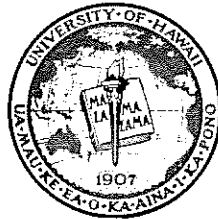


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# FEDERAL LIMITATIONS ON THE TERRITORIAL TAXING POWER



**REPORT NO. 1 -- 1953**

**LEGISLATIVE REFERENCE BUREAU  
UNIVERSITY OF HAWAII**

FEDERAL LIMITATIONS ON THE  
TERRITORIAL TAXING POWER

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Hawaii's power to tax, like other powers granted by Congress to the Territory, is not without limitation. This report supplies background data on the federal limitations which help to shape the tax structure of Hawaii.

Limitations recognized with regard to the taxing power of the states are generally considered applicable, by analogy, to the territorial power. Probably the most important of these limitations is that which holds the federal government immune from taxation. As noted in this report, such immunity may be due to express declaration by Act of Congress or implied under interpretation of the Federal Constitution.

Limitations also arise when attempts are made to tax goods or transactions involving interstate commerce. Since Congress is charged with the regulation and control of interstate commerce, some forms of territorial exercise of the taxing power are treated as interferences with or burdens on interstate commerce.

Finally, the territorial tax structure is influenced by the benefits to be gained through taking advantage of the provisions of federal statutes. Although not legal limitations upon Hawaii's taxing power, indirectly they serve much the same function in limiting territorial action.

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## FEDERAL LIMITATIONS ON THE TERRITORIAL TAXING POWER

The United States Constitution does not expressly exempt the federal government from state or local taxation. However, by the case of McCulloch v. Maryland, (1819) 4 Wheat. 316, it was early established that properties, functions and instrumentalities of the federal government are not subject to such state and local taxation. Power of taxation was conferred by Congress upon the Territory with all the completeness and effectiveness which that power is exercised by any of the States (In Re Craig - 1911 - 20 Haw. 483). With Hawaii having taxing power analogous to that of a state, the converse--that the same limitations are also applicable--is assumed. Consequently, in the absence of Congressional action, it is normally the rule that the limitations on state taxing power also are to be treated as narrowing the Territory's grant of power to tax.

Federal immunity from taxation was considered necessary to forestall undue interference with the activities of the federal government. Although Congress has expressly prohibited taxes in many areas, it has indicated willingness to accommodate state taxing power and, in recent years, has consented to taxation of same federal properties, functions and instrumentalities. Also, United States Supreme Court decisions have curtailed the immunity doctrine insofar as it applied to nondiscriminatory taxes on third parties, even though the burden of such taxes may indirectly be passed on to the federal government. There are thus areas of taxation where directly or indirectly state and territorial taxes may reach the federal government and its instrumentalities.

If Congress wishes, it may expressly open a designated activity to the full scope of state taxation. Thus, any officer or agent conducting a business under the authority of a United States court is subject to taxation to the same extent that such business would be taxable were it conducted by an individual or corporation (28 U.S.C. 960). Conversely, the statutory exemption of the Home Owners'

Loan Corporation from taxation (12 U.S.C. 1463(c)) was held broad enough to carry with it exemption from a state recording tax on mortgages made in connection with such loans (Pittman v. H.O.L.C. - 1939 - 308 U.S. 21).

In deciding upon the validity of any state or territorial tax, and in the absence of express Congressional exemption, it must be determined whether or not the taxpayer is a true federal agency or instrumentality entitled to tax immunity. If so, and if it appears that the tax imposes a real and substantial burden on or interference with federal operations and functions, the tax will be considered invalid. The mere fact that a private individual does business with an instrumentality of the federal government, does not clothe him with the immunity from taxation which is given to a true instrumentality of the federal government. Nor does the payment of a tax by him necessarily directly hamper or burden the operations of the federal government.

Further limitations upon state and territorial taxing power arise under interstate commerce. The regulating of interstate commerce is a power granted to Congress that may not be interfered with by the Territory and the various states. A tax is unconstitutional where it tends to prohibit interstate commerce, or discriminate against it by placing it at a disadvantage with intrastate commerce, or otherwise burdens or seeks to regulate interstate commerce. However, all taxes affecting interstate commerce are not prohibited. Where no undue burden or substantial interference is placed upon interstate commerce and where the tax is reasonable and fair, a tax may be levied although some interstate commerce activity is affected. Interstate commerce, therefore, is not altogether immune from taxation, but must pay its fair share of local taxes (McGoldrick v. Berwind-White Coal Mining Co. - 1940 - 309 U.S. 33).

Territorial taxing power is also limited by the constitutional provision that a levy on foreign imports or exports cannot be made without consent of Congress,

except what may be necessary for executing inspection laws. By this provision, restriction is placed upon the power to tax foreign commerce, the words "exports" and "imports" only being applicable to goods to and from foreign countries and not goods brought from or shipped to other states (American Steel & Wire Co. v. Speed - 1904 - 192 U.S. 500). Thus, while a nondiscriminatory state tax upon merchandise brought in from another state, or upon its sale, whether in original package or not, is lawful, a tax upon an imported article and the right to sell the article in its original package is beyond the taxing power of the states (Brown v. Maryland - 1827 - 12 Wheat. 419). Inspection laws which may be enforced without the consent of Congress must be fair and reasonable, and it is not so much a matter of taxation as it is one of regulation. The charging of an inspection fee which grossly exceeds the actual cost of inspection will not be permitted (Hale v. Bimco Trading - 1939 - 306 U.S. 375).

Although not express limitations upon the Territory's power to tax, federal taxes may give direction to the form taken by territorial taxes. Deductibility in computing the federal income tax may determine where the legal activity of a territorial tax is to be placed or the stage of economic activity at which it will be levied. Other federal legislation, such as grants-in-aid conditioned upon levy and application of designated local taxes, may similarly give direction to the imposing of territorial taxes.

