

# California Law Review

Volume XXI

SEPTEMBER, 1933

Number 6

## Recent Changes in the Bank and Corporation Franchise Tax Act

IN THE ATTEMPT to solve the problem of taxing national banks<sup>1</sup> and to comply with the requirements of section 5219 of the United States Revised Statutes, which sets forth the conditions upon which the states may tax national banks, a drastic change was made in 1929 in the taxation of banks and corporations in California. This change was authorized by a constitutional amendment<sup>2</sup> approved by the

<sup>1</sup> For a detailed discussion of national bank taxation in general and for an analysis of some of the problems presented by the Bank and Corporation Franchise Tax Act as enacted in 1929, see Traynor, *National Bank Taxation in California* (1929) 17 CALIF. L. REV. 83, 232, 456; for an exposition of the Bank and Corporation Franchise Tax Act as it read in 1931, see Traynor, *The Bank and Corporation Franchise Tax Act*, BALLANTINE, CALIFORNIA CORPORATION LAWS (1932) c. 20.

<sup>2</sup> CAL. CONST., art. XIII, §16: "Notwithstanding any other provision of this Constitution:

1. (a) Banks, including national banking associations, located within the limits of this state, shall annually pay to the state a tax according to or measured by their net income, which shall be in lieu of all other taxes and licenses, state, county and municipal, upon such banks, or the shares thereof, except taxes upon their real property. The amount of the tax shall be equivalent to four per cent of their net income.

(b) 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.

(c) If it be finally determined that any tax levied upon or respecting any bank, national banking association, or the shares thereof, is invalid, said bank or association, or the shares thereof, shall be reassessed in conformity with any method provided by law. No claim against the state for refund or rebate of taxes paid shall be allowed without first deducting therefrom the amount of any such unpaid reassessment.

2. (a) All financial, mercantile, manufacturing and business corporations doing business within the limits of this state, subject to be taxed pursuant to subdivision (d) of section 14 of this article [see No. 301], in lieu of the tax thereby provided for, shall annually pay to the state for the privilege of exercising their corporate franchises within this state a tax according to or measured by their net income. The amount of such state tax shall be equivalent to four per cent of their net income. 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

people November 6, 1928. In pursuance thereof the Bank and Corporation Franchise Tax Act was passed and went into effect upon March 1, 1929.<sup>3</sup> In 1931 various provisions of this act were amended.<sup>4</sup> Further changes of a fundamental nature were made during the 1933 session of the legislature.<sup>5</sup> It is proposed to analyze these most recent changes in the following pages of this article.<sup>6</sup>

of such tax. In any event, each such corporation shall pay an annual minimum tax to the state, not subject to offset, of twenty-five dollars.

(b) 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 (a) of paragraph 2 of this section or subdivision (d) of section 14 of this article.

3. 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....

5. The Legislature shall define "corporations" and "doing business"; shall define "net income", and may define it to be the entire net income received from all sources; shall provide for the allocation of income, for the assessment, levy and collection of the aforesaid taxes, and for reassessment in the event of the invalidity of any tax under 2(a) or 2(b) hereof. Said taxes shall become a lien on the first Monday in March of 1929 and of each year thereafter. The Legislature shall pass laws necessary to carry out this section. The acts of the forty-eighth session of the Legislature passed pursuant to this section shall be effective immediately upon their passage."

This section was changed by an amendment approved by the people June 27, 1933 to read as follows:

"Sec. 16. 1. (a) Banks, including national banking associations, located within the limits of this State, shall annually pay to the State a tax according to or measured by their net income, which shall be in lieu of all other taxes and licenses, State, county and municipal, upon such banks, or the shares thereof, except taxes upon their real property, at the rate to be provided by law.

(b) The Legislature 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.

2. The Legislature may provide by law for the taxation of corporations, their franchises, or any other franchises by any method not prohibited by this Constitution or the Constitution or laws of the United States.

3. Any tax imposed pursuant to this section must be under an act passed by not less than two-thirds vote of all the members elected to each of the two houses of the Legislature."

Although the Bank and Corporation Franchise Tax Act was not amended to conform with the amendments to section 16 of article XIII of the Constitution, it is clear that these amendments do not in any way impair the validity of the act. *Ex parte Prindle* (1905) 7 Cal. Unrep. 223, 94 Pac. 871, 873; *Reade v. City of Durham* (1917) 173 N. C. 668, 92 S. E. 712; *Norfolk-Southern R. R. v. Forbes* (1924) 188 N. C. 151, 124 S. E. 132.

<sup>3</sup> Cal. Stats. 1929, c. 13, p. 19.

<sup>4</sup> *Ibid.* 1931, c. 64, p. 60; c. 65, p. 64; c. 1066, p. 2225.

<sup>5</sup> *Ibid.* 1933, c. 209, c. 210.

<sup>6</sup> For a critical analysis of the Bank and Corporation Franchise Tax Act as it read in 1931, for proposed changes therein and arguments in support of such

## I. CORPORATIONS TAXABLE UNDER THE ACT

The constitutional provision<sup>7</sup> 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 of the state constitution.<sup>8</sup>

All corporations taxable, with the exception of banks, are subject to a minimum tax of \$25.<sup>9</sup>

The constitutional section further provides, however, that the legislature, two-thirds of all the members elected to each of the two houses voting in favor thereof, 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, subject to the limitation that such form of taxation shall apply to all banks located within the limits of this state,<sup>10</sup> and may provide by law for the taxation by any other method authorized in the constitution of the corporations, or the franchises, subject to be taxed pursuant to subdivision (d) of section 14.<sup>11</sup>

It will be observed that the only constitutional requirement for the

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changes, see Roger J. Traynor and Frank M. Keesling, *Analysis of the Bank and Corporation Franchise Tax Act*, submitted to the California Tax Research Bureau in the Office of the State Board of Equalization January 1933.

