Taxation -- Patents and Copyrights as Immune Federal Instrumentalities

James H. Chadbourn

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The doctrine that federal and state governmental instrumentalities are reciprocally immune from taxation has been an elementary canon since *McCulloch v. Maryland.*[1] It was there that Mr. Chief Justice Marshall deduced from the Constitution by "necessary implication" this principle considered necessary to preserve a governmental structure of dual sovereignties. "General propositions," however, "do not decide concrete cases"; and two recent decisions which reach different results in considering the effect of state taxes on the federal function of issuing patents and copyrights give further sanction to this aphorism of Mr. Justice Holmes.

On January 12, 1931, the United States Supreme Court in *Educational Films Corp. v. Ward*[2] upheld the levy of a New York franchise tax on corporations for the privilege of doing business, although the tax was measured by net income made up in part from the returns on copyrights. On March 25, 1931, the North Carolina Supreme Court in *Maxwell v. Chemical Construction Co.*[3] refused to uphold the levy of an income tax, because part of such income was made up of royalties received from patents. The opinion relies chiefly on *Long v. Rockwood,*[4] a Federal Supreme Court case holding a similar tax invalid. The Attorney General, however, pointed out that the *Long* case was a five to four decision. This he suggested as a reason, especially strong in the light of the instant federal holding, for a decision in his favor.[5] The argument was repudiated on the ground that one was an income tax as contrasted with the other as a franchise tax. Despite the form of the tax, in both cases there is presented the fundamental problem of striking a practical and workable balance between the interest of the state in unimpaired taxing power and the interest of the federal government in the free exercise of its power to "promote the progress of Science and Useful Arts"[6] by issuing patents and copyrights. Cases involving the effect of these types of taxes on other federal powers may throw light on this problem.[7]

[1] 4 Wheat. 316 (1819).
[2] 51 Sup. Ct. 170 (1931).
[3] 200 N. C. 500 (1931).
[4] 277 U. S. 145, 48 Sup. Ct. 463, 72 L. ed. 824 (1928).
[5] Plaintiff Appellant's Brief, page 5.
[6] U. S. CONSTITUTION, Art. I, §8.
[7] For a discussion of the relation of other types of taxes to the encroachment problem see the following which begins a series of articles: Thomas

Income Taxes.

Taxes on income derived from federal instrumentalities are consistently declared invalid as hampering the operations of the federal government. In *Miller v. Milwaukee*[8] an income tax levied on corporate dividends paid directly from United States bonds was declared invalid as impairing the federal borrowing power. In *Gillespie v. Oklahoma*[9] the fact that part of the income consisted in profits from a lease of Indian lands served to invalidate the tax as interfering with the government's care of its wards. In neither case does there appear any disposition to determine whether the interference is negligible or substantial. In fact, the only reaction against a mechanical and technical application of the doctrine of reciprocal exemption in the income tax cases appears in the dissenting opinion of Holmes, J., in *Long v. Rockwood*.[10] He is willing to question whether patents are instrumentalities in the sense of the rule which forbids taxation thereon. This willingness to face actualities is perhaps more significant in the light of a long line of state cases holding patents immune from various kinds of taxation.[11]

Corporate Franchise Taxes.

The corporate franchise tax cases are more numerous and their history is more complex. The court has been reluctant to pierce the form of a franchise tax and recognize its actual effect on a federal instrumentality. And having perceived such an effect, it has not yet expressly based a decision on the theory that the interference of the

Reed Powell, *Indirect Encroachment on Federal Authority by the Taxing Powers of the States* (1918) 31 HARV. L. REV. 321. See also Note (1930) 30 COL. L. REV. 92.

[8] 272 U. S. 713, 47 Sup. Ct. 280, 71 L. ed. 487 (1927).

[9] 257 U. S. 501, 42 Sup. Ct. 171, 66 L. ed. 339 (1922). Holmes, J., differentiates cases in which the state tax is claimed to burden interstate commerce on the ground that they concern a regulatory power of the federal government and not an instrumentality. In these cases interference, he says, is a question of degree. On the other hand, "the rule as to instrumentalities of the United States is absolute in form and at least stricter in substance." For an apparent change in his view see *infra* note 22. In Oil Corp. v. Bass, 6 U. S. Daily 365 (1931) a federal income tax on income from a lease of state lands was upheld.

