 Cal. Stats. 1931, p. 1308.
increases the cost of collecting delinquent taxes. It is suggested that the act should contain a provision patterned after Section 3321 of the political code, permitting the Controller to seize and sell any personal property, or if there is not sufficient personal property, to seize and sell any real property of the delinquent taxpayer.

**Suggested Amendment**

Add the following to Section 31:

At any time within which an action can be brought to collect any delinquent tax as provided in the preceding paragraph, the Controller may collect the tax, together with penalties, by seizure and sale of any personal property owned by the bank or corporation against whom the tax is assessed, or if sufficient personal property cannot be found, then the Controller may collect the tax by seizure and sale of the right to the possession of, claim to, or right to the possession of land.

**Section 32:**

**REVIVOR OF CORPORATIONS**

All Taxes Due Should Be Paid Before Corporation Reinstated

Under the act as it now reads, a suspended corporation may be revived by paying only the tax, interest and penalties for non-payment of which it was suspended, if such payment is made during the year in which suspension occurred, although the tax for the year in which it was suspended may be due and unpaid. It is submitted that no corporation should be reinstated that has not paid up all taxes due under the act.

Present Penalties Operate Harshly and Inequitably

If payment is made in any other year than the year in which it is suspended, the corporation must pay the amount for non-payment of which it was suspended plus twice the amount due for the year in which the suspension occurred.

This latter provision operates harshly and inequitably. For example, suppose a corporation is suspended in 1931 for non-payment of its franchise tax for the year 1930, which, let us
esusse, amounted to $25. Suppose the franchise tax for the year 1931 amounted to $1000. If the payment of the tax for which it was suspended is not made until 1932, the corporation will be required to pay the tax for which it was suspended ($25), plus interest and penalties thereon (approximately $8.43), plus twice the amount of the tax and penalties due the state for the year in which it was suspended ($2250) or a total of approximately $2258.43.

On the other hand, if the tax for the year 1930 had been $1000 and the tax for 1931 had been $25, the corporation could be revived by paying $1,335 (amount of tax plus interest and penalties due for 1930) plus $62.25 (twice the amount of tax and penalties due for 1931) or a total of approximately $1397.25.

It is submitted that a fairer method, in case payment is made in any year other than the year in which suspension occurred, would be to impose a penalty of twice the amount for which the corporation was suspended as it is believed that penalties should be measured by the tax for the non-payment of which suspension occurred, and not by amounts having no relation thereto.

**Suggested Amendment**

Amend the first paragraph of Section 33 to read as follows:

Any corporation which has suffered the suspension or forfeiture provided for in the preceding section may be relieved therefrom upon payment of the tax and the interest and penalties for nonpayment of which the suspension or forfeiture occurred together with all other taxes, deficiencies, interest and penalties due under the act if payment is made during the taxable year in which the suspension or forfeiture occurred, or upon payment of the above amounts together with an amount equal to the amount of the tax and penalties for the nonpayment of which the suspension or forfeiture occurred, if payment is made in any year other than such
year, and upon the issuance by the controller of a certificate of reviver. Application for such certificate on behalf of any domestic corporation which has suffered such suspension may be made by any stockholder or creditor or by a majority of the surviving trustees or directors thereof; application for such certificate may be made by any foreign corporation which has suffered such forfeiture or by any stockholder or creditor thereof.