<sup>7</sup> CAL. CONST., art. XIII, §16.

<sup>8</sup> Section 14 (d), pursuant to an amendment approved by the people June 27, 1933 will be effective only until December 31, 1934. The only corporations taxable under section 14 (d) which were not taxed under other sections of the constitution, were those having a franchise of assessable value, for no specific mention is made of corporations as such in section 14 (d) which provides:

"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." (Italics added.)

The specifically excluded franchises are those of public utilities, banks and insurance companies, inasmuch as they are subject to special taxation under other provisions of the same section.

<sup>9</sup> The reason national banks are not subject to a minimum tax is that section 5219 of the United States Revised Statutes permits a tax on such banks "according to or measured by their net income." A minimum tax when there is no net income would not be a tax measured by net income. To prevent discrimination against state banks they are likewise not subject to the minimum tax.

<sup>10</sup> CAL. CONST., art. XIII, §16, par. 1b.

<sup>11</sup> *Ibid.* par. 2b.

taxability of banks is that they be "located within the limits of this state."<sup>12</sup> 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."<sup>13</sup>

It will be further observed that two requirements are imposed by the constitutional provision as it read at the time the act was passed with reference to the taxability of corporations. The first of these requirements, that of "doing business," is discussed later.<sup>14</sup> The second requirement precluded the extension of the act to public utilities and insurance companies doing business in this state for they were not subject to the provisions of section 14 (d).<sup>15</sup>

From 1929 until 1931 only corporations that were actually doing business within the limits of this state were subjected either to the minimum tax of twenty-five dollars or to a tax measured by net income. In 1931 the legislature, by amending the definition of "doing business" to include the "right to do business" enlarged the class of corporations subject to the minimum tax.<sup>16</sup> The act as amended in 1933 imposes a tax on all corporations except those noted below, that were subject to be taxed pursuant to subdivision (d) of section 14.<sup>17</sup> If the corporation is a "financial, mercantile, manufacturing or business corporation" "doing business" within the limits of this state, it must pay a tax for the privilege of doing business according to or measured by its net income, and in any event must pay for that privilege an annual minimum tax of twenty-five dollars. If the corporation is not doing business then regardless of whether it is a financial, mercantile, manufacturing or business corporation it does not pay a tax according to or measured by its net income but pays an annual tax of twenty-five dollars in lieu of the tax on its general corporate franchise under the provisions of

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<sup>12</sup> See Cal. Stats. 1929, c. 13, §1, p. 19, as amended by Cal. Stats. 1933, c. 303.

<sup>13</sup> See Cal. Stats. 1929, c. 13, §2, p. 19, as amended by Cal. Stats. 1933, c. 303.

<sup>14</sup> *Infra* page 550.

<sup>15</sup> *Supra* note 8. Under the provisions of the constitutional amendment approved by the people June 27, 1933, public utilities remain taxable on their gross receipts until January 1935. Until that time the Bank and Corporation Franchise Tax cannot apply to them for the reason that the gross receipts tax is in lieu of all other taxes and licenses, state, county and municipal upon the operative property of such corporations. CAL. CONST., art. XIII, §14.

<sup>16</sup> Cal. Stats. 1931, c. 1066, p. 2225. This amendment was apparently designed to subject inactive corporations to the minimum tax. However, for reasons indicated below (page 550) the amendment also resulted in subjecting such corporations to the tax measured by net income. Under the 1933 amendments all such corporations are subject only to an annual tax of \$25.

<sup>17</sup> Cal. Stats. 1933, c. 303.

section 14 (d).<sup>18</sup> Corporations organized for religious, charitable, social, fraternal or civic purposes, where their organization or activities result in no pecuniary gain or profit to the stockholders or members thereof, are not taxable under the act. These corporations, theoretically at least, remain taxable under section 14 (d). A corporation must have a franchise of "actual cash value," however, to be subject to a tax under that section and it is doubtful whether any of these corporations possess such a franchise.

The status of foreign corporations not doing intra-state business in this state has not been changed. Such corporations, apparently, were not taxable under section 14 (d) and hence are not taxable under the act.<sup>19</sup> Foreign corporations doing exclusively interstate business in the state are not subject to a franchise tax.<sup>20</sup>

A radical change has been made with reference to holding companies. Considerable doubt has existed whether such corporations were taxable under the act as it read before the recent amendments inasmuch as it is uncertain whether they can be classed as "financial, mercantile, manufacturing or business" corporations.<sup>21</sup> If such corpora-

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<sup>18</sup> Although corporations which are not "doing business" in this state or which are not "financial, mercantile, manufacturing or business corporations" are not subject to the tax measured by net income, they are, however, required to file returns (§13) and to pay the \$25 tax to which they are subject at the same time (§23) as corporations subject to the tax measured by net income. This result follows from the definition of the term "corporation" contained in section 5 of the act, which it is to be noted, was amended to provide that the term should include all corporations taxable under the act. Cal. Stats. 1933, c. 210.

