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TAXATION - FEDERAL INCOME TAX - NON-EXEMPTION OF COMPENSATION OF STATE EMPLOYEES DERIVED FROM FUNDS OF LIQUIDATED CORPORATIONS

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TAXATION — FEDERAL INCOME TAX — NON-EXEMPTION OF COMPENSATION OF STATE EMPLOYEES DERIVED FROM FUNDS OF LIQUIDATED CORPORATIONS — The Commissioner of Internal Revenue assessed employees [1] of a state or an instrumentality thereof for federal income tax,[2] their compensation having been paid from funds of banks and insurance companies in the liquidation of which they were engaged. *Held*, that the tax was properly assessed against the taxpayers so engaged because (1) the compensation was paid

[1] Four cases involving similar issues were considered together by the Supreme Court. Helvering v. Therrell, (U. S. 1938) 58 S. Ct. 539 at 540; taxpayer, having been appointed liquidator for several Florida banks in pursuance of a statute by the State Comptroller, took no oath of office though he was under bond. Compensation assessed for federal income tax was paid from the corporate assets. Helvering v. Tunnicliffe, (U. S. 1938) 58 S. Ct. 539 at 541: semble. McLoughlin v. Helvering, (U. S. 1938) 58 S. Ct. 539 at 541: taxpayer, being legal counsel in liquidation bureau of Insurance Department of New York, received compensation in the form of fees from the assets of several insurance companies in liquidation which likewise was assessed for federal income tax. Helvering v. Freedman, (U. S. 1938) 58 S. Ct. 539 at 541: taxpayer, employee of the Department of Justice of Pennsylvania on annual salary, was assigned for legal work in relation to the closing and winding up of certain banks. Compensation assessed for federal income tax was paid by Secretary of Banking from the funds of the closed banks.

[2] 48 Stat. L. 683 (1934), 26 U. S. C. (1935), § 1 et seq. In § 22, gross income is defined as "income derived from salaries, wages, or compensation for personal service . . . of whatever kind . . . from any source whatever." Prior revenue acts contained the same language as does the present act. 49 Stat. L. 1652 (1936), 26 U. S. C. (Supp. 1937), § 22.

out of assets of private corporations and (2) the business in which they were employed for the state was not in the discharge of essential governmental duties. *Helvering v. Therrell*, (U. S. 1938) 58 S. Ct. 539.

Although the Federal Constitution imposes some restrictions upon the taxing power of the national government,[3] it is only by implication arising from the dual sovereignty concept that the national government is restrained from exercising its taxing power over the states or the governmental agencies thereof.[4] The principle that state instrumentalities are exempt from national taxation was first established in *Collector v. Day*,[5] which held that Congress did not have the power to levy an income tax upon the compensation of a state judicial officer. This exemption has been extended to all officers and employees of a state or political subdivision thereof engaged in the exercise of governmental functions.[6] Even after the ratification of the Sixteenth Amendment [7] subsequent income tax laws specifically provided for exemption of the compensation of such state officers and employees.[8] However, since the Sixteenth Amendment has been

[3] Apportionment of direct taxes, uniformity of duties, imports and excises, and prohibition of taxes on exports from any state constitute such restrictions. U. S. Const., Art. 1, §§ 2, 8, 9.

[4] 1 COOLEY, TAXATION, § 90 (1924); POWELL, NATIONAL TAXATION OF STATE INSTRUMENTALITIES 11 (1936); Mallory v. White, (D. C. Mass. 1934) 8 F. Supp. 989. The converse principle, that a state may not in the exercise of its taxing power interfere with governmental agencies of the federal government, was early determined in McCulloch v. Maryland, 4 Wheat. (17 U. S.) 316, 4 L. Ed. 579 (1819). Nor may a state tax the salary of an officer of the United States. Dobbins v. Erie County, 16 Pet. (41 U. S.) 435, 10 L. Ed. 1022 (1842).

[5] 11 Wall. (78 U. S.) 113, 20 L. Ed. 122 (1871). There had been dictum in opinions of state courts on this question wherein the same view was expressed several years before. Smith v. Short, 40 Ala. 385 (1867); Fifield v. Close, 15 Mich. 505 (1867). See 25 GEO. L. J. 1013 at 1015 (1937).

[6] Brush v. Commissioner, 300 U. S. 352, 57 S. Ct. 495 (1937) (employee of municipal water system), noted 14 N. Y. L. Q. REV. 550 (1937), 37 COL. L. REV. 1019 (1937), 12 IND. L. J. 421 (1937), 21 MINN. L. REV. 866 (1937), 22 WASH. UNIV. L. Q. 572 (1937); Commissioner v. Lamb, (C. C. A. 9th, 1936) 82 F. (2d) 733 (secretary of board of park commissioners); Commissioner v. Ten Eyck, (C. C. A. 2d, 1935) 76 F. (2d) 515 (chairman of municipal port commission), noted 20 MINN. L. REV. 232 (1936); 108 A. L. R. 1439 at 1441 (1937); 82 A. L. R. 989 at 990 (1933); 11 A. L. R. 532 at 535 (1921); POWELL, NATIONAL TAXATION OF STATE INSTRUMENTALITIES 18 (1936); 10 N. C. L. REV. 106 (1931); Burns, "Taxation of Federal and State Instrumentalities," 10 TAX MAG. 208 (1932); Cohn and Dayton, "Federal Taxation of State Activities and State Taxation of Federal Activities," 34 YALE L. J. 807 (1925); Magill, "Tax Exemption of State Employees," 35 YALE L. J. 956 (1926); 9 UNIV. CIN. L. REV. 95 (1935); 10 WASH. L. REV. 179 (1935). Cf. Hubbard, "The Sixteenth Amendment," 33 HARV. L. REV. 794 (1920).