[10] *Supra* note 4.

[11] Edison Electric Co. v. Board of Assessors, 156 N. Y. 417, 51 N. E. 269 (1898) (property tax); Commonwealth v. Westinghouse Co., 151 Pa. St. 265, 24 Atl. 1107 (1892) (tax on corporate capital invested in patents); Celotex Co. v. Louisiana Tax Commission, 165 La. 195, 115 So. 457 (1928); Commonwealth v. Petty, 96 Ky. 452, 29 S. W. 291 (1895) (license tax on sale of patents); *In re* Sheffield, 64 Fed. 833 (C. C. Ky. 1894) (same); Quicksafe M'f'g. Corp. v. Graham, 29 S. W. (2d) 253 (Tenn. 1930); and see McCullock v. Maryland, *supra* note 1, at 432. *Cf.* Appeal of Ross, U. S. Daily, Sept. 2, 1930, at 7 commented on in (1930) 40 YALE L. J. 136.

state tax with the exercise of federal powers was not vital or substantial. In four early cases—three in 1867, one in 1889—the court upheld state franchise taxes on corporations measured by a percentage of net income part of which was made up of returns from United States securities.[12] The announced ground of the decisions was the seemingly futile distinction between a tax *on* such income and a tax *measured* by it. In 1910 the same conceptualism resulted in upholding the levy in the converse situation of a federal franchise tax on state corporations measured by net income derived in part from the returns on municipal bonds.[13] The two later cases of *Northwestern Mutual Life Insurance Co. v. Wisconsin*[14] and *Macallen Co. v. Massachusetts*[15] refused to uphold franchise taxes measured by gross and net income respectively where such income represented receipts from United States securities. In effect the decisions deny significance to the tenuous distinction between a tax on a subject and a tax measured by it, but the court refuses to carry its realism to the extent of considering the practical effect of the tax on the federal borrowing power judged by the degree of encroachment. Furthermore, the true significance of both cases is obscured by an attempt to avoid the appearance of overruling previous cases by laying down spurious tests to reconcile them. The vice of the tax in the *Northwestern* case is declared to be that it is measured by *gross* income. Obviously the federal agency is just as surely, if not as substantially, touched when the measure is *net* income.[16] The *Macallen* case is said to rest on the differentiating fact that the legislative history of the tax disclosed that it was passed for the specific purpose of taxing federal bonds, whereas no sinister legislative intent is disclosed in the other cases of this class.[17] And unfortunately the *Educational Films* case distinguishes the *Macallen* case on this ground.[18] Bad faith on the part of the legislature affects in no way the fact or the degree of en-

[12] Provident Institution v. Mass., 6 Wall. 611 (1867); Society for Savings v. Coite, 6 Wall. 594 (1867); Hamilton Co. v. Mass., 6 Wall. 632 (1867); Home Insurance Co. v. New York, 134 U. S. 594, 10 Sup. Ct. 593, 33 L. ed. 1025 (1889).

[13] Flint v. Stone Tracy Co., 220 U. S. 107, 31 Sup. Ct. 342, 55 L. ed. 389 (1910).

[14] 275 U. S. 136, 48 Sup. Ct. 55, 72 L. ed. 202 (1927).

[15] 279 U. S. 620, 49 Sup. Ct. 432, 73 L. ed. 875 (1928). See the following comments: T. R. Powell, *The Macallen Case—and Before* (1930) 8 N. I. T. M. 47, *ibid.* 91; (1930) 25 Ill. L. Rev. 103; Note (1930) 43 Harv. L. Rev. 280.

[16] For an argument that the distinction between gross and net income as a measure of franchise taxes is well taken see (1929) 15 Corn. L. Q. 127.

[17] This test appears also in Miller v. Milwaukee, *supra* note 8.

[18] Educational Films Corp. v. Ward, *supra* note 2.

croachment. Both suggested differentiations seem a resort to judicial duplicity in order that there may be created what Jerome Frank in his recent brilliant book has called "illusory certainty in law."[19]

The actual effect of the *Educational Films* case seems to be to reinstate franchise taxes measured by income constituted of returns from federal instrumentalities.[20] It is to be regretted that the opinion professes approval of the conceptualistic test developed in 1867 and the legislative motive test of the *Macallen* case. Language in the majority opinion,[21] however, coupled with previous expressions of the individual judges constituting the majority[22] suggests that perhaps the *ratio decidendi* of the opinion is that the tax is not a substantial burden on the efficient functioning of the federal government.

