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Taxation -- Constitutionality of Income Allocation Formulae as Applied to Corporations

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fide lienors of importer,[13] purchasers from dealer with notice,[14] mortgagee with notice,[15] and as against the dealer himself.[16]

In the principal case the court based its decision on the ground that no credit was extended to the bankrupt while the trust receipt remained unrecorded. When the court refused to restrict the usefulness of the trust receipt by bringing it within the purview of the local conditional sales recording act, it followed the general trend of the state[17] and federal[18] decisions and preserved the integrity of the trust receipt as a commercially desirable financing device.

It seems desirable to uphold the trust receipt as a highly useful independent security device in financing both foreign and domestic purchases, and at the same time give creditors of and purchasers from the importer or dealer notice of its use. To this end it has been suggested that, instead of requiring the recordation of each individual trust receipt, the general plan of financing under which the goods are purchased be recorded, once and for all.[19]

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Taxation—Constitutionality of Income Allocation Formulae as Applied to Corporations.

The North Carolina allocation formula for determining the taxable income of a foreign corporation was, in a recent Federal Supreme Court decision,[1] held to result in a tax on income not rea-

[13] T. D. Downing Co. v. Shawmut Corp., 245 Mass. 106, 139 N. E. 525 (1923) (not classified); International Trust Co. v. Webster Nat'l Bank, 258 Mass. 17, 154 N. E. 330 (1926) (not classified); *cf.* Century Throwing Co. v. Muller, 197 Fed. 252 (C. C. A. 3rd, 1912).

[14] Ohio Savings Bank & Trust Co. v. Schneider, *supra* note 7 (trust receipt as conditional sale).

[15] Commercial Credit Co. v. Schleglelstorseth Motor Co., 23 S. W. (2d) 702 (Tex. App. 1930) (not classified).

[16] Industrial Finance Co. v. Turner, 215 Ala. 460, 110 So. 904 (1926) (trust receipt as conditional sale); Commercial Credit Co. v. Peak, 195 Cal. 27, 231 Pac. 340 (1924) (trust receipt as bailment); Brown v. Green Hickey Leather Co., 244 Mass. 169, 138 N. E. 714 (1923) (not classified).

[17] Cases cited, *supra* note 2.

[18] Cases cited, *supra* note 3.

[19] Vold, *Trust Receipts Security in Financing Sales* (1930) 15 CORN. L. Q. 543.

[1] Hans Rees' Sons Inc. v. State of North Carolina *ex rel* Maxwell, 51 Sup. Ct. 385 (April 13, 1931). Appellant, a New York corporation, operated a leather tannery in North Carolina. It applied to the Commissioner of Revenue for the readjustment of its income tax assessment. Revision was disallowed, and appeal taken to the Superior Court where evidence was excluded which would have shown the corporation's income to be divided into profits from buying, manufacturing, and selling, and that only 17 per cent of the entire net profit was due to manufacturing within North Carolina, but 80

sonably attributable to business within the state. The tax was 4½ per cent of such proportion of the corporation's entire net income as the value of its tangible property in North Carolina was to the value of all its tangible property.[2] The corporation admitted that the allocation was in full accord with the statute. Its sole contention was that the formula as applied in this case was arbitrary and unreasonable and violated the commerce and due process clauses. The state court was of opinion that the corporation was a unitary business and the statutory formula was an equitable method of allotting income to business within the state.[3] The Supreme Court rejected the formula, for there was evidence of three distinct sources of income, buying profit, manufacturing profit, and selling profit, and there was considerable discrepancy between the income derived from the one North Carolina activity, manufacturing, and the income assigned North Carolina by the statute.

The formula in question had been approved in its application in *Underwood Typewriter Co. v. Chamberlain*,[4] and the state court relied on that case to validate the tax. The Supreme Court, however, said that there was not in the *Underwood* case evidence to show that business within the taxing state did not produce the income allocated to it by the formula, whereas such evidence was offered in the present instance.

Because few corporations have accounting systems that can show the income derived from each economic activity, formulae are designed to apportion a part of the income to the taxing jurisdiction by comparison with a constant factor.[5] The formulae often reach a

per cent of its tangible property was located in North Carolina, with the result that the formula allotted 80 per cent of the income to this state. The state Supreme Court sustained the ruling of the trial court striking out this evidence, but said that if the evidence were deemed competent, it would not change the result.

[2] N. C. ANN. CODE (Michie Supp., 1929) §7880 (317). Formula applicable to corporations deriving profits from dealing in tangible property.

[3] 199 N. C. 42, 153 S. E. 850 (1930).

