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Maryland Law Review

Volume 17 | Issue 4 Article 5

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Recommended Citation

P. M. Cromwell, *"Gross Receipts" Apportionment Formula in State Taxation of Foreign Corporation Operating Partly Through Subsidiaries - Household Finance Corp. v. State Tax Commission*, 17 Md. L. Rev. 327 (1957)
Available at: http://digitalcommons.law.umaryland.edu/mlr/vol17/iss4/5

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Comments and Casenotes

"Gross Receipts" Apportionment Formula In State Taxation Of Foreign Corporation Operating Partly Through Subsidiaries

Household Finance Corp. v. State Tax Commission[1]

In 1953, Household Finance Corporation, a foreign finance corporation, was engaged in a nation-wide small loan business. Although the corporation itself did business in Maryland, a part of its out-of-state operations was conducted through ten wholly owned subsidiaries. Maryland imposes an annual tax on "[s]o much of the capital stock of foreign finance corporations doing business in Maryland as represents the business done in this State . . ."[2] The State Tax Commission is directed to determine the total value of all the capital stock of such a company.[3] It next must allocate to Maryland that portion of this total value as fairly represents the business done in Maryland. The statute provides that:

> ". . . in apportioning the value of the shares between the business within and without Maryland, it shall be presumed in the absence of clear evidence to the contrary that the value of the property and business within Maryland bears to the value of the total business and property the same ratio which the gross receipts or earnings in Maryland . . . bears to the total gross receipts of earnings . . ."[4]

In the year 1953, the Commission arrived at $163,262,300 as the total value of all the stock. In order to allocate to Maryland its proper portion of this valuation, the Commission multiplied it by a fraction the numerator of which was the gross receipts of Household in Maryland ($2,481,626), and the denominator of which was the total gross receipts of Household everywhere ($61,812,951). This last figure was not the gross receipts of Household and all its subsidiaries figured on a consolidated basis ($75,000,000); it

[1] 212 Md. 80, 128 A. 2d 640 (1957).

[2] MD. CODE (1951), Art. 81, sec. 7(7).

[3] *Ibid*, Art. 81, secs. 20(a), 20(b), 19(a).

[4] *Ibid*, Art. 81, sec. 20(a). Omitted from the quotation of the statutory language are several references to the treatment of income from permanent investments which were not material in the instant case.

was the gross receipts of the parent corporation alone. The result of this multiplication was a figure of about $6,500,000, which was the Commission's assessment of the value of that part of the capital stock of Household that represented "the business done in Maryland". Household appealed to the Circuit Court of Baltimore City, claiming, *inter alia,* that the failure of the Commission's gross receipts fraction to include in its denominator *consolidated* gross receipts of the parent and the subsidiaries necessarily resulted in a larger portion of the total capital stock being attributed to Maryland than should have been, and that the tax was invalid because it was not imposed in accordance with the Maryland statutory language and because it accomplished the taxation of extra territorial values in violation of the "due process" clause of the Fourteenth Amendment to the United States Constitution. The Circuit Court found for Household. On appeal, the Maryland Court of Appeals affirmed, Judges Hammond and Henderson dissenting.

The majority opinion written by Judge Prescott explains the holding as follows:

> ". . . if the Commission sees fit to arrive at the total value of a unitary enterprise on a consolidated basis, it cannot in fairness apportion that value as between Maryland and other jurisdictions on a basis which is inconsistent with, and which rejects, an element used in building up that value. Here, of course, that element is the earnings of the subsidiaries. They have been discarded and the gross earnings of the parent company only have been used for the apportionment.
>
> "We have reached the conclusion above stated on the basis of our statute, and we have not found it necessary to seek to determine the limit of the constitutional power of the State in imposing or apportioning a tax such as that here involved."[5]

Judge Hammond in his dissenting opinion[6] disputed the Court's holding that the Commission's use of the apportioning formula was at odds with the statutory directive that "it shall be presumed in the absence of clear evidence to the contrary that the value of the property and business within Maryland bears to the value of total business and property the same ratio which gross receipts or earnings in Maryland . . . bears to the total gross receipts of earn-

[5] *Supra*, n. 1, 98.
[6] *Supra*, n. 1, *dis. op.* 99, in which Judge Henderson concurred.