The balance of this report deals more specifically with each of these areas briefly commented upon: with federal limitations on the territorial power to impose property, income, and excise taxes on the federal government and its agencies, functions, and activities; with limitations due to interstate commerce; and with deduction of territorial taxes for purposes of computing federal income taxes.

## I. Property Taxes.

Unless Congressional authorization permits such action, federal property may not be taxed by the Territory. This immunity does not apply to property in the hands of an individual, notwithstanding that the United States has an interest in such property, so long as the interest of the United States is not prejudiced (Baltimore Ship Building Co. v. Baltimore - 1904 - 195 U.S. 375; New Brunswick v. U. S. - 1928 - 276 U.S. 547). Thus, a purchaser of real property from the federal government who takes possession with the purchase price payable in installments but with legal title retained by the federal government as security has an interest upon which a property tax may be imposed (S.R.A. Inc. v. Minn. - 1946 - 327 U.S. 558).

As of 1949, 29 states could tax federal property if permission were granted to do so. In the remaining states, 11 exempted federal government property by statutes while in the other 8 the exemption is found in the state constitution (PACH Release No. 4 for Thursday, March 31, 1949). The proposed Constitution of Hawaii, Article XIV, Section 9, declares that no taxes are to be imposed upon federal lands unless the United States consents to such taxation.

In the past, the federal government has followed no consistent program, sometimes permitting taxation on the same basis as private property, sometimes paying specified percentages of revenues in lieu of taxes, and sometimes authorizing particular administrative agencies to make voluntary payments to state and local governments. The variety of approaches in part reflects the multiplicity of federal activities. They also signify recognition of a degree of federal responsibility, but not a surrender of the federal government's tax immunity ("Federal Contributions to States and Local Governmental Units with Respect to Federally Owned Real Estate," House Document No. 216, 78th Congress, 1st Session; "Report on Federal-State Relations" submitted by the Council of State Governments, Senate

Document No. 81, 81st Congress, 1st Session).

Not all of these federal acts are pertinent to conditions in Hawaii. The following acts appear applicable to taxation of federal property in the Territory:

1. Authorization to tax:

All property utilized by the Secretary of Agriculture in assisting farmers to purchase farms secured by mortgages or deeds of trust under the law relating to farm mortgage insurance (Bankhead-Jones Farm Tenant Act, 7 U.S.C. 1001-1005d), other than property used solely for administrative purposes, is subject to property taxation (7 U.S.C. 1024). Ordinarily, this would mean that the farmer pays the tax directly. However, a 1941 U. S. Attorney General Opinion holds that if such a farm is acquired through purchase at foreclosure sale or the acceptance of a deed in lieu of foreclosure, it becomes subject to state and local taxation as soon as it is determined that the land is going to be used to carry out the purposes of the Act (40 Op. Atty. Gen. 467). The tax would be paid by the federal government until the land is sold; if it is leased or sold under contract of sale without immediate transfer of title, the obligation to pay the tax presumably would be agreed upon by the parties.

Real property and tangible personal property of federal credit unions are subject to state and local property taxes to the same extent as other similar property is taxed (12 U.S.C. 1768). Holdings in federal credit unions may be included in assessing taxes on individuals, but the rate cannot exceed that imposed upon holdings in domestic credit unions and the federal union cannot be required to collect the tax (Idem.).

Real property of the Federal Deposit Insurance Corporation is subject to state and local taxation to the same extent according to value as other real property (12 U.S.C. 1825).

Real property acquired by the Federal Housing Commissioner under F.H.A. insured loans (12 U.S.C. 1714), war housing insured loans (12 U.S.C. 1741), moderate cost housing insured loans (12 U.S.C. 1747j), military housing insured loans (12 U.S.C. 1748f), and national defense housing insurance loans (12 U.S.C. 1750e) is subject to state and local taxation, according to value, to the same extent as other real property. In addition, the secretaries of Air, Army, and Navy may lease land for military housing and other purposes (12 U.S.C. 1748d) and the lessee's interest is subject to state and local taxation (5 U.S.C. 626s-6, 10 U.S.C. 1270d, 34 U.S.C. 522e).

Real property of the Federal Savings and Loan Insurance Corporation is subject to state and local taxation to the same extent, according to its value, as other real property is taxed (12 U.S.C. 1725(a)). No state or local government can impose a tax on federal savings and loan associations or their franchises, capital reserves, surplus, loans, or income, greater than that imposed on similar local mutual or cooperative thrift and home financing institutions (12 U.S.C. 1464(h)). It will be noted that this does not expressly refer to property; however, such associations pay property taxes.

Real property of national banks is not exempted from state or local taxation according to its value, if taxes as other real property is taxes (12 U.S.C. 548)

## 2. Express prohibition to tax:

Federal securities and interest thereon are declared exempt from state and local property taxes (31 U.S.C. 742; also secs. 747 and 757c).

The same sort of exemption applies to proceeds from various federal benefits (for example: railroad retirement act pensions - 45 U.S.C. 228-1, mustering out pay of veterans - 38 U.S.C. 691e, and World War Veterans' relief benefits - 38 U.S.C. 454a. 618). However, the point of time for losing of the exempt character

was spelled out with regard to benefits under the World War Veterans' Act, 1924, and to national service life insurance benefits, the law declaring the benefits are exempt from taxation, but property purchased in whole or in part out of such payments are taxable (38 U.S.C. 454a, 618).