[4] 254 U. S. 113, 41 Sup. Ct. 45, 65 L. ed. 165 (1920). The court indicated that if it were shown that a formula caused actual injustice it would be rejected. "We have no occasion to consider whether the rule prescribed if applied under different conditions might be obnoxious to the constitution."; Notes (1920) 20 COL. L. REV. 324; (1920) 29 YALE L. J. 512; (1920) 33 HARV. L. REV. 736

[5] Of the factors used in allocating income of manufacturing corporations tangible property and gross sales receipts are the more common. For other factors see *infra* note 8; see 2 STATE INCOME TAXES 113, NATIONAL INDUSTRIAL CONFERENCE BOARD (1930); Isaacs, *The Unit Rule* (1926) 35 YALE L. J. 838.

fair distribution, but they sometimes operate unevenly.[6] North Carolina's formula, with property the constant factor, is well adapted to yield revenue in this state, which consumes a relatively small proportion of its manufactured goods. However, the North Carolina formula is extreme in the inclusion of only one factor and may result inequitably more often than a formula which embodies other elements of business in addition to property.[7] Such a formula which attributes most of the income to the manufacturing jurisdiction may possibly be justified on the ground that it is the manufacturing element which in ultimate economics produces the income, and buying and selling are more incidental. Also a tax allocated by manufacturing will enure to the benefit of those producing the goods who are residents of the taxing state, while frequently purchases and sales entered into in a large number of states are concluded at a central office. A tax levied there, measured by sales, will usually benefit a small group of employees only incidentally engaged in producing the income. Without such justification the North Carolina statute is unfortunate, and the more so since it is mandatory. In a number of states the tax authorities are empowered to set aside the formula and substitute a method which will with greater accuracy ascertain the income earned within the state. The *Hans Rees'* case, presenting a discrepancy of 60 per cent between the statutory method and the corporation's accounting, is palpably a situation demanding discretionary power in the tax authorities.

The North Carolina formula could be improved by including sev-

[6] If the corporation owns property only in North Carolina, this state will tax the entire net income although the corporation may do as much business in other states in leased premises. A result of unfair allocation fractions may be the organization of separate corporations to conduct the various activities. A corporation will be organized to buy and will contract with the manufacturing corporation, which in turn will be linked by contract with a sales corporation, and the corporation with the most profitable contract will be located in a state with favorable income tax laws or in one with no income tax law at all. If these corporations are given sufficient autonomy the tax authorities may find it difficult to reach their true earnings. See, Palmolive Co. v. Conway, 43 F. (2d) 226 (W. D. Wis. 1930); Buick Motor Co. v. City of Milwaukee, 43 F. (2d) 385 (E. D. Wis. 1930), aff'm'd. C. C. A. 7th, 6 U. S. Daily 448 (April 23, 1931); Breckenridge, *Tax Escape by Manipulations of Holding Company* (1931) 9 N. C. L. REV. 189; Magill, *Allocation of Income by Corporate Contract* (1931) 44 HARV. L. REV. 935. Income allocation formulae rejected in Standard Oil Co. of Indiana v. Thoresen, 29 F. (2d) 708 (C. C. A. 8th, 1928); Standard Oil Co. of Indiana v. Wisconsin Tax Commission, 197 Wis. 630, 223 N. W. 85 (1929); see Gorham Mfg. Co. v. Travis, 274 Fed. 975 (S. D. N. Y. 1911); Fisher v. Standard Oil Co., 12 F. (2d) 744 (C. C. A. 8th, 1926).

[7] *Infra* note 8.

eral material factors of business.[8] Wisconsin utilizes an arithmetical average of three factors, property, manufacturing cost, and sales.[9] Since allocation at best is but an average, this formula by taking into account three important elements, reduces the probability of unjust allocation. The Wisconsin authorities are authorized to omit any one of the three factors when it is shown to their satisfaction that its use would give an unreasonable final average, because the corporation does not to an appreciable extent employ the element. This seems to mean that the taxpayer takes the initiative to have the factor omitted. It would seem desirable to empower the tax authorities as well to initiate the move to omit the factor when including it would prejudice the state's interest.[10]

Two other methods of avoiding the *Hans Rees'* situation and employed in several states are: (1) discretionary power in the tax authorities to entirely depart from the formula and set up a new method apposite to the particular corporation;[11] (2) discretionary power to accept the separate accounting of the corporation showing the income within the state.[12] The first of these may be inexpedient