ings . . ."[7] He presented various comparative financial data to support his belief that this presumption was justified in this instance.[8] It is interesting that nowhere in the majority opinion was there presented any factual evidence in the nature of operating or financial statistics to refute the presumption in the statute. The Court relied on the fact that:

> "The result has been to produce a considerably larger apportionment of value to Maryland than would have been reached if the gross earnings of subsidiaries, . . . had been used in determining the ratio of gross receipts in Maryland to gross receipts outside of Maryland."[9]

This fact is indisputable, but does it *per se* establish that the statutory formula used by the Commission imputes to Maryland a higher percentage of the value of Household's total business than actually belongs here? Or, should the presumption be discarded only when concrete facts and figures are submitted proving that the presumption is factually incorrect in the particular case? This was the line of cleavage between the members of the Court, and upon this point the case was decided.

It was therefore unnecessary to examine the constitutionality of the apportioning formula as applied to Household, but this second aspect of the matter is of interest in its own right and also to the extent that it reflects light on the initial problem of statutory interpretation. The constitutional doctrine here applicable seems to be that any statutory formula reasonable on its face (as is the one in the instant case)[10] is valid and constitutional unless it is

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[7] *Supra*, n. 4.

[8] *Supra*, n. 6, 104. For instance, consolidated net income of Household everywhere was 43.3% of consolidated gross income, but Maryland net income was 50% of Maryland gross. Each dollar of consolidated assets produced 9 cents of net income; each dollar of Maryland assets produced 12 cents. Maryland assets comprised only 2.8% of consolidated assets but produced 3.81% of consolidated net income. Judge Hammond argued from these figures that the Maryland business of Household had a relatively higher "going concern" value than Household's average business and concluded that the figure of $6,500,000 (about 4% of the value of Household's entire property and business) was perfectly reasonable as a proper evaluation of the Household property and business in Maryland.

[9] *Supra*, n. 1, 98.

[10] The fact that in the case of a unitary enterprise, property outside of the taxing state may be taken into consideration in order to arrive at a value of the taxable property within the state has long been well settled.

> "The only reason for allowing a State to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of the things within it, when they are part of an organic

shown by clear and cogent evidence that the formula produces "a palpably disproportionate result".[11] In other words, there is a presumption of constitutionality which can be rebutted only by clear evidence that values outside the state are being taxed in the present instance. It is apparent that this constitutional presumption and the statutory presumption in Sec. 20(a) are very nearly identical.[12] Hence, it would appear that the same considerations used in determining when this presumption of constitutionality breaks down would be helpful also in determining when the statutory presumption in Sec. 20(a) is invalid. And, of course, the most important consideration that concerns us is what is meant by "clear and cogent evidence".

There is an astonishing lack of direct authority on the problem posed by the fact situation in the instant case. In one of the few similar cases, *People v. Knapp*,[13] Judge Cardozo sitting on the Court of Appeals of New York, was asked to rule upon the validity of a franchise[14] tax imposed

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> system of wide extent, that gives them a value above what they otherwise would possess."
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> Wallace v. Hines, 253 U. S. 66, 69 (1920).

The Maryland Court of Appeals had no difficulty at all in finding that Household was engaged in such a unitary enterprise.

> ". . . Through the operation of its headquarters, and the combined borrowing power . . ., the most advantageous rates of interest may be attained with resultant benefit to all parts of the corporate body. The branches in Maryland, . . . contributed to the whole; and, naturally, obtained many benefits therefrom."
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> 212 Md. 80, 95, 128 A. 2d 640 (1957).

[11] N. & W. Ry. Co. v. N. Carolina, 297 U. S. 682, 688 (1936); Harvester Co. v. Evatt, 329 U. S. 416, 422 (1947).

[12] This should not be surprising because undoubtedly the statutory presumption was created and designed among other reasons to minimize the possibility of unconstitutional applications in particular cases.

[13] 230 N. Y. 48, 129 N. E. 202 (1920).

[14] It may be well at this point to consider the nature of the tax imposed on foreign finance corporations by Md. Code (1951), Art. 81, sec. 20(a), (b). There are two broad classifications in the area of state taxation of foreign corporations: (1) "property" taxes and (2) all the various other types, which can be lumped together under the term "excise" taxes. Property taxes are subject to the constitutional requirements of uniformity of taxation and the requirement of taxation according to value, whereas the excise taxes are not. See 14 FLETCHER CYCLOPEDIA CORPORATIONS (Perm. ed., 1945), §6902. On the other hand, sometimes an excise tax will fail when, if it had been deemed to be a property tax, it would have been sustained. See Railway Express Agency v. Virginia, 347 U. S. 359 (1954), where the Court decided that the tax was not a property tax and hence was void as a privilege tax imposed on the privilege of doing interstate business.