3. In lieu taxes:

The Public Housing Administration is not to make annual contributions to low rent housing projects initiated after March 1, 1949, unless the project is free from property taxes. However, the local public housing agency may make payments in lieu of taxes up to 10% of the shelter rents charged. If the law of the jurisdiction requires the project to be taxable, then the local jurisdiction must furnish at least 20% of what the Public Housing Administration contributes. As to projects initiated before the 1949 date, a maximum amount of in-lieu-payments is not specified by statute (42 U.S.C. 1410). Local housing authorities leasing PWA housing projects are authorized to make in-lieu-payments up to 10% of actual shelter rents, but not to exceed the amount of full real property taxes which would be levied (24 C.F.R. 320.6).

Congress has provided for grants to help operate some local services (such as schools) in areas affected by national defense preparations, but this type of aid is not in lieu of taxes nor is it measured by the tax exempt status of the property of the war establishments.

## II. Income Taxes.

The immunity from taxation of the federal government, its properties, instrumentalities, and agencies, is generally broad enough to preclude the application of a state income tax in the absence of consent by Congress. In a number of instances, the United States Supreme Court has determined that the claim of immunity does not lie after it is established that the taxpayer is not a true federal agency or instrumentality, or that there is no real or substantial burden on or interference with federal operations and functions. This then permits the levy of a territorial income tax with limited applicability to federal operations and personnel.

### 1. Salaries of Federal Officers and Employees:

Since 1939, it has been established as law that nondiscriminatory taxation of income received as salaries by federal government officers and employees does not interfere with operation of the federal government. Initially this was determined by the holding of Graves v. People of State of New York ex. rel. O'Keefe - 1939 - 306 U.S. 466, and was followed by an act of Congress expressly authorizing nondiscriminatory taxation of income of federal officers and employees (5 U.S.C. 84a). To invalidate an income tax, the discrimination must go to the source of the compensation (Wood v. Tawes - 1942 - 181 Md. 155, 28 A.2d 850). As for example, the taxing of salaries of federal officers and employees at rates different from that paid by other persons would be discriminatory. However, the mere requiring of federal employees to file monthly returns while returns of other employees are filed by their employers is not such discrimination as to invalidate the tax (Yerian v. Territory of Hawaii - 1942 - 130 F.2d 786).

Whether Congress has the power by statute to exempt completely the salaries of all federal officers and employees from state income taxes has not been determined by the United States Supreme Court.

## 2. Federal Benefits:

It would appear that in the absence of express exemption, ordinarily a benefit payment authorized by Congress may be subjected to a nondiscriminatory income tax. The income tax is levied on the person receiving the payment, and not on the federal government, even though the burden may indirectly be passed on to the federal government in the form of exerting pressure on Congress for greater benefits. Conceivably, though, the levy of such a tax might defeat the very purpose of making the benefit--as an incentive, for example--and in a situation of this kind, a territorial levy might be impliedly prohibited.

Congress has exempted the following benefits from income taxation: (1) relief payments under the World War Veterans' Act, 1924 (38 U.S.C. 454a and 618), (2) World War II veterans mustering-out payments (38 U.S.C. 691e), and (3) Railroad Retirement Act payments (45 U.S.C. 228-1).

## 3. Federal Securities:

Federal securities are generally exempt from state and local taxation (31 U.S.C. 742). This exemption encompasses direct income taxes, for it was early held that such a tax, in effect, is one upon the property itself (Pollack v. Farmer's Loan & Trust - 1895 - 157 U.S. 429; Missouri v. Gehner - 1930 - 281 U.S. 313). In addition, to hold otherwise might impair the value of federal securities and would affect the ability of the federal government to borrow money (Home Sav. Bank v. City of Des Moines - 1907 - 205 U.S. 503).

Where the levy is in the form of a franchise or excise tax measured by income, the levy will be permitted even though it includes income from federal securities (Pacific Co. v. Johnson - 1932 - 285 U.S. 480). The distinction is drawn on the ground that the proceeds from nontaxable property are not being directly taxed, and therefore, there is no burden upon the federal government. However,

such indirect taxation will not be allowed where it clearly appears that the purpose of a tax statute is to reach proceeds from federal securities (Macallen Co. v. Commonwealth - 1929 - 279 U.S. 620).

4. Federal Banks and Savings Associations:

A tax on the net income of national banks may be levied, as one of four alternative methods of taxation of national banks approved by Congress (12 U.S.C. 548) (For other methods, see p. 14). The tax must be at a rate no higher than those on other financial corporations nor higher than the highest rate on the net income of mercantile, manufacturing, and business corporations. Congress has also provided that federal savings and loan associations may be subject to a tax on income but no greater than that imposed on other similar local mutual or cooperative thrift and home financing institutions (12 U.S.C. 1464(h)).

Expressly prohibited is taxation on income of the Federal Savings and Loan Insurance Corporation (12 U.S.C. 1725(e)), the Federal Deposit Insurance Corporation (12 U.S.C. 1825), the Central Bank of Cooperatives and related organizations (12 U.S.C. 1138c), and Federal Credit Unions (12 U.S.C. 1768).

5. Income Earned on Federal Lands:

Mention was previously made of the fact that the lessee's interest in federal land may be subjected to a nondiscriminatory property tax (see p. 6). Similarly, a lessee of federal lands may be taxed on income derived from the lease, provided there is no direct or substantial burden on the federal government. Such a lessee does not necessarily become a federal agency or instrumentality by virtue of the lease so as to be immune from taxation. However, the tax must be a nondiscriminatory one (Guy T. Helvering v. Mountain Producers Corporation - 1939 - 303 U.S. 376).

Congress has acted so as to permit the taxation of profits earned by a private person in the carrying on of business on federal property (4 U.S.C. 106). Similarly, net profits of a contractor earned in the performance of a federal contract on a military reservation over which the federal government has exclusive control are taxable (Winston Bros. v. Galloway - 1942 - 168 Or. 109, 121 P. 2d 457). Here in the Territory, the right granted by Congress to tax persons and corporations, their franchises and property on lands included in the Hawaii National Park appears to make such persons and corporations subject to the territorial power to impose an income tax (16 U.S.C. 395).