Although paragraph 2(a) of section 16 expressly authorized a tax only upon financial, mercantile, manufacturing and business corporations doing business within the limits of this state, it would nevertheless seem that the tax imposed upon other corporations by the act is constitutional in view of paragraph 2(b) which provided: "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 (a) of paragraph 2 of this section or subdivision (d) of section 14 of this article." (Italics added.) See Roger J. Traynor and Frank M. Keesling, *op. cit. supra* note 6, at 47-50.

<sup>19</sup> *People v. Alaska Pacific S. S. Co.* (1920) 182 Cal. 202, 187 Pac. 742.

<sup>20</sup> *Alpha Portland Cement Co. v. Commonwealth* (1925) 268 U. S. 203; *Anglo-Chilean Nitrate Corp. v. Alabama* (1933) 288 U. S. 218.

<sup>21</sup> Such companies can hardly be considered financial, mercantile, or manufacturing corporations, hence, if they were taxable under the act it was because they are "business" corporations. A number of cases have held that the test whether a corporation is a business corporation is whether its activities result in pecuniary gain or profit to its members. *Flint v. Stone Tracy Co.* (1911) 220 U. S. 107, 171; *Dairy Marketing Ass'n of Fort Wayne* (D. Ind. 1925) 8 F. (2d) 626, 628; *People v. Board of Trade of Chicago* (1875) 80 Ill. 134, 136; *McLeod v. Lincoln Medical College of Cotner University* (1903) 69 Neb. 550, 553, 96 N. W. 265, 266; *Greenough v. Board of Police Commissioners of Town of Tiverton* (1909) 30 R. I. 212, 219, 74 Atl. 785, 789.

Is the purpose of a holding company personal material gain of a pecuniary

tions were not taxable under the act they were not subject either to the minimum tax or to the tax measured by net income. On the other hand if such corporations were taxable under the act they were subject not only to the minimum tax but also to the tax measured by their net income, which included for the most part, dividends received on stock held by them which were declared out of earnings from non-California business.

Uncertainty as to the taxability of holding companies led to uncertainty as to the taxability of dividends received from them by other corporations. Section 8 (h) excluded from gross income dividends received from "income arising out of business done in this state." If holding companies were taxable as business corporations doing business in this state, it would seem to follow that dividends received from holding companies by other corporations could be regarded as being received from "income arising out of business done in this state,"<sup>22</sup> and hence within the exemption, even though declared by the holding company out of dividends received by it which were declared out of income from non-California business. On the other hand, if holding companies were not taxable under the act it would seem that dividends declared by them could not be regarded as being within the exemption of section 8 (h).<sup>23</sup>

These uncertainties have been removed. Holding companies are declared not to be financial, mercantile, manufacturing or business

nature to its members? This question was presented in a number of cases under the Federal Capital Stock Act of 1909. See *Zonne v. Minneapolis Syndicate* (1911) 220 U. S. 187; *United States v. Nipissing Mines Co.* (C. C. A. 2d, 1913) 206 Fed. 431; *Rose v. Nunnally Investment Co.* (C. C. A. 5th, 1927) 22 F. (2d) 102, 104; *Emery, Bird, Thayer Realty Co. v. United States* (W. D. Mo. 1912) 198 Fed. 242, 250; *Clallam Lumber Co. v. United States* (W. D. Mich. 1927) 34 F. (2d) 944; *Del Norte Co. v. Wilkinson* (E. D. Wis. 1928) 28 F. (2d) 876; *Argonaut Consol. Mining Co. v. Anderson* (S. D. N. Y. 1930) 42 F. (2d) 219, 221; *Automatic Fire Alarm Co. of Delaware v. Bowers* (S. D. N. Y. 1931) 51 F. (2d) 118, 120. These cases indicate that holding companies are not business corporations. If these cases were followed, holding companies would not be deemed 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 gain or benefits were derived therefrom they would not be created, and that if the members desire those benefits they should pay therefor a franchise tax exacted by the state for the privilege of having such corporations. See the opinion of the State Board of Equalization in *The Matter of the Appeal of Union Oil Associates* (Oct. 10, 1932) 1 Prentice-Hall State and Local Tax Service, par. 29056.

<sup>22</sup> See the opinion of the State Board of Equalization in *The Matter of the Appeal of Keck Investment Co.* (Dec. 14, 1931) *ibid.* par. 29008.

<sup>23</sup> The taxability of dividends received from corporations not doing business in this state declared out of income which was itself derived from dividends declared out of earnings from California business will be considered in a later installment of this article.

corporations or corporations doing business in this state for the purpose of the act.<sup>24</sup> Consequently such corporations are definitely excluded from taxation according to or measured by their net income.<sup>25</sup> Domestic holding companies, however, will be required to pay an annual tax to the state of twenty-five dollars on their general corporate franchises in lieu of the tax under section 14 (d).<sup>26</sup> Dividends received from holding companies by other corporations will be included in their gross income regardless of whether or not the holding companies receive their income from corporations doing business within or without the limits of this state. This result follows from the amendment to section 8 (h) restricting the deductions of dividends from gross income to "dividends received during the taxable year from a bank or corporation *doing business* in this state declared from income arising out of business done in this state."<sup>27</sup>

The principal significance of these changes, assuming that holding companies were taxable under the act prior to the effective date of the amendments, is to relieve holding companies from taxation on account of income received by them which was declared out of earnings from non-California business, and to subject corporate stockholders of

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<sup>24</sup> "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." Section 4 of the act as amended, Cal. Stats. 1933, c. 303.