Often it is difficult to determine in which category a particular income, franchise, license, privilege, or other tax belongs. The distinction is often very subtle. For instance, it is settled that it is beyond a state's power to tax the privilege of carrying on interstate commerce; yet taxes can validly be levied on property used in interstate commerce, *e.g.*, see Adams Express Co. v. Ohio, 165 U. S. 194 (1897).

It would appear that the Maryland tax concerned here is a property tax. It is listed as such in the statute itself, and is clearly designed to operate

on that part of a foreign corporation's net income which was attributed to New York by the following statutory formula. Its net income was to be multiplied by a fraction the numerator of which consisted of the monetary value of certain of its assets located in New York, and the denominator of which consisted of the total value of these types of assets wherever situated. The resulting figure was taxable in New York. It happened that a substantial part of the taxpayer's net income derived from bonds held outside New York and that the value of bonds held by the corporation was not includable in either numerator or denominator of the apportioning fraction. The Court held that the tax was bad on constitutional grounds.[15] It made no finding that the actual result was disproportionate or excessive. For all that appears the formula may have attributed a smaller percentage of the entire net income to New York than was in fact earned there. However, under the circumstances of the case the formula was bad in theory and was therefore rejected without further ado.[16]

However, other cases in which taxes of this sort have been struck down have emphasized and relied on the fac-

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as a tax on the value of the business in Maryland; Art. 81, Sec. 7(7). Also, the tangible personal property of the taxpayer is exempt from the ordinary tax imposed on such personalty; Sec. 8(14). Likewise the assessed value of realty owned by such a corporation is to be subtracted from the value of the tax base (total capital stock) before the tax is assessed; Sec. 19(b). These provisions evidence a legislative intent not to tax the corporation's physical property twice and to this extent indicate that the tax is a property tax. The problem was touched upon, but not decided, in Commercial Corp. v. Tax Comm., 181 Md. 234, 239, 29 A. 2d 294 (1942), where the Court mentioned in passing the Commission's contention that the tax was not on the property of the corporation but on the privilege of doing business in the state (which would make it an excise tax).

[15] *Supra*, n. 13, 206.

> "Here, . . . the statute prescribes a rule of allocation which, as applied to foreign corporations holding bonds . . . in other states, involves an artificial and arbitrary augmentation of the value of the local privilege. It measures the value of the franchise, here and elsewhere, by income from all sources, and excludes some of the same sources when the value is apportioned. To take from assets elsewhere is equivalent to adding to assets here."

[16] Certiorari to the U. S. Supreme Court was denied; 256 U. S. 702 (1921). Judge Cardozo cited and relied heavily on Oklahoma v. Wells Fargo & Co., 223 U. S. 298 (1912). In this case the tax was imposed on that part of the gross receipts of an express company which were apportioned to Oklahoma by the use of a fraction, the numerator of which was "business done" in Oklahoma and the denominator of which was "business done" everywhere. Apparently substantial income was realized from bonds and land outside of Oklahoma. This income was included in the measure of the tax, *i.e.*, the total gross receipts, but was excluded from the denominator of the apportioning fraction, evidently on the theory that it was not a part of the "business done" by the company. Judge Cardozo said of this case:

> "The scheme of allocation limited the assessors to the comparison of the receipts of business done within the state with the receipts of business there and elsewhere. Investments in bonds and lands were

tual showing of a disproportionate result effected in the individual instance. *Fargo v. Hart*[17] is an early leading case which condemned a property tax on the assets of an express company apportioned by using a mileage ratio (number of miles of track within the state to total miles everywhere), because the allocation fraction imputed much more property to the taxing state than was actually in the state. The Court speaking through Mr. Justice Holmes cited factual evidence to prove that the result reached was erroneous; *e.g.*, the total assets of the company were valued at $22,000,000; those situated in the taxing state at $8,000. But the worth of the latter was assessed at $800,000 by the operation of the statutory formula.[18] *Wallace v. Hines*,[19] a later case, made a similar holding. Another case[20] struck down a tax on freight cars produced by an apportionment formula which attributed a daily average of over 400 freight cars to the taxing state; the taxpayer proved by its figures that the actual daily average was 57 cars. In the celebrated *Hans Rees* case,[21] the Court condemned the tax on a showing that the allocation formula allotted 80% of total income

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disregarded in the apportionment, though the income from such investments was included in the measure. On that ground, as well as on others, the statute was held invalid."