Holmes, Brandeis, and Stone, JJ., dissented in the *Long* and *Macallen* cases to express their approval of the income and franchise taxes there involved. With them are now joined Hughes, C. J., and Roberts, J., to make up the majority which approves the tax in the

[19] FRANK, LAW AND THE MODERN MIND (1930) 196.

[20] For example, the California court recently upheld on the authority of the Educational Films case a franchise tax levied under an act expressly declaring that no deductions in computing net income should be allowed for returns from Federal bonds. The Pacific Co. Ltd. v. Johnson, 6 U. S. Daily 346 (Calif. 1931). A probable further effect is to make safe the state taxation of national banks pursuant to 12 U. S. C. SUPP, III §548 (1929) (provides for state excise taxes on national banks measured by net income from all sources). Where the bank's capital was invested in U. S. securities, the Macallen case would perhaps prohibit this state tax. Under the Educational Films case there seems no such likelihood.

[21] Per Stone, J., in Educational Films Corp. v. Ward, *supra* note 2, at 173: "This court, in drawing the line which defines the limits of the powers and instrumentalities of state and national governments, is not intent upon a mechanical application of the rule that governmental instrumentalities are immune from taxation, regardless of the consequences to the operations of government. . . . Having in mind the end sought, we cannot say . . . that the present tax, viewed in the light of actualities, imposes any such real or direct burden on the federal government as to call for the application of a different rule."

[22] Holmes, J., dissenting (Brandeis and Stone, JJ., concurring) in Panhandle Co. v. Miss., 277 U. S. 218, 48 Sup. Ct. 451, 72 L. ed. 857 (1928): "The power to tax is not the power to destroy while this court sits. . . . The question of interference with government, I repeat, is one of reasonableness and degree, and it seems to me that the interference in this case is too remote." Stone, J., dissenting (Brandeis and Holmes JJ., concurring) in Macallen Co. v. Mass., *supra* note 15, at 637: "It would seem that only considerations of public policy of weight, which appear to be here wholly wanting, would justify overturning a principle (allowability of franchise tax measured by income from tax exempt securities) so long established. It has survived a great war, financed by the sale of government obligations; and it has never even been suggested that in any practical way it has impaired either the dignity or credit of the national government."

Educational Films case. The changed personnel of the court is a strong indication that probably the instant North Carolina case is based on an authority of which the majority of the court now disapproves. Under the realistic approach which it seems the present tendency of this majority to follow the tax in the North Carolina case would perhaps be sustained as only a negligible impairment of the operations of the national government. Especially is this true in the light of the concession even by the minority of the court that the function of granting patents is not "a vital power of the federal government."[23]

JAMES H. CHADBOURN.

OPEN COURT

CONSOLIDATION OF COUNTY AND CITY GOVERNMENTS

The principal purpose in establishing counties is to make effectual the political organization and civil administration of the state, in respect to its general purposes and policy which require local direction, over matters of local finance, education, provisions for the poor, the establishment and maintenance of highways and bridges, and, in large measure, the administration of public justice.

A municipal corporation is an organized body, consisting of the inhabitants of a designated area of contiguous territory, established by the Legislature of the State with or without the consent of such inhabitants, and constituting a legal entity with perpetual succession under its corporate name, and having the power to own and hold property, to select its own offices, to levy and collect taxes and appropriate and expend the funds thus raised, to enact and enforce police regulations within such area, and confers upon the individuals of which it is composed, powers, privileges and immunities which they would not otherwise possess.

The consolidation of counties and municipal corporations has been attempted outside of North Carolina—the cities of Baltimore and Memphis are said to be coterminous with the counties in which they lie—and it might be well to consider whether it can be done in this state. In the absence of constitutional restrictions, it is generally considered that the power of a state Legislature over the boundaries of the political subdivisions of the state, is absolute, and

[23] Educational Films Corp. v. Ward, *supra* note 2, at 174.