<sup>25</sup> If holding companies were taxed under the act according to or measured by their net income the tax would fall almost entirely on dividends declared out of earnings from non-California business. Since other corporations which are taxable according to or measured by net income are taxed on dividends received by them which are declared out of earnings from non-California business it is arguable that holding companies should likewise be taxed on dividends received by them declared out of earnings from such business. If cement companies, for example, are taxed on such dividends, why should not holding companies? However, to tax holding companies according to or measured by their net income 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. If they would they could easily cease such business by holding the stock outside the state and distributing the dividends therefrom. Furthermore it is questionable whether foreign corporations are taxable by this state on dividends received by them whether they are doing business here or not. See Traynor, *The Bank and Corporation Franchise Tax Act*, *op. cit. supra* note 1, at 705 *et seq.* If the tax could easily be avoided by becoming a foreign corporation and holding stock outside the state it would have driven holding companies out of the state.

<sup>26</sup> Section 4 of the act as amended, Cal. Stats. 1933, c. 210.

<sup>27</sup> Section 8(h) of the act as amended, Cal. Stats. 1933, c. 209. (Italics added.)

holding companies to taxation on such income when distributed to them. In addition, income from California business received by holding companies and distributed to corporate stockholders doing business in this state will be taxable to such stockholders. As a result of these changes it is likely that the taxes imposed upon income passing through holding companies will be greatly reduced, inasmuch as non-corporate stockholders in holding companies probably greatly outnumber corporate stockholders in such companies.

## II. THE DEFINITION OF DOING BUSINESS

As noted above,<sup>28</sup> to be subject to the tax expressly provided for in the constitution, a corporation must not only be a financial, mercantile, manufacturing or business corporation taxable under section 14 (d) of article XIII of the state constitution but must also be "doing business" within the limits of this state.

The definition of the term "doing business" first contained in the act read as follows:

"The term 'doing business' as herein used, means 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 intra-state business in this state."<sup>29</sup>

This definition afforded but little if any assistance in determining what corporations were taxable under the act inasmuch as the meaning of the definition depended upon the meaning of the word "business"—the very word in the term requiring definition.

It would seem clear, however, that corporations which engaged in no activities whatever would not be doing business within the meaning of the above definition and hence not subject even to the minimum tax. In 1931 the definition just given was extended by the addition of the following, "and shall include the right to do business through such incorporation or qualification."<sup>30</sup> The effect of this amendment was to subject inactive corporations which were financial, mercantile, manufacturing or business corporations taxable under section 14 (d) to the minimum tax. It should be noted, however, that if such corporations had any net income they also became subject to the tax measured by net income in the same manner and to the same extent as corporations actively engaged in business.<sup>31</sup>

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<sup>28</sup> *Supra* page 545.

<sup>29</sup> Cal. Stats. 1929, c. 13, §5, p. 20.

<sup>30</sup> *Ibid.* 1931, c. 65, p. 64, and c. 1066, p. 2225.

<sup>31</sup> At the same time that the definition of "doing business" was extended to include the right to do business, section 13 of the act was amended (Cal. Stats. 1931, c. 65, p. 64) to provide that if any bank or corporation discontinued actual operations within the state in any year and thereafter had no net income but did



There does not appear to be any desire to exact more than the minimum tax from inactive corporations. Amending the definition of "doing business" to include the right to do business, aside from the fact that it is difficult to understand how having the right to do something can sensibly be considered doing that thing, seems to be a devious and roundabout method of imposing the minimum tax on inactive corporations.<sup>32</sup>

In 1933 the definition of "doing business" was amended to read as follows:

"The term 'doing business,' as herein used, means actively engaging in any transaction for the purpose of financial or pecuniary gain or profit."<sup>33</sup>

This definition is more in accord with accepted usage of the term<sup>34</sup> and will eliminate much confusion and uncertainty as to the scope of the act. Furthermore, this definition should be of assistance in determining what constitutes a business corporation for it would seem that any corporation organized to do business within the meaning of the definition would be a business corporation.

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not dissolve or withdraw from the state, it should in the succeeding year and thereafter until dissolution, withdrawal or resumption of operations pay an annual tax to the state of \$25.

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.

Under the 1931 amendment defining doing business to include the right to do business, a corporation that discontinued active business during any year and did not dissolve during that year remained subject to the act and was required to file a return for that year, and were it not for the above described amendment to section 13, would be required to pay a tax measured by the net income of that year for the privilege of "doing business" in the statutory sense during the succeeding year even though its place of business was closed down, all of its employees discharged, and no business transactions of any kind entered into.

Apparently it was the purpose of the amendment to 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 in which it discontinued operations. However, that purpose was not adequately provided for in view of the language used. If, after such discontinuance, it received net income, no matter how small the amount thereof, or if it dissolved in the year succeeding such discontinuance of operations, the corporation was subject to a tax measured by the preceding year's income.

The 1933 amendment to the definition of doing business removed the necessity of this provision in section 13 and it was therefore repealed. Under the act as it now reads, a corporation that discontinues actual operations in any year and thereafter remains inactive, will under no circumstances be required to pay more than the \$25 tax for any subsequent year.

<sup>32</sup> For the present method of reaching these corporations, see *supra* page 546.