#### 6. Patents and Copyrights:

Although patents and copyrights are exclusively granted by the federal government, such action does not clothe them with governmental character so as to make them immune from taxation. It is now well settled that income derived from patents and copyrights is subject to state taxation (Fox Film Corporation v. Royal - 1932 - 286 U.S. 123).

### III. Franchise, Sales and Other Excise Taxes.

There is no fixed rule which can be followed for determining when a tax may be imposed on the manufacture, sale or consumption of goods or on business transactions and activities without burdening or interfering with federal functions. It is clear that a taxpayer claiming federal immunity from tax has the burden of proving that the interference with federal operations is real and substantial (Panhandle Oil Co. v. Mississippi - 1926 - 277 U.S. 218). The fact that the tax will eventually economically burden the federal government is not sufficient to invalidate it. Provided that the tax does not fall directly upon the federal government

so that legally it is required to pay the tax as such, it is immaterial that the tax may be passed on to the federal government through its effect on price of goods and services (Alabama v. King & Boozer - 1941 - 314 U.S. 1).

Organizations that operate nominally on behalf of, or in cooperation with, the United States are subject to an excise tax if operated for private profit. Thus, taxes have been enforced against a licensee under the United States Warehouse Act (Federal Compress & W. Co. v. McLean - 1934 - 291 U.S. 17), a national park concessioner (Ranier Nat. Park Co. v. Martin - 1937 - 192 Wash. 592; 74 P. 2d 464; 302 U.S. 661), a stockyard (Union Stock Yards v. St. Tax. Comm. - 1937 - 93 Utah 174, 71 P. 2d 542), and a mail carrying railroad (Missouri-Kansas-Texas R. Co. v. St. Tax. Comm. - 1939 - 150 Kan. 614, 95 P. 2d 293). In the case of the national park concessioner, the right to tax persons and corporations, their franchises and property on lands included in the park was given by statute (16 U.S.C. 95) and was held to extend to the corporation doing business in the park, even if such corporation was a federal instrumentality. A similar provision permits the Territory to tax activities carried on in the Hawaii National Park (16 U.S.C. 395). Congress has also declared that no person shall be relieved of liability for a sales or use tax on the ground that the sale or use, with respect to which the tax is levied, occurred within a federal area (4 U.S.C. 105).

A tax may be imposed on gross receipts from the sale of goods to or for the performance of services for the federal government; a taxpayer may not claim immunity merely on the basis that payment was received from the federal government. An organization which appears to be a federal instrumentality may actually be an independent contractor (Penn. Dairies v. Milk Control Comm. - 1943 - 318 U.S. 261), and "lump sum" contractors are generally considered to be taxable since they act primarily on their own behalf and buy on their own account (James v. Dravo Contracting Co. - 1937 - 302 U.S. 134). Thus, a gross receipts tax on such "lump sum"

is valid, although paid to the contractor by the federal government. It has been suggested that Congress might exempt "cost-plus" contractors from taxation by declaring that they act for the government in the accomplishment of a governmental purpose (House Committee on Ways and Means, Report No. 2044, 77th Congress, 2d Session). In the absence of such express exemption, a sale to a contractor working for the federal government under a "cost-plus" contract is subject to tax, such as a consumer's sales tax which requires the seller to add the tax to the sales price and collect it from the purchaser, in this case the "cost-plus" contractor (Alabama v. King & Boozer - 1941 - 314 U.S. 1).

Although a federal agency may not be taxed on its properties or activities, it may be under a duty to collect a tax. The United States Supreme Court has held that a national bank may not claim exemption from collecting and remitting a "service tax" where such tax is applied on a safe-deposit service and the user is the true taxpayer (Colorado Nat'l. Bank. v. Bedford - 1940 - 310 U.S. 41).

#### 1. Franchise Tax:

The earnings of a taxpayer in carrying on or doing business are often due in part to tax-immune income or transactions. In determining the validity of a franchise tax, a tax will not be upheld where it appears that the purpose of a tax statute is to reach the proceeds which are ordinarily immune from direct taxation (Macallen Co. v. Commonwealth - 1929 - 279 U.S. 620). Where it is otherwise deemed to be reasonable, income from transactions and properties which is exempt from a direct income tax may be included in the basis of a franchise or other form of an excise tax. For example, income from tax-immune securities when measured together with other taxable income, may be reached for purposes of a franchise tax when part of the taxpayers business deals with such securities (Pacific Co. v. Johnson - 1932 - 285 U.S. 480; Bank of Oklahoma City v. Oklahoma Tax Comm. - 1940 -

309 U.S. 560); and sales to the federal government may be included within the base of a gross receipts tax imposed on sellers for the privilege of doing business, although the sales themselves are not subject to a tax (Ruling, U. S. Comptroller General to U. S. Secretary of Agriculture - 1939 - 18 Decisions of the Comptroller General 832). In this manner, activities and income may be reached and taxed through an excise measured by income where a direct income tax would be precluded.

National banks. As national banks are creatures of the federal government, they may not be taxed except as provided by Congress. At the present time, four alternatives for taxing national banks have been authorized by Congress, one of which allows a bank excise or franchise tax measured by net income at a rate no higher than upon other financial corporations nor higher than the highest rates on mercantile, manufacturing, or business corporations (12 U.S.C. 548).

(Other methods of taxation of national banks that are authorized are (1) a tax on all the shares of national banking associations within the limits of the Territory at a rate that is no greater than that assessed upon other moneyed capital in the hands of individual citizens of the Territory coming into competition with the business of national banks, (2) a bank dividend tax at rates no higher than upon net income from other sources, and (3) a tax on the net income of banks at rates no higher than the highest rates on the net income of mercantile, manufacturing, and business corporations. These several methods are alternatives except that the dividend tax may be used in conjunction with either the income or excise tax measured by income.)

