Annual Survey of Massachusetts Law

Volume 1967 Article 21

1-1-1967

Chapter 18: State and Local Taxation

Brian J. Quinn

CHAPTER 18

State and Local Taxation

§18.1. Sales and use tax: Governmental immunity: First Agricultural National Bank of Berkshire County v. State Tax Commission.[1] The plaintiff is one of ninety national banks doing business in Massachusetts. In order to carry on its banking operations, the bank must make purchases which are taxable under the state's Sales and Use Tax Act,[2] and its vendors refuse to make such sales unless they are reimbursed for the taxes by the bank. On March 28, 1966, the plaintiff requested that the State Tax Commission rule national banks exempt from Massachusetts sales and use taxes. No ruling was received in answer to the request, and the plaintiff paid sales taxes to its vendors as required.[3] On May 31, 1966, the Commission issued Emergency Regulation No. 6, ruling that "the sale, lease or rental of tangible personal property to national banks and federal savings and loan associations is subject to the sales and use tax."[4] On receipt of this regulation, the plaintiff filed a bill for declaratory relief, seeking a binding declaration of its exemption from the Massachusetts sales and use taxes on the ground that, as instrumentalities of the United States, national banks enjoy immunity from state taxation. The case first came before a single justice, and was reserved and reported without decision. The Supreme Judicial Court HELD: federal governmental immunity from taxation by the states does not extend to purchases of tangible personal property made by national banks in Massachusetts. The state's sales and use tax, therefore, may be applied to such purchases made by the plaintiff.

The plaintiff based its claim for exemption from these taxes on three propositions: (1) that the bank, as an agency of the federal government, qualifies for the specific exemptions enumerated in the act;[5] (2) that the application of the tax to the plaintiff violates the implied immunity of federal instrumentalities from state taxation; and (3) that the imposition of the tax on the plaintiff is contrary to congressional legislation.[6]

The Court first examined the plaintiff's claim for a statutory exemption under Sections 1 and 2 of the act. Section 1, subsection

§8.1. [1] 1967 Mass. Adv. Sh. 1301, 229 N.E.2d 245.

[2] G.L., c. 58 App., §§1-1, 1-2.

[3] Total taxes paid by the plaintiff amounted to $575.66 from April 1, 1966, to June 30, 1966. 1967 Mass. Adv. Sh. at 1032, 229 N.E.2d at 247.

[4] Id.

[5] G.L., c. 58 App., §1-1(6) (sales tax), and §1-2(5) (use tax).

[6] See 12 U.S.C. §548 (1964).

6(d), exempts from the sales tax "Sales to the United States, the commonwealth of Massachusetts or any political subdivision thereof, or their respective agencies." Section 2, subsection 5(b), exempts from the use tax out-of-state purchases made by those exempted from the sales tax by Section 1, subsection 6(d). In discussing this contention, the Court held that the intent of the legislature was to have "agency" mean "a regularly constituted department of government, or an entity which is wholly owned by the government and which exercises exclusively governmental functions."[7] The Court conceded that national banks are subject to supervision by the federal government,[8] and that they do perform certain governmental services. The Court ruled, however, that such performance is "incidental to [the bank's] primary purpose of returning a profit to its stockholders."[9] The plaintiff, therefore, did not qualify for the explicit exemptions of Sections 1 and 2 of the act.

The Court next considered whether the imposition of a sales and use tax upon a national bank was prohibited by the United States Constitution. Subsection 6(a) of Section 1 of the Sales and Use Tax Act exempts from the operation of the sales tax "sales which the commonwealth is prohibited from taxing under the Constitution and laws of the United States." Section 2, subsection 5(b), applies the same limitation to the operation of the use tax. The United States Supreme Court has held that those taxes which directly burden either the government itself, or the exercise of the functions of government are violative of the Constitution.[10] Such a burden has been found to exist where the legal obligation for payment of the tax falls upon the government.[11] The Supreme Judicial Court ruled that, for purposes of the sales tax, the vendor bears the legal obligation for the tax.[12] Since the bank is not legally obligated to pay the tax, it is not an object of state taxation under that section of the act. The bank, therefore, could not assert implied governmental immunity in relation to the sales tax.