<sup>33</sup> Cal. Stats. 1933, c. 210.

<sup>34</sup> See cases cited in note 21, *supra*.

## III. THE PROPERTY TAX OFFSETS

One of the outstanding changes recently effected is the virtual elimination of all property tax offsets. The constitutional provision pursuant to which the act was passed provides that the tax thereby imposed shall be subject to offset in a manner to be prescribed by law in the amount of personal property taxes paid by corporations taxable thereunder to the state and its political subdivisions, subject to the limitation that the offset shall not exceed 90% of the franchise tax imposed.<sup>35</sup> When the Bank and Corporation Franchise Tax Act was passed the legislature included in the offset an allowance for ten per cent of real property taxes paid locally,<sup>36</sup> omitted the offset for personal property taxes paid to the state,<sup>37</sup> and reduced the total offset permissible from 90% of the tax imposed by the act to 75% of that tax.

The Tax Commission of 1927 which recommended the adoption of the constitutional provision admitted that the personal property tax offset was defensible only as a temporary expedient until all personal property taxes should be abolished and a statewide income tax on all corporations and individuals established.<sup>38</sup> No steps were taken either by the 1929 or 1931 legislatures to carry out the recommendation that personal property taxes be abolished. The California Tax Research Bureau, in the office of the State Board of Equalization, realizing that attainment of the commission's objective was at best a remote possibility, undertook in 1932 an investigation of the property tax offsets to determine whether they should be retained as a permanent feature of the act.<sup>39</sup> This investigation disclosed that the allowance of offset

<sup>35</sup> CAL. CONST., art. XIII, §16, par. 2a; see note 2, *supra* for the text of this constitutional provision.

<sup>36</sup> Cal. Stats. 1929, c. 13, §4, p. 20. For a discussion questioning the validity of the real property tax offset, see Traynor, *National Bank Taxation in California*, *op. cit. supra* note 1, at 501 *et seq.*

<sup>37</sup> The corporate franchise tax assessed under section 14(d) 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 moneys, credits, bonds, stocks, dues, *franchises*, and all other matters and things, real, personal, and mixed, capable of private ownership. . . ." (Italics added.) If an offset for personal property taxes paid the state had been allowed, it would seem that franchise taxes for 1928 computed under the old law could have been offset against the franchise taxes for 1929 imposed under the new law. To have permitted the franchise tax for 1929 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 the minimum. If any substantial revenue was to be expected from the new franchise tax, it was necessary to eliminate the provision for offset of personal property taxes paid to the state.

<sup>38</sup> Final Report of the California Tax Commission, 1929, p. 78.

<sup>39</sup> Summary Report of the California Tax Research Bureau, 1932, pp. 78-81.

operated unfairly and inequitably between corporations subject to the act,<sup>40</sup> that less than 12% of the corporations taxable thereunder received any benefit from the offsets and that the remainder of the corporations were either unaffected by offsets or would benefit by elimination of offsets and reduction of the franchise tax rate.<sup>41</sup> Accordingly, the Bureau recommended that offsets be eliminated, except for a limited offset for financial corporations, and that the rate of tax on mercantile, manufacturing and business corporations be reduced from 4% to 2%.<sup>42</sup> Subsequently, the legislature adopted amendments to sections 4 and 26 of the act consistent with these recommendations.<sup>43</sup>

<sup>40</sup> *Ibid.* Corporations that had net income, but which paid no real or personal property taxes, were required to pay the full amount of the franchise tax, i.e., 4% of their net income. In other words, such corporations did not benefit from the offset allowance. Likewise, corporations that had no net income but which paid real or personal property taxes did not benefit by the offset allowance. Corporations which had net income and which paid real or personal property taxes benefited from the allowance of offset but in varying amounts, depending upon the relation which their real or personal property taxes bore to their franchise tax prior to offset.

Corporations which paid real or personal property taxes in such amounts that 10% of their real property taxes and 100% of their personal property taxes exactly equaled 75% of their franchise tax obtained, and were the only corporations which obtained, the full advantage of the offset. Such corporations were enabled in all cases to reduce their franchise taxes to 1% of their net income. Other corporations which paid real or personal property taxes, subject to offset, in amounts either less or greater than 75% of 4% of their net income did not get the full advantage of the offset. If their real or personal property taxes were less than 75% of 4% of their net income, they were not enabled to reduce their franchise tax to 1% of their net income and were consequently actually required to pay franchise taxes at a greater rate than corporations whose real and personal property taxes, subject to offset, amounted to 75% of 4% of their net income. On the other hand, if their real and personal property taxes were greater than 75% of 4% of their net income, they were not enabled to offset all of such taxes and consequently their total tax burden was greater in terms of net income than the tax burden of corporations which paid real and personal property taxes exactly equal to 75% of 4% of their net income.

<sup>41</sup> Summary Report of the California Tax Research Bureau, 1932, p. 80. 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 from 4% 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, 9.38% of the 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. In other words, only 11.96% of the corporations subject to the act obtained any benefit from the allowance of offset, whereas the remaining corporations, i.e., 88.04%, either were injured by allowing offsets or were unaffected by such allowance.

<sup>42</sup> For discussion of the rate on banks and financial corporations, see *infra* page 554.