[7] U. S. Const., 16th Amendment (1913), establishes the power of the federal government to assess income taxes. Constitutional amendment for such an income tax was necessitated by the decision in Pollock v. Farmers' Loan & Trust Co., 157 U. S. 584, 15 S. Ct. 673 (1895).

[8] 38 Stat. L. 114 at 168 (1913); 39 Stat. L. 756 at 759 (1916); 40 Stat. L. 300 at 330 (1917).

construed as opening no new tax sources,[9] more recent revenue acts have not specifically provided for this exemption, the assumption being that the doctrines of *McCulloch v. Maryland* [10] and *Collector v. Day* [11] still prevail. For the application of this exemption, it must be shown that the officer or employee is engaged in an office or employment of a governmental nature,[12] that the officer occupies a "public station conferred by the appointment of government . . . the tenure, duration, emolument and duties" [13] of which are prescribed by law, or that the employee renders continuous services as provided by law subject to direct supervision of state officers.[14] But "independent contractors" are not immune from federal income taxation although their contracts are made with states or subdivisions thereof,[15] whether or not the state in making such a contract is engaged in governmental functions.[16] While in the principal cases the taxpayers were all employees of the states or instrumentalities thereof, it is clear that they were not engaged in strictly governmental functions since they were employed in the liquidation of private corporations which merely were under public supervision.[17] The fact that these taxpayers were paid not from the state treasury but rather from the funds of the defunct private corporations in liquidation alone would be sufficient ground for the decision denying the application of the exemption. If the taxpayer is compensated from funds of a private source and hence subject to a non-discriminatory federal income tax, there certainly is no need for the consideration of questions of status or of the nature of the function engaged in, be it proprietary or governmental, for in such a case the federal taxing power could exert no interference with state functions inferentially prohibited in the Constitution.[18]

Gerald L. Stoetzer

[9] Brushaber v. Union Pacific R. R., 240 U. S. 1, 36 S. Ct. 236 (1915).

[10] 4 Wheat. (17 U. S.) 316, 4 L. Ed. 579 (1819). But see Lewinson, "Tax-Exempt Salaries and Securities: A Re-Examination," 23 A. B. A. J. 685 at 686 (1937).

[11] 11 Wall. (78 U. S.) 113, 20 L. Ed. 122 (1871).

[12] See note 6, supra.

[13] Metcalf & Eddy v. Mitchell, 269 U. S. 514 at 520, 46 S. Ct. 172 (1925).

[14] POWELL, NATIONAL TAXATION OF STATE INSTRUMENTALITIES 27 (1936); and see South Carolina v. United States, 199 U. S. 437, 26 S. Ct. 110 (1905).

[15] Metcalf & Eddy v. Mitchell, 269 U. S. 514, 46 S. Ct. 172 (1925) (duties of consulting engineers were prescribed by contract, there being no oath of office nor limitation of freedom to undertake concurrent employment). See note 18, infra.

[16] POWELL, NATIONAL TAXATION OF STATE INSTRUMENTALITIES 28 (1936).

[17] "The fact that the State has power to undertake such enterprises and that they are undertaken for what the state conceives to be the public benefit does not establish immunity." Helvering v. Powers, 293 U. S. 214 at 225, 55 S. Ct. 171 (1935), noted 24 CAL. L. REV. 110 (1935). The efforts of the state in supervising the liquidation of banking and insurance corporations are analogous to the non-exempt "governmental-proprietary" functions first recognized in South Carolina v. United States, 199 U. S. 437, 26 S. Ct. 110 (1905).

[18] That there is a trend toward limiting immunity from federal income taxation when the effect on the functions of the state is indirect or remote is further evidenced by the even more recent case of Helvering v. Mountain Producers Corp., (U. S. 1938)

58 S. Ct. 623, holding that the taxpayer is not exempt from payment of federal income tax on the income received from an oil and gas lease from a state. Gillespie v. Oklahoma, 257 U. S. 501, 42 S. Ct. 171 (1922), and Burnet v. Coronado Oil and Gas Co., 285 U. S. 393, 52 S. Ct. 443 (1932), were there expressly overruled when the court, through Chief Justice Hughes, said "where it merely appears that one operating under a government contract or lease is subjected to a tax with respect to his profits on the same basis as others who are engaged in similar businesses, there is no sufficient ground for holding that the effect upon the [state] government is other than indirect and remote." 58 S. Ct. 623 at 628.