A tax may also be imposed on the franchise of federal savings and loans associations provided the tax is no greater than that on other similar local mutual or cooperative thrift and home financing institutions (12 U.S.C. 1464(h)).

## 2. Sales Tax:

The immunity of the federal government applies also to sales taxes attempted to be levied directly upon it. Of course, if a general exception from taxation is made by Congress for a federal instrumentality this also precludes the levy of a sales tax. Thus, a federal land bank operating under such a statute (12 U.S.C. 931) is exempt from sales taxes on expenditures made to conserve property foreclosed by the bank (Federal Land Bank of St. Paul v. Bismarck Lumber Co. - 1941 - 314 U.S. 95).

Sales tax complications also arise in cases where the tax is legally imposed on the seller but may be collected from the consumer, the federal government. A tax was upheld which was levied on sales to a national bank, the consumer, where the tax was by the terms of the statute upon the seller, although the amount of the tax could be added to the purchase price and thereby passed on to such consumer (Western Lithograph Co. v. St. Bd. of Equal. - 1938 - 11 Cal. 2d 156, 78 P. 2d 731). The United State Supreme Court approved a consumer's sales tax collected from, and in effect imposed on, a "cost-plus" contractor with the federal government, under a statute requiring the seller to add to the sales price and collect from the contractor the amount due and where the government thereafter reimbursed the contractor for the cost of the materials, including the tax (Alabama v. King & Boozer - 1941 - 314 U.S. 1). Such reimbursement is not an illegal burden on the federal government.

## 3. Excise Tax on Production:

A lessee of federal lands as such is not necessarily a federal agency and the purposes of the lease and the activity of the lessee will determine whether the rule of federal immunity from taxation will apply to such a lessee. In addition to property, income and other taxes, a lessee of federal lands may be subject to an excise tax on goods produced on such lands, since such taxes do not generally

interfere or directly burden the federal government (Oklahoma Tax Comm. v. Texas Oil Co. - 1949 - 336 U.S. 342).

#### IV. Estate and Inheritance Taxes.

To encourage the passage of state and territorial inheritance and estate taxes, Congress adopted a federal estate tax which permits a maximum credit of 80 per cent of the tax for any estate or inheritance taxes paid to a state or territory (26 U.S.C. 813b). Twenty-three states, the District of Columbia, and Hawaii impose an inheritance tax as well as a differential estate tax, the latter designed to absorb the difference between the inheritance tax and the maximum credit allowed by the federal government on the basic estate tax ("Coordination of Federal, State and Local Taxes", House Report No. 2519, 82d Congress, 2d Session). Subsequent to the adoption of this initial federal estate tax, an additional federal estate tax was enacted, but no offsetting credit is allowed for state and territorial taxes, nor are such taxes allowed as deductions to reduce the base of the tax (26 U.S.C. 812(b)(5)).

Although most state and local taxes are deductible from gross income in computing the federal income tax, state and territorial estate and inheritance taxes are excluded as deductible items (26 U.S.C. 23(c)(1)).

Federal securities. In general, federal securities are by express provision declared not exempt from estate and inheritance taxes (12 U.S.C. 1138c, 1433, 1464(h), 1725(e), and 1825). However, even in the absence of express authority to tax, it would seem that the value of federal securities may be included in computing estate and inheritance taxes, for such taxes are upon the transfer or transmission of property, not upon the property itself (Igleheart v. Comm. of Internal

Revenue - 1935 - 77 F. 2d 704, In Re Sherwood's Estate - 1922 - 122 Wash 648, 211 P. 734).

Bequests to the federal government. The fact that the federal government is a beneficiary does not limit the state taxing power. An inheritance tax may be levied on bequests to the federal government (United States v. Perkins - 1896 - 163 U.S. 625).

#### V. Gasoline and Motor Vehicle Taxes.

Just as both the federal and state governments may adopt income taxes as components of their respective fiscal structures, so, too, do both the federal government and the states levy an excise tax on gasoline and other motor fuels. The federal government does not require the imposition of state income taxes, nor does it prescribe the manner in which funds raised by such state income taxes shall be expended. However, it does encourage the levy of state gasoline taxes, and the application of their proceeds for highway purposes. With the intent that the program of highway improvement be extended, Congress has authorized the levying of gasoline and motor fuel taxes on sales by post exchanges, ship store, commissaries, filling stations, licensed traders, and other similar agencies located on federal military and other reservations, when such fuels are not for the exclusive use of the United States (4 U.S.C. 104).

Section 55 of Title 23 of the United States Code provides in part:

" . . . after June 30, 1935, Federal aid for highway construction shall be extended only to those States that use at least the amounts now provided by law for such purposes in each State from State motor vehicle registration fees, licenses, gasoline taxes, and other special taxes on motor vehicle owners and operators of all kinds for the construction, improvement, and maintenance of highways and administrative expenses in connection therewith, including the retirement of bonds for the payment of which such revenues have been pledged. . ."

The section also provides that no state is to be deprived of more than one-third of its federal apportionment because of failure to comply therewith. Pursuant to section 41 of the same Title, the Territory of Hawaii is entitled to share in federal highway aids "upon the same terms and conditions as any of the several States," with minor exceptions relating to the selection and designation of roads.

The U. S. Attorney General ruled in 1938 (39 Op. Atty. Gen. 157) that if a state diverts gasoline and other motor vehicle tax funds to other than highway purposes, it is violating this federal requirement notwithstanding the state still expends for highway purposes from these taxes an amount equal to that expended for such purposes in 1934. This ruling of the Attorney General would thus preclude all such diversions.