[8] The proposed 1931 Budget Revenue Bill, §311, provided that the formula be an arithmetical average of two factors, tangible property and manufacturing expenses, the latter to include cost of goods, payroll, and manufacturing overhead. The model plan of the National Tax Association utilizes two factors, for a mercantile or manufacturing business one-half the income to be allocated by ratio of tangible property within the state to total tangible property, and one-half by ratio of business within to total business. "Business" includes costs of labor, goods, materials and supplies, and receipts from sales. PROCEEDINGS NATIONAL TAX ASSOCIATION (1922) 198; 2 STATE INCOME TAXES 120, NATIONAL INDUSTRIAL CONFERENCE BOARD (1930). North Dakota has in effect adopted this formula, N. D. COMP. LAWS ANN. (Supp. 1925) §2346a6. States which use three or more factors, CAL. STAT. (1929) c. 13, §10, property, sales, payroll, purchases, expenses of manufacture; MASS. GEN. LAWS (1921) c. 63, §38, property, sales, payroll; Mo. LAWS (1929) §13106, sales, intrastate business, interstate business; N. Y. LAWS (1929) c. 385, §214, property, certain accounts receivable, shares of stock of other corporations owned; VA. CODE ANN. (Supp. 1926), Tax Bill, §10 (7), and WIS. STAT. (1927) §71.02, property, sales, manufacturing expenses.

[9] WIS. STAT. (1927) §71.02.

[10] Example, corporation takes orders in taxing state for goods to be shipped from factory in that state to the purchaser, the contract stipulating that it is subject to confirmation at office without the state and the sale to take place there.

[11] ARK. ACTS (1929) Act 118, §15; CAL. STAT. (1929) c. 13, §10; GA. LAWS (1929) H. B. 143, §14; MASS. GEN. LAWS 1921) c. 63, §42; MISS. ANN. CODE (Hemingway, 1927) §5663; N. Y. CONS. LAWS ANN. (Supp. 1927) c. 61, §211; N. D. COMP. LAWS ANN. (Supp. 1925) §2346a7; ORE. LAWS (1929) c. 427, §7; TENN. ANN. CODE (Supp. 1926) §723a14; VA. CODE ANN. (Supp. 1926) Tax Bill §10 (7); WIS. STAT. (1927) §71.02.

[12] ARK. ACTS (1929) Act 118, §15 and regulations; GA. LAWS (1929) H. B. 143; MASS. GEN. LAWS (1921) c. 63, §42; MISS. ANN. CODE (Hemingway, 1927) §5663; Mo. LAWS (1929) §13106; MONT. REV. CODE (1921) §2298, re-

because of the uncertainty as to the basis of allocation from year to year, which is objectionable from the viewpoint of management. Allocation by separate accounting will usually produce a figure very favorable to the corporation, and, though its acceptance is discretionary with the tax officials, they may be inclined in any doubtful case to accept the accounting without complete investigation. Another means of avoiding allocation by rigid formula, would be the enacting of several formulae and empowering the tax authorities to apply the one suited to the corporation.[13] The objection of uncertainty equally applies here.[14] The Wisconsin formula is not only definite but there is also the advantage of a restricted discretion in order to prevent manifest injustice.

It is believed this discretion in the authorities is constitutional.[15] Although legislative powers are not generally delegable, the ascertaining of net earnings is properly an administrative detail which, it is believed, can be delegated. The legislature dictates its intent that income from business within the state be taxed 4½ per cent, and determining the most equitable method of arriving at net income is a detail to accomplish that intent.

In the absence of any discretion in the North Carolina officials the result of the *Hans Rees'* case raises an awkward problem. Under the decision the allocation formula cannot be used for that corporation, and the tax officials have no power to depart from the formula.[16] Thus it seems that the corporation will, under the present law, escape taxation. Other corporations might raise the question of unequal taxation for here is one which is not taxed at all.

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quired; S. C. LAWS (1927) Act 1; VA. CODE ANN. (Supp. 1926) Tax Bill, §10 (7); WIS. STAT. (1927) §71.02.

[13] It does not appear that any state has this method.

[14] However, corporations might be classified and a formula be enacted for each class. This would narrow the chances of disparity incidental to a single formula for all corporations. Under the present law North Carolina has three classifications, corporations dealing in tangible property, those dealing in intangible property, and railroads and public service corporations. N. C. ANN. CODE (Michie Supp. 1929) §7880 (317), (318).

[15] Bank of Commerce v. Senter, 149 Tenn. 569, 260 S. W. 144 (1924), upholding Tennessee discretionary provision. See Hampton and Co. v. U. S., 276 U. S. 394, 48 Sup. Ct. 348, 72 L. ed. 624 (1928), President's discretionary power in administering flexible tariff; Notes (1927) 36 YALE L. J. 573; (1928) 37 YALE L. J. 1151; Frischer v. Bakelite Corp., 39 F. (2d) 247 (C. C. Cus. and Pat. App. 1930); Interstate Commerce Comm. v. Goodrich Transit Co., 224 U. S. 194, 32 Sup. Ct. 436, 56 L. ed. 729 (1912); Express Co. v. R. R., 111 N. C. 463, 16 S. E. 393 (1892).

[16] Although the tax law does not authorize the officials to depart from the formula, it appears that they do in fact sometimes compromise with the taxpayer.