<sup>43</sup> It might be questioned whether it is permissible to eliminate offsets in view of the provisions of section 16 of article XIII of the Constitution stating

## IV. THE BANK TAX RATE

Probably the most significant amendment recently made to the act is that presented in the new section numbered 4a which sets forth the method of computing the tax on banks and financial corporations.<sup>44</sup>

In 1932 the Tax Research Bureau, in the office of the State Board of Equalization, made a critical and detailed study of the operations of the act and embodied its conclusions in a report submitted to the legislature December 1, 1932. That study revealed that the combined revenue from banks and corporations greatly declined as a result of the change in taxation inaugurated in 1929, that the tax on corporations generally had increased, and that the decline was due to decreased collections from banks.<sup>45</sup> In order to equalize the burden of taxation between banks and other corporations and to obtain, in a manner consistent with the restrictions of section 5219 of the Revised Statutes of the United States, a fair and equitable tax from banks, the Bureau recommended the adoption of the method set forth in section 4a.

The purpose of this section is to impose upon banks a tax burden in terms of net income more nearly equivalent to the tax burden borne by other corporations taxable under the act. Banks are in a peculiarly favorable position. Although they pay real property taxes

that the tax thereby imposed "shall be subject to offset." It is to be noted, however, that the provision is not self executing inasmuch as the offset is to be allowed in "a manner to be prescribed by law." Furthermore, paragraph 3 of section 16 provides that the legislature may change the "percentage, amount, or nature of offset provided." This provision clearly authorizes complete elimination of offsets. Assuming, however, that the constitution contemplates that some offset be allowed regardless of the "amount, percentage or nature" thereof, the above discussed amendments are nevertheless valid for an offset is retained for financial corporations.

<sup>44</sup> Cal. Stats. 1933, c. 210.

<sup>45</sup> The following comparison of actual yield of the combined state taxes on banks and corporations under the old and new methods is found on page 75 of the Bureau's report:

Year	Bank Taxes (Share Tax)	Corporation Taxes (Corporate Excess Tax)	Total Taxes
1926 . . . . .	\$4,347,803	\$4,057,026	\$8,404,829
1927 . . . . .	4,384,791	4,725,215	9,110,006
1928 . . . . .	4,766,780	4,691,340	9,458,120
Totals . . . . .	\$13,499,374	\$13,473,581	\$26,972,955
	(Measured by Net Income)	(Measured by Net Income)	
1929 . . . . .	\$ 554,604	\$5,755,300	\$6,309,904
1930 . . . . .	905,669	6,366,171	7,271,840
1931 . . . . .	831,982	4,642,418	5,474,400
Totals . . . . .	\$2,292,255	\$16,763,889	\$19,056,144

to the same extent as other corporations they pay no taxes upon their personalty.<sup>46</sup> Consequently under any system of taxing banks and corporations according to or measured by net income, where the rate of tax applicable to net income is the same for both banks and corporations, the total burden of taxation on corporations in terms of net income is necessarily greater than on banks, although the personal property owned by banks may be just as valuable as the personal property owned by other corporations. One of the reasons for allowing corporations to offset their personal property taxes against their franchise tax was to eliminate this inequality.<sup>47</sup> However, the inequality was not entirely eliminated due to the limitation that the total offset should not exceed 75% of the franchise tax,<sup>48</sup> 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. Furthermore, as above noted,<sup>49</sup> allowance of offsets resulted in serious inequalities between corporations. To have increased the offset would simply have resulted in magnifying these inequalities.

The act makes net income the measure of the tax on both banks and corporations and as amended, contemplates, except for the limitation that the rate of tax on banks shall not exceed 6%, that the same percentage of the net income of banks shall be taken in taxes as is taken of the net income of corporations in taxes. To that end it is provided, that the rate of tax on banks

"shall be a percentage equal to the percentage of the total amount of 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; provided, however, that said rate of tax shall not exceed six per centum."<sup>50</sup>

Although the tax is annually imposed for the privilege of doing business for a one year period it is measured by the net income of the preceding year, designated by the act as the taxable year.<sup>51</sup> The act recognizes the fact that many corporations keep their books on a

<sup>46</sup> 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. *Rosenblatt v. Johnston* (1881) 104 U. S. 462. To prevent discrimination, state banks are not taxed on their personalty. CAL. CONST., art. XIII, §16, par. 1(a).

<sup>47</sup> See Final Report of California Tax Commission, 1929, p. 302.

<sup>48</sup> Cal. Stats. 1929, c. 13, §4, p. 20.

<sup>49</sup> *Supra* page 552.

<sup>50</sup> Cal. Stats. 1933, c. 303, §4a.

<sup>51</sup> *Ibid.* 1929, c. 13, §11, p. 25.

fiscal year rather than on a calendar year basis.<sup>52</sup> This recognition serves as an accommodation to the taxpayers and enables them to make their returns under the act largely on the basis of returns made to the federal government as the federal act also permits the computation of taxes on a fiscal year basis.<sup>53</sup>

Even under the act as amended it is to be noted that banks remain in a more favored position than corporations. Regardless of what the tax burden is on corporations the burden on banks will never exceed 6% of their net income. Corporations enjoy no such protection. It is highly probable that their tax burden exceeds 6% of their net income. If it is justifiable to impose upon banks a burden approximately equivalent to the burden imposed upon corporations, where the burden on corporations in terms of their net income is less than 6%, it would seem equally justifiable to impose upon banks the same burden as that imposed upon corporations where the burden on corporations is greater than 6%. Hence it would seem that the 6% limitation has no logical foundation and simply operates to prevent the bank tax burden from being as high as the burden on corporations.