Practice of the federal government does not appear to follow this ruling of the Attorney General. The rules and regulations of the Secretary of Commerce refer to the imposition of the statutory penalty upon findings of the Secretary that "lesser amounts of the revenues derived from State" gas and vehicle taxes are required by law to be applied to highway purposes than were required to be so applied by the laws of a State on June 18, 1934, the original approval date of the federal act (23 C.F.R. 1.18, 1952 Supplement). Thus, this continues the ambiguity, and if anything, leans against the effect of the Attorney General's ruling.

The only States that appear to ever have been penalized are Massachusetts, New Jersey, and Georgia, although also Maryland and Pennsylvania were cited. In New Jersey and Georgia less funds were used for highway purposes than in 1934. A somewhat similar situation resulted in withholding funds from Massachusetts in June, 1938. The Georgia citation for diversion of gas tax funds occurred early in the enforcement of the federal act, but negotiations continued until 1941. As far as can be determined, no penalty has been inflicted under this provision of federal law since that date. (Information supplied by Federation of Tax Administrators).

The Commissioner of Public Roads apparently was not too confident in the reasoning which the Attorney General depended upon in his opinion precluding diversions because in 1938, when testifying on federal highway aid appropriations, he recommended the applicable section of federal law to be amended so as specifically to preclude any State diversions for non-highway use, other than where pledged for such purposes prior to the 1934 effective date of the law. In his testimony, he stated there was a ". . . certain ambiguity in the existing law which has made it difficult to prevent additional diversions subsequent to June 18, 1934, . . ." (Idem.).

Data compiled by the Bureau of Public Roads indicates that in 1949 more than \$166,000,000 collected from State highway user taxes were used for non-highway purposes. This included diversion to the State's general fund or for educational purposes (PACH Release No. 4 for Thursday, January 4, 1951). The data reported for calendar 1951 by the U. S. Bureau of Public Roads indicates that by 1951 this total had reached almost 267 million dollars, or nearly one-tenth of the total highway user tax collections for that year (Bureau of Public Roads, Highway Statistics 1951, p. 35).

This same source notes:

"The amounts shown do not necessarily constitute diversions from highway use requiring a penalty under the terms of the Hayden-Cartwright Act of 1934. Such diversions can be determined only after analysis in the light of State laws in force in 1934. . ."

The net result is that diversions for non-highway purposes are occurring, but apparently no penalty has been imposed under the federal anti-diversion law for over a decade. The federal law is ambiguous. The U. S. Attorney General's ruling that it includes all highway user tax revenues is not being enforced. If it were, a court decision would be necessary to construe the federal provisions applicable. Although Congressional debate cited by the Attorney General in his ruling may have

tended to indicate the language used in the federal statute was inclusive of all tax revenues, failure of Congress to amend the law after being advised of the ambiguity and long administrative usage adopting the least restrictive interpretation would tend to indicate similar federal judicial interpretation if suit were brought to construe the law.

#### VI. Interstate Commerce Limitations.

The grant to the federal government of the power to regulate commerce among the several states operates as a limitation upon state taxing power. However, the principle has been firmly established that interstate commerce must pay its fair share of the local tax burden (McGoldrick v. Berwind-White Coal Mining Co. - 1940 - 309 U.S. 33). Similarly, if the subject of taxation can be separated so as to distinguish between commerce within and without the state, the commerce within the state is taxable without regard to interstate commerce limitations (East Ohio Gas Co. v. Ohio - 1931 - 283 U.S. 465).

A state tax violates the interstate commerce clause only when it burdens or regulates such commerce, i.e., when the tax tends to prohibit interstate commerce or to discriminate against it by placing it at a disadvantage with intrastate commerce. A tax becomes an undue burden when it is imposed upon the privilege of transacting a purely interstate business (Aloha Portland Cement Co. v. Massachusetts - 1925 - 268 U.S. 203). On the other hand, where local activity, such as protection or maintenance, is also the basis of a franchise tax, it may be imposed upon an exclusively interstate business (Memphis Natural Gas Co. v. Stone - 1948 - 335 U.S. 80). There is also an undue burden, as well as discrimination, on interstate commerce by a state tax where the possibility exists that two or more taxes

may be imposed on such commerce by different states while intrastate business bears but one tax (Gwin, White & Prince, Inc. v. Henneford - 1939 - 305 U.S. 434). However, no undue burden is imposed where taxation by more than one state is impossible or too remote as was determined in the case of a privilege tax on gross receipts of a publishing company whose circulation was partly interstate (Western Live Stock v. Bureau of Revenue - 1938 - 303 U.S. 250).

#### 1. Tax upon Property in Interstate Commerce:

A state may impose nondiscriminatory property taxes on personal property permanently located within its borders, although such property is used in interstate commerce (Fargo v. Hart - 1904 - 193 U.S. 490, Cudahy Packing Co. v. Minnesota - 1918 - 246 U.S. 450). It is well settled that property while in motion in interstate commerce is not taxable by the states (Kelley v. Rhoades - 1903 - 188 U.S. 1). Such property is deemed to be still in transit while at a halt which is a necessary incident to reaching its ultimate destination (Carson Petroleum Co. v. Vial - 1929 - 279 U.S. 95). However, the property loses its immunity from taxation if there is a stop to enjoy what is called an "independent local advantage" (State of Minnesota v. Blasius - 1933 - 290 U.S. 1). Similarly, goods held for over a year, being stored in a warehouse for that period, are not in interstate commerce, although destined for reshipment to another state (Independent Warehouses Inc. v. Scheele - 1947 - 331 U.S. 70).