The use tax provisions of the act, on the other hand, are expressly imposed on the purchaser.[13] The use tax, therefore, represents a direct tax upon the bank. The Court, however, found that because of their involvement in the private sphere of commercial banking, national banks no longer qualify for exemptions from state taxation as federal instrumentalities. Therefore, imposition of the use tax would result in no unconstitutional interference with any federal instrumentality.

Finally, the Court discussed whether the imposition of a state use

7 1967 Mass. Adv. Sh. at 1305, 229 N.E.2d at 248.
8 Id. at 1304, 229 N.E.2d at 248.
9 Id.
10 See Railroad Co. v. Peniston, 85 U.S. 5 (1873).
11 Kern-Limerick Inc. v. Scurlock, 347 U.S. 110, 121-122 (1953).
12 See G.L., c. 58 App., §§1-1(10), 1-1(15)(b), 1-1(16), 1-1(17).
13 Id. at §1-2(11).

tax upon a national bank contravenes Section 548 of Title 12 of the United States Code, which defines the manner in which states may tax the income produced by national banks located within the taxing state.[14] The language of Section 548 contains no express prohibition of a state-imposed use tax on national banks. The Court reasoned that since Congress has the power to create exemptions from taxation by express declaration, if it omits to do so, no exemption may be created by implication.[15] Ruling that Section 548 does not set an outer limit upon state power to tax national banks,[16] the Court rejected the last of the plaintiff's claims.

The Supreme Judicial Court based its conclusions on the premise that, since national banks do not meet the test presently applied by the United States Supreme Court for determining if an entity is a governmental instrumentality, they do not qualify for the immunity from state taxation to which such instrumentalities are entitled.[17] The essential question, therefore, is whether the Court was correct in concluding that national banks are not federal instrumentalities within the United States Supreme Court's definition. In attempting to answer that question, the following discussion will trace the development of the Supreme Court's test for determining whether a given entity is a federal instrumentality, and will analyze the distinctions which have been made to classify instrumentalities as either governmental or non-governmental. The test will then be applied to national banks to determine whether they may be considered federal instrumentalities.

The Constitution of the United States does not expressly protect from state interference those instrumentalities through which the United States chooses to carry out its functions and responsibilities. A rule of intergovernmental immunity, implied from the supremacy[18] and necessary and proper[19] clauses of the Constitution, was laid down by the United States Supreme Court in *M'Culloch v. Maryland.*[20] *M'Culloch* established the principle that a state may not levy any tax which would "retard, impede, burden, or in any manner control, the operations of the constitutional laws enacted by Congress to carry into execution the powers vested in the general government."[21] Where Congress has chosen to empower an instrumentality to carry

14 Section 548 provides in part: "The several states may (1) tax said shares, or (2) include dividends derived therefrom in the taxable income of an owner or holder thereof, or (3) such associations on their net income, or (4) according to or measured by their net income. . . ."

The section also declares that the above taxation must be non-discriminatory, that is, national banks may not be taxed at a higher rate than other banks doing business within the state. Moreover, states are not prohibited from imposing a non-discriminatory tax on real estate owned by the banks within the taxing state.

15 1967 Mass. Adv. Sh. at 1323, 229 N.E.2d at 260.

16 Id. at 1322-1323, 229 N.E.2d at 259.

17 Id. at 1317-1318, 229 N.E.2d at 256-257.

18 U.S. Const. art. VI.

19 Id. art. I, §8.

20 17 U.S. 316 (1819).

21 Id. at 436.

out federal functions, a state may tax neither those functions, nor the privilege of exercising them.[22]

In early considerations of state taxation of governmental instrumentalities, the Supreme Court tried to determine what situations would warrant its intervening to limit the state action. A remote effect on the "efficient exercise of the Federal power could not, for that reason alone, be considered a prohibited exercise of state power."[23] The interference must amount to more than a mere token or theoretical effect. Accordingly, a test was established in *Railroad Co. v. Peniston,*[24] which provided that, for a state tax to be struck down, it must represent some measurable hindrance to the exercise of federal functions. In *Peniston,* the Supreme Court was called upon to consider whether property used in the operation of a federally chartered railroad was a legitimate object of state taxation. The Court ruled that the exemption of federally chartered instrumentalities from the reach of state taxation depended "not upon the nature of the agents, or upon the mode of their constitution, or upon the fact that they are agents, but upon the effect of the tax. . . ."[25] In other words, the question to be asked was whether the tax applied to the alleged federal instrumentality, in fact, deprived the instrumentality of the power to perform its governmental functions.[26] The tax in *Peniston* was found to be not upon the agent's activities on behalf of the government, but on the property belonging to the agent. The Court held that a tax on the railroad's property "leaves them free to discharge the duties they have undertaken to perform. A tax upon their operations is a direct obstruction to the exercise of Federal powers."[27]