In arriving at the rate of tax on banks for a given year, the act requires the computation of the total amount of net income allocable to this state of mercantile, manufacturing and business corporations<sup>54</sup> taxable under the act for the preceding calendar year or fiscal year ended in such calendar year and the computation of the total amount of personal property taxes paid or required to be paid by such corporations during that same taxable period as well as the amount of state franchise tax based on the net income for that taxable period. When this is done the total tax burden (aside from real property taxes) sustained by mercantile, manufacturing, or business corporations for that period can be determined. In other words, it can be ascertained how much or what percentage of the net income of corporations was taken in the form of personal property taxes and in the form of a franchise tax. This percentage (subject to the 6% limitation just mentioned) will be the rate of tax on banks on the basis of their net income for the same period.

The percentage of the net income of corporations paid to the state as franchise taxes will be the rate fixed in the act for such corporations, namely 2%. The act provides that the percentage of net income of such

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<sup>52</sup> *Ibid.* §12, p. 25.

<sup>53</sup> Federal Revenue Act of 1932, §41, 47 STAT. (1932) 185, 26 U. S. C. SUPP. IV (1932) §3041.

<sup>54</sup> Provision is made for taxing financial corporations in the same manner as banks. Consequently, the burden of taxation on them in terms of net income is not considered as a factor in computing the tax on banks.

corporations required to be paid by them in personal property taxes<sup>55</sup> shall be determined

"by ascertaining the ratio which the total amount of such personal property taxes, less two per cent thereof, bears to the total amount of net income of such corporations, allocable to California, increased by the amount of such personal property taxes; provided, however, that if any such corporation sustains a net loss allocable to California the personal property taxes required to be paid by such corporation to this State or its political subdivisions during the preceding calendar year or fiscal years ending during such calendar year shall be considered for the purpose of determining such ratio only to the extent which such personal property taxes exceed such net loss allocable to California."<sup>56</sup>

This provision presents a number of questions: (1) Why add the personal property taxes to the net income of corporations before ascertaining the ratio? (2) Why deduct 2% of the total amount of personal property taxes paid by corporations? (3) In the case of corporations sustaining a net loss why consider the personal property taxes only to the extent that such taxes exceed such net loss?

(1) *Addition of Personal Property Taxes to Net Income.*—The purpose of section 4a is to ascertain what the actual tax burden is on corporations. That burden is measured in terms of net income because a greater burden in terms of net income cannot be imposed upon banks than is imposed upon financial corporations nor can banks be the most heavily tax-burdened class of corporations in the state.

In order to impose upon banks a burden comparable to that borne by corporations it is necessary that the burden on both banks and corporations be determined according to the same measure. The measure fixed by the federal statute according to which the tax burden on national banks is determined is net income. That measure does not include a deduction for personal property taxes inasmuch as national banks pay no personal property taxes. Consequently if the same measure is employed in determining the tax burden on corporations it will not include a deduction for personal property taxes.<sup>57</sup> For this reason

<sup>55</sup> Since 1910 corporations have not been required to pay personal property taxes to the state. However, if in the future personal property taxes are required to be paid to the state pursuant to a state *ad valorem* tax they will be considered in arriving at the tax rate applicable to banks.

<sup>56</sup> Cal. Stats. 1933, c. 303, §4a.

<sup>57</sup> For example, suppose corporations had net income of \$100,000 before paying personal property taxes and that banks had the same net income. Suppose further that corporations paid \$20,000 in personal property taxes. In order to impose upon banks the same burden in terms of net income imposed upon corporations it would be necessary to obtain \$20,000 from banks, or in other words 20% ( $\frac{20000}{100000}$ ) of their net income. If the ratio which personal property taxes paid by corporations bears to net income as defined in the act is considered indicative of the burden on corporations, banks would be required to pay \$25,000 or 25% ( $\frac{20000}{80000}$ ) of their net income and would thus be sustaining a 5%

personal property taxes are added back to the net income of corporations inasmuch as net income is defined in the act as gross income less the deductions allowed, one of the deductions allowed being for personal property taxes.

(2) *The 2% Deduction.*—To impose upon banks a rate equal to that borne by corporations it is necessary to consider the burden of the franchise tax on corporations in terms of their net income prior to the deduction of personal property taxes for the same reasons that the burden of personal property taxes is computed in terms of net income prior to the deduction of such taxes. The franchise tax rate on corporations is fixed at 2% of their net income. In arriving at net income, however, corporations are allowed to deduct personal property taxes and hence are enabled to reduce their franchise tax to the extent of 2% of their personal property taxes. In other words, although the act fixes the rate on corporations at 2%, the actual rate in terms of net income comparable to the net income of banks is less than 2%.

The net income of corporations (prior to the deduction of personal property taxes) is relieved of a burden to the extent of 2% of the personal property taxes paid by them. In the ascertainment of the tax burden on corporations, an adjustment must be made for this item.<sup>58</sup> One method for making this adjustment would be to ascertain the ratio which franchise taxes paid by corporations bore to their net income prior to the deduction of personal property taxes. Another method would be to decrease the personal property taxes of corporations to the extent that corporations are enabled to reduce their franchise taxes in ascertaining the percentage of their net income paid in personal property taxes.<sup>59</sup>

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heavier tax burden than corporations, whereas if the ratio which personal property taxes paid by corporations bears to their net income prior to the deduction of personal property taxes is taken as the test of the burden of such taxes on corporations, banks would be required to pay \$20,000 or 20% of their net income, the same amount as corporations.