Property used in transporting goods. A tax may be imposed on property used to carry goods in interstate commerce if the tax is levied only upon the proportionate part of the total of such transporting property coming into the state and commonly used within its borders during the taxable year (Pullman's Palace-Car Co. v. Commonwealth of Pennsylvania - 1891 - 141 U.S. 18; Pullman Co. v. Richardson - 1922 - 261 U.S. 330). Further power to tax may be enjoyed if the state imposing

the tax is the domiciliary state of the taxpayer. A state was allowed to tax the full value of all airplanes of a corporation where such planes were outside the state on flights but always returned to the home port within the state sometime during the year (Northwest Airlines v. State of Minnesota - 1944 - 322 U.S. 292). (The United States Supreme Court in the case cited did not consider whether or not other states could impose a tax on a proportionate part of these same planes. It would appear that such a tax remains valid.)

## 2. Gross Receipts Taxes:

A tax levied directly on gross receipts from interstate activity is a tax upon the privilege of carrying on interstate commerce (Freeman v. Hewit - 1946 - 329 U.S. 249), or a burden on interstate commerce if the entire proceeds are taxed without apportionment (Adams Mfg. Co. v. Storen - 1938 - 304 U.S. 307), and the tax is invalid. However, gross receipts from interstate transactions may be the measure of a tax so long as the tax is not one on gross receipts as such, but instead is in essence a tax on property the value of which is computed with reference to gross receipts only as a means of determining the real value of the property (Pullman Co. v. Richardson - 1923 - 261 U.S. 330). Similarly derived gross receipts may be the measure of a franchise tax. If in view of other facts a tax is clearly imposed by a state on the privilege of operating a business within the taxing state, the tax is valid (Southern Gas Corp. v. Alabama - 1937 - 301 U.S. 148).

Apportionment of a gross receipts tax must be fair and reasonable (Illinois Cent. R. v. Minnesota - 1940 - 309 U.S. 157; Pullman's Palace Car v. Commonwealth of Pennsylvania - 1891 - 141 U.S. 18). Where it is not fairly apportioned, the gross receipts tax will be held invalid (Oklahoma v. Wells Fargo Co. - 1912 - 223 U.S. 298).

In the past, taxes have been invalidated as not being apportioned so as to be limited to activities carried on within a state in cases where the business or activity was engaged substantially in interstate commerce: a radio broadcasting station (Fisher's Blend Station v. State Tax Comm. - 1936 - 297 U.S. 650), a railroad organization (Galveston Ry. Co. v. Texas - 1908 - 210 U.S. 217), a telephone company (New Jersey Bell Tel. Co. v. State Board - 1930 - 280 U.S. 338), and a wholesaler-exporter (Crew Levick Co. v. Pennsylvania - 1917 - 245 U.S. 292).

Where there is a "local incidence", as upon the local delivery of goods upon their purchase for consumption, the activity is subject to tax and a gross sales tax upon the sale of goods is valid (McGoldrick v. Berwind-White Coal Mining Co. - 1940 - 309 U.S. 33). All the essential elements of the transaction must occur within the taxing state. Therefore, an out-of-state seller, who only solicits business within the taxing state with the sale completed elsewhere, is not subject to a gross receipts tax (McLeod v. J. E. Dilworth - 1944 - 322 U.S. 327).

### 3. Use Tax:

A use tax is generally valid for it is not considered as being upon operations in interstate commerce, but upon the privilege of use after commerce is at an end (Henneford v. Silas Mason Co., Inc. - 1936 - 300 U.S. 577). Furthermore, despite an intended subsequent activity or transaction in interstate commerce, a use tax may be levied if there is a local use, such as storage (Southern Pac. Co. v. Gallagher - 1939 - 306 U.S. 167). An out-of-state seller may be made to collect the use tax imposed upon the buyer, although the seller merely solicits orders by travelling salesmen in the taxing state (General Trade Co. v. St. Tax Comm. - 1944 - 322 U.S. 335).

#### 4. Net Income:

A tax may be levied directly upon net income or as an excise tax measured by net income. In either event, the net income may be derived from interstate commerce. States have adopted taxes imposed directly on net income arising from interstate activities, and also have imposed franchise taxes based on such net income. At least two states, California and Pennsylvania, have both forms of taxes and in these states, where a corporation may not be reached by one tax, it may be subjected to taxation under the other ("Presto! Pennsylvania Taxes Interstate Commerce," Taxes, the Tax Magazine, September 1953).

Tax on Net Income. A tax on net income derived from interstate commerce is to be distinguished from a tax on the privilege of engaging in business, the latter tax being based on net income arising from interstate commerce. A tax on net income, including that derived from interstate commerce, is not repugnant, per se, to the interstate commerce clause (U. S. Glue Co. v. Oak Creek - 1918 - 247 U.S. 321). A resident may be taxed on his entire net income, obtained from interstate as well as intrastate commerce, but a non-resident may only be taxed upon net income which is earned within or derived from sources within the taxing state (Goodrich: "Conflict of Laws", Sec. 65). Although the net income of a non-resident is wholly from interstate commerce, if it is determined to be due to sources within a state, the state may tax such net income (West Publishing Co. v. McCoglan - 1946 - 27 Cal. 2d 705; 166 P. 2d 861; 328 U.S. 823). Where it is difficult or impossible to determine the exact portion of the net income of a non-resident which is derived from sources within the taxing state, a fair method of allocation which reasonably determines the portion of net income to be taxed may be adopted (Idem.), but upon a showing that the method is arbitrary and the results of the determination are unreasonable, the net income tax will not be upheld (Hans Rees' Sons v. North Carolina - 1931 - 283 U.S. 123).