Supra, n. 13, 206. There is little doubt that the case was authority for the proposition made out for it by Judge Cardozo, but it seems to have lost its vitality in this regard because it has never since been cited for this purpose, but has repeatedly been used as authority for its other entirely distinct doctrine that a state tax on the gross receipts of interstate business is violative of the "commerce clause" of Article 1, §8 of the U. S. Constitution. See, for example, Lemke v. Farmers' Grain Co., 258 U. S. 50 (1922); Matson Nav. Co. v. State Board, 297 U. S. 444 (1936); McGoldrick v. Berwind-White Co., 309 U. S. 33 (1940); Northwest Airlines v. Minnesota, 322 U. S. 292 (1944).

In a later case involving the same New York statute under very similar factual circumstances, the Supreme Court rejected a demand for the application of the doctrine in the Knapp case and sustained the tax. It relied partially, however, on the fact that the issue had not been raised in the lower court. Bass, etc., Ltd. v. Tax Comm., 266 U. S. 271 (1924).

[17] 193 U. S. 490 (1904).

[18] The Court also based its decision on the impropriety of including in the measure of the tax (gross assets) investments which had nothing to do with the running of the business in the taxing state, *i.e.*, it made the point that when a business is not entirely unitary in its nature, that part of it which differs from the business carried on within the taxing state should not be considered in determining the value of the business in the taxing state.

[19] *Supra*, n. 10. Here, a North Dakota excise tax was imposed on that part of a railroad's capital that was used in the state. Again, the apportioning formula was a track mileage fraction, and again, the actual facts of the case indicated that the result of the statutory formula was erroneous. It was shown that the very valuable terminals of the railroad were in other states and that in North Dakota there were for the most part only long stretches of track running through sparsely populated territory.

[20] Union Tank Line v. Wright, 249 U. S. 275 (1919).

[21] Hans Rees' Sons v. No. Carolina, 283 U. S. 123 (1931).

to North Carolina, while the evidence showed that only 17% of it was in fact derived from operations in that state. In all these cases the statutory formula was constitutional on its face and the Court in voiding the tax relied to a greater or lesser degree on evidence that the *actual result* of the allocation formula (without regard to the theory of its composition and computation) was erroneous and unfair.

There are a number of decisions indicating that the theory of the allocating formula is immaterial if the result produced by it is in line with the realities of the situation.[22] *Norfolk & Western Railway Co. v. North Carolina,*[23] is a very significant case. There North Carolina sought to tax that part of an interstate railroad's net income that was attributable to the state. The statute required that the average gross income per mile of system track be computed and that North Carolina's share be assigned on the basis of the number of miles of track located in that state. The same procedure was to be followed in allocating to the state its portion of total operating expenses. The expenses attributable to North Carolina then were to be subtracted from the gross income allocated to it and the resulting figure was to be the net income taxable in North Carolina. The railroad sought to have the tax voided on the ground that its actual operating expenses were substantially greater than the expenses attributed to it by the statutory formula. Proof was submitted which left little question of this fact. Nevertheless, the Court sustained the tax. It reasoned that there was a possibility that the operation of

[22] "However, it is *apparent from the result reached* that we cannot say the evidence of the plaintiff clearly and convincingly shows the method used by the commission is in error, . . ."

Knappton Towboat Company v. Chambers, 202 Or. 618, 276 P. 2d 425, 429 (1954). (Emphasis supplied.)

"The method or formula used by the taxing authorities . . . is not disclosed. This we do not regard as of controlling importance. If the result arrived at was clearly within the permissive limits of their discretion, the particular method used would seem unimportant."

Bailey v. Megan, 102 F. 2d 651, 654 (8th Cir., 1939).

". . . The question lies solely in the result, which must not culminate in gross injustice or over-assessment."

Grand Trunk Western R. Co. v. Brown, 32 F. Supp. 784, 792 (E. D. Mich., 1940).