<sup>58</sup> For example, suppose corporations had net income of \$100,000 before paying personal property taxes and that banks had the same net income. Suppose further that corporations paid \$20,000 in personal property taxes. The 2% franchise tax on corporations will be measured by \$80,000 (\$100,000—\$20,000) and as so measured will be \$1,600 or 1.6% of their net income prior to the deduction of personal property taxes. This percentage added to the 20% of such net income paid in personal property taxes gives a total of 21.6%. If this percentage is applied to the net income of banks they will be required to sustain the same burden as corporations. If, however, the franchise tax burden on corporations were considered to be 2% of their net income and this percentage were added to the percentage of net income paid in personal property taxes and the resulting percentage applied to the net income of banks they would be required to sustain a burden of 22% of their net income or a greater burden than corporations.

<sup>59</sup> In the preceding example it was shown that under the facts there assumed the percentage of the net income of corporations paid as franchise taxes and per-



Whether this adjustment is made in computing the burden of the franchise tax or in computing the burden of the personal property taxes, the method adopted in the statute, is a matter of indifference.

(3) *Consideration of Personal Property Taxes Only to Extent They Exceed Net Loss.*—If, before deducting personal property taxes, a corporation has net income in excess of its personal property taxes, ascertaining the ratio which such taxes bear to its net income presents no particular difficulty. However, if a corporation sustains a loss and hence pays its personal property taxes out of capital it is difficult to determine how such property taxes should be treated. What is the burden of such taxes in terms of net income when there is no net income? The act provides that personal property taxes required to be paid by a corporation which sustains a net loss will not be considered except insofar as they exceed such net loss. This is simply another way of stating that if a corporation has no net income before the deduction of personal property taxes or has net income before such deduction but the deduction thereof results in a net loss, such taxes in the first instance will not be included in arriving at the total amount of such taxes required to be paid by corporations, and in the second instance will be included only to the extent of the net income before they are deducted.<sup>60</sup>

Although personal property taxes required to be paid by corporations which sustain a loss either before or after the deduction of such taxes are a burden on such corporations and the total or partial exclusion of them means that they will not be reflected in the bank tax rate, it would seem proper to exclude such taxes in the manner provided in the statute in order to obviate any question as to the propriety of including them.

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sonal property taxes was 21.6%. This percentage was arrived at by ascertaining the ratio which both franchise taxes and personal property taxes bore to net income prior to the deduction of personal property taxes. If their franchise tax burden were considered to be 2% of their net income and if in arriving at the burden of personal property taxes the personal property taxes were reduced to \$19,600 (\$20,000 less 2% thereof) the same total percentage—21.6%—would have been obtained, as \$19,600 is 19.6% of \$100,000 and 19.6% plus 2% equals 21.6%.

<sup>60</sup> For example, suppose a corporation sustains a loss of \$10,000 before paying personal property taxes and that its personal property taxes amount to \$5,000. Its net loss will thus be \$15,000. Inasmuch as the net loss is in excess of the personal property taxes none of such taxes will be considered. Suppose, however, a corporation has a net income of \$2,000 before paying personal property taxes and that its personal property taxes amount to \$5,000. Its net loss will be \$3,000. Since the personal property taxes exceed the net loss to the extent of \$2,000, only \$2,000 of such taxes (an amount equal to the net income before deducting personal property taxes) will be considered.

The percentage to be applied to the net income of banks for any particular year necessarily cannot be ascertained until the returns of corporations for that year and for fiscal years ended during that year have been filed and audited. The returns for calendar year corporations are not due until two months and fifteen days after the close of the calendar year.<sup>61</sup> In order to allow time for auditing these returns it is provided that the commissioner shall determine not later than December 31 what percentage of the net income of corporations was paid in franchise and personal property taxes, *i.e.*, the percentage to be applied to banks.<sup>62</sup> It is provided that public hearing shall be granted and opportunity be given to examine the data on which the commissioner's determination is based. It is also provided that he shall forthwith mail notice of his determination and the amount of tax due on the basis thereof to banks and financial corporations affected thereby.

It is further provided that such determination shall not be considered a deficiency assessment within the meaning of section 25 of the act. This provision operates to prevent the possibility of banks contesting the validity of the determination without first paying the tax due on account thereof inasmuch as it is only in the case of a deficiency assessment that a tax can be questioned before it is paid.

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(TO BE CONTINUED)

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<sup>61</sup> All fiscal year returns will be filed before calendar year returns are due since a fiscal year is any accounting period of twelve months ending on the last day of any month other than December and inasmuch as fiscal year returns are required to be filed within two months and fifteen days after the close of the fiscal year.

<sup>62</sup> It seems clear that the legislature has not made an unconstitutional delegation of power to the commissioner inasmuch as the legislature has fixed the rate and has simply left to the commissioner the ascertainment of the facts necessary to the application of the rate. See *Field v. Clark* (1892) 143 U. S. 649; *McCabe v. Carpenter* (1894) 102 Cal. 469, 36 Pac. 836; *Utah Construction Co. v. Richardson* (1921) 187 Cal. 649, 203 Pac. 401. For a discussion of the problem of delegation of power to the Franchise Tax Commissioner, see Traynor, *National Bank Taxation in California*, *op. cit. supra* note 1, at 510 *et seq.*