Franchise Tax measured by Net Income. The privilege of carrying on interstate commerce does not depend upon state authorization, and a state may not exact a franchise tax therefor. The fact that such a franchise tax is based upon net income does not save it nor prevent it from being declared invalid. Thus, where the business engaged in is exclusively interstate, such business cannot be subjected to a franchise tax based on net income (Spector Motor Service Inc. v. O'Conner - 1951 - 340 U.S. 602). However, if both interstate and intrastate business is engaged in, the interstate commerce clause is not violated by a franchise tax measured by that portion of total net income justly attributable to business done within the state, even if part of the income so attributable is from interstate commerce (Matson Navigation Co. v. State Board of Equalization - 1936 - 297 U.S. 441). Interstate and intrastate business being conducted, the franchise tax may be validly imposed on that portion of total net income which is allocated by a fair and reasonable formula to the doing of business in the taxing state (S. S. Kresge Co. v. Bennett - 1931 - 287 U.S. 565). The method of allocation may still be fair and reasonable although the accounts of the office within the taxing state show no net income (Butler Bros. v. McColgan - 1942 - 315 U.S. 501).

##### 5. Tax upon Solicitors:

A license tax may not be imposed upon drummers or solicitors who take orders for goods to be shipped into the taxing state (Crenshaw v. Arkansas - 1913 - 227 U.S. 389; Real Silk Hosiery Mills v. Portland - 268 U.S. 325), particularly when the tax discriminates against interstate commerce in favor of intrastate businesses, as in the case where only persons who are not regular retail merchants in the state are subject to a flat annual privilege tax (Best & Co. v. Maxwell - 1940 - 311 U.S. 454). In the case cited, the United States Supreme Court declared that its duty was to determine whether the practical operation of the tax would

work discrimination against interstate commerce. Subsequently, the Court held that a license tax could not apply to a solicitor where there was no showing that the solicitor carried on a continuous and regular course of business within the state and where the fixed sum for the privilege of soliciting business bears no relation to the volume of business carried on (Nippert v. Richmond - 1946 - 327 U.S. 416). There was some implication in this case that a nondiscriminatory tax on solicitors measured by volume of orders would be valid so long as it did not relate solely to soliciting of orders for goods to be shipped in interstate commerce.

#### VII. Deduction of Territorial Taxes for Federal Income Tax Purposes

In the computation of the federal income tax, most taxes imposed by the Territory are allowed as deductions from gross income. By federal law, estate, inheritance, legacy, succession, and gift taxes are specifically declared not deductible under any circumstances, as are assessments for local benefits unless made for the purpose of maintenance or repair or for meeting interest charges. Further provision is made for gasoline and retail sales taxes to be deductible by the consumer, even if they are imposed on the seller (26 U.S.C. 23(c)).

##### 1. Gasoline and Retail Sales Taxes:

Gasoline and retail sales taxes provide a special case, for while they are deductible by those upon whom they are imposed (26 U.S.C. 23(c)(1)), they may also be deducted by others. Thus, they are deductible by the seller when imposed upon him, and similarly, they are deductible by consumers or purchasers when imposed upon them. Also, under certain prescribed conditions, a gasoline or retail

sales tax is deductible by the consumer, although imposed on the seller. The fact that the incidence of the tax does not fall on the consumer under the law imposing it is immaterial (T. D. 5935, Internal Revenue Cum. Bul. 1952-2), but the tax must be (i) a retail sales tax or (ii) a gasoline tax within the meaning of the Internal Revenue Code, and be (iii) separately stated when paid by the consumer and not paid in connection with the consumer's trade or business (26 U.S.C. 23(c)(3)).

A "retail sales tax," as used by the federal statute, is a tax upon persons selling tangible personal property at retail, which is measured by the gross sales price or the gross receipts from the sale, or which is a stated sum per unit of such property sold. It also includes a tax imposed upon persons engaged in furnishing services at retail, which is measured by the gross receipts for furnishing such services (26 C.F.R. 39.23(c)-1-(b)).

A "gasoline tax" to be deductible by the consumer although imposed on another is a tax imposed upon persons selling gasoline or other motor vehicle fuels either at wholesale or retail, which is measured by the gross sales price or the gross receipts from the sale, or which is a stated sum per unit of the gasoline or fuel sold (Idem.).

The requirement that the amount be "separately stated" is complied with where it clearly appears that, at the time of the sale to the consumer, the tax was added to the sales price and collected or charged as a separate item. Where the law imposing the sales or gasoline tax for which the taxpayer seeks a deduction contains a prohibition against the seller absorbing the tax, or a provision requiring a posted notice stating that the tax will be added to the quoted price, or a requirement that the tax be separately shown in advertisements or separately shown on all bills or invoices, it is presumed that the amount of the sales or gasoline tax was separately stated when paid by the consumer (T. D. 5935, Internal Revenue Cum. Bul. 1952-2). The tax is also considered as appearing as a separate item where the

federal and territorial gasoline tax appears as a combined amount (I. T. 4063, Internal Revenue Cum. Bul. 1951-2).

In Hawaii, the same gasoline tax may be deducted by the seller and by the consumer. The gasoline tax is imposed upon the distributor who may deduct it from gross income, provided that the gross receipts of the distributor have been augmented by reason of the passing on of the tax which thus increased the sales price. It is also deductible by the consumer since the amount is separately stated and the other requirements are met to allow the consumer to deduct the tax, even though it is imposed on the seller (I. T. 4059, Internal Revenue Cum. Bul. 1951-2).

## 2. The Territorial General Excise Tax:

The tax on retail transactions under Hawaii's general excise tax law may not be taken as a deduction by the consumer in filing federal income tax returns, even where the seller shows the tax separately in billing the purchaser. The office of the Director of Internal Revenue, United States Treasury Department, does not regard the general excise tax as a retail sales tax within the meaning of Section 23(c)(3) of the Internal Revenue Code, but holds that it is a privilege tax which is generally imposed upon all persons engaging in business, whether personal, professional or corporate (letter to Legislative Reference Bureau, dated January 6, 1954). It is difficult to reconcile this holding with the allowance of the deduction in other states, such as Indiana. In the absence of a change in the ruling, it would appear that the territorial law must be amended before the consumer may deduct the Territorial general excise tax in computing net income for federal tax purposes.