See also Pacific Fruit Express Co. v. McColgan, 67 Cal. App. 2d 93, 153 P. 2d 607, 612 (1944), where the Court conceded that the Commissioner's application of the allocating formula was in error, but refused to give the taxpayer any relief because the taxpayer:

". . . failed to show that the formula applied resulted in the payment of more taxes than in equity and good conscience it should have paid, or that under the formula applied it had paid a tax measured by more than the amount of net income reasonably and fairly attributable to the business done in the state."

[23] 297 U. S. 682 (1936).

the formula attributed to North Carolina less gross income than was in fact derived from that state and therefore there might have been a compensating error which would save the final result.[24] The *Norfolk & Western* case holds firmly and explicitly that the taxpayer must prove that the final net result of the allocation formula is wrong, and failing this, he cannot rely on defects or flaws inherent in the formula to save him.[25] And it seems to be established that in the case of an unitary enterprise it is very difficult to satisfy the court that the assessment is too high, that the result produced by the formula is arbitrary and unfair. Consider, for example, *Ford Motor Co. v. Beauchamp*,[26] upholding a franchise tax formula which attributed $23,000,000 of capital stock to the taxing state in spite of the fact that the company had tangible assets in that state in the value of only $3,000,000. Other cases hold similarly in analogous circumstances.[27]

One Pennsylvania case[28] dealt tangentially with the very problem in the instant case. The Court sustained the tax; it was not impressed by the argument that the gross receipts of the subsidiaries should be included in the denominator of the allocating fraction.[29]

It would seem that the courts have indicated that the net product of the formula is what counts, not its theoretical

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[24] "For all that appears in the case developed by the Railway, actual gross revenues in North Carolina may have been so far in excess of average gross revenues computed under the statute as to neutralize the discrepancy between actual and average cost of operation. If such a counter balance exists, appellant has not been injured through the application of the formula."

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"We must bear in mind steadily that the burden is on the taxpayer to make oppression manifest by clear and cogent evidence."

Ibid, 686, 688.

[25] Justice Cardozo asked:

"Would it have had to pay less if net income had been ascertained without reference to mileage? Would the difference have been so great as to overpass the bounds of reason? In the evidence for the railway, there is no answer to those questions. . . . the state in presenting computations did not lift the burden from the railway of satisfying the court, after all the evidence was in, that it was a victim of oppression."

Supra, n. 23, 688-9.

[26] 308 U. S. 331 (1939). The Court says at page 336:

"In a unitary enterprise, property outside the state, when correlated in use with property within the state, necessarily affects the worth of the privilege within the state. . . . The weight, . . . given the property beyond the state boundaries is but a recognition of the very real effect its existence has upon the value of the privilege granted within the taxing state."

[27] Underwood T'writer Co. v. Chamberlain, 254 U. S. 113 (1920); Atl. & Pac. Tea Co. v. Grosjean, 301 U. S. 412 (1937); Butler Bros. v. McColgan, 315 U. S. 501 (1942).

[28] Commonwealth v. Ford Motor Co., 350 Pa. 236, 38 A. 2d 329 (1944).

[29] *Ibid*, 334.

imperfections.[30] Perhaps this approach has merit also in construing these statutes. If so, a statutory presumption that "the value of the property and business within Maryland bears to the value of the total business and property the same ratio which the gross receipts . . . in Maryland bears to the total gross receipts . . ." should not be cast aside in the absence of clear factual evidence that it is wrong.

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[30] See also Harvester Co. v. Evatt, 329 U. S. 416, 422 (1947), where the Court said:

> "Unless a palpably disproportionate result comes down from an apportionment . . . this Court has not been willing to nullify honest state efforts to make apportionments."

And Hump Hairpin Co. v. Emmerson, 258 U. S. 290, 296 (1922):

> "If this same amount of tax had been imposed . . . without reference being made to the basis of its computation, very certainly no objection to its validity would have been thought of."

Cf. State of Wisconsin v. J. C. Penney Co., 311 U. S. 435, 444 (1940), where the Court said:

> "The Constitution is not a formulary. It does not demand of states strict observance of rigid categories nor precision of technical phrasing in their exercise of the most basic power of government, that of taxation. For constitutional purposes the decisive issue turns on the operating incidence of a challenged tax. A state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society."