The *Peniston* principle eventually merged into the "economic burden" test established in *Panhandle Oil Co. v. Mississippi ex rel. Knox.*[28] There the Court declared that:

> The States may not burden or interfere with the exertion of national power or make it a source of revenue or take the funds raised or tax the means used for the performance of federal functions. . . . While [a state] may impose charges . . . for the privilege of carrying on trade that is subject to the power of the State, it may not lay any tax upon transactions by which the United States secures the things desired for its governmental purposes.[29]

Specifically, *Panhandle Oil* declared that a state franchise tax on the privilege of selling gasoline was unconstitutional as applied to instru-

22 Traynor, National Bank Taxation in California, 17 Calif. L. Rev. 83, 85 (1929).
23 Railroad Co. v. Peniston, 85 U.S. 5, 30 (1873).
24 Id.
25 Id. at 36.
26 Id.
27 Id. at 36-37.
28 277 U.S. 218 (1928).
29 Id. at 221.

mentalities of the United States. In *Peniston*, the Supreme Court had outlawed those state taxes which represented some "measurable hindrance" to the exercise of federal functions. *Panhandle Oil* narrowed the states' taxing powers by declaring that no interference with national activities would be allowed.

Under a more recent trend, developed in cases decided over the last thirty years, the broad exemptions allowed under the *Panhandle Oil* rule have been limited in favor of a more selective approach to granting immunities. In these cases, the Supreme Court has sought to distinguish between interests which are truly governmental in character, and those which are actually private activities seeking shelter from state taxation on grounds that the work they perform is for the government.[30]

The first major departure from the earlier broad grants of immunity suggested that the fact that a tax results in an economic burden upon the government is not sufficient, by itself, to condemn a tax on private persons dealing with the government. The problem initially arose in situations where private industry was hired by the United States to perform various contracts for the government.[31] States felt that these private concerns, as part of the private economy, were subject to the states' taxing powers, in the same manner as any other private industry located within the taxing state. The industries, on the other hand, sought exemption from the tax on the ground that they would otherwise be forced to charge the government a higher price for the goods or services provided. The earlier "economic burden" test of *Panhandle Oil* would have extended an immunity from state taxes in such a situation. The Supreme Court, however, proceeded to distinguish between those activities which are truly those of the government, or are so bound up with government as to be considered governmental, and those activities which are undertaken by private individuals in pursuit of private gain.

Such a situation was presented in the case of *James v. Dravo Contracting Co.*,[32] which involved work to be performed for the United States under a cost-plus, fixed-fee contract. West Virginia had imposed a tax on the business of contracting, based on gross income. Dravo sought to escape the tax because it would be assessed, in part, on the basis of work being performed for the government, and would ultimately be passed onto the United States in a higher cost figure. Dravo contended that this would be, in substance, a tax on the United States itself.

The Supreme Court rejected this argument, and ruled the tax valid as applied to the income earned by Dravo from its government contract. Private contractors, under contract to the government, could be taxed even if the economic burden of the tax was passed on to the

30 See United States v. Allegheny, 322 U.S. 174, 186 (1944).
31 E.g., James v. Dravo Contracting Co., 302 U.S. 134 (1937).
32 Id.

United States. The Court distinguished the *Panhandle Oil* rule, and held that it was limited to those situations where sales were made directly to the government of the United States.[33] Following *Dravo,* similar reasoning was applied when exemptions were sought from state taxes on materials purchased for government contracts. Such purchases were held taxable even though the materials purchased were incorporated into the finished product for the government.[34]

The *Dravo* case indicated that, for an entity to enjoy the immunity of a "governmental instrumentality," it is not enough that it is working on behalf of the government and that any state taxation of it would have some ultimate economic effect on the United States. To qualify as a governmental instrumentality, the entity seeking that status must be either a specifically designated agency of the government, or be so closely connected with the government that its activities must be considered governmental. Once an entity has qualified for the status of a governmental instrumentality, however, the question remains whether the function or feature which the state wishes to tax is itself governmental. A governmental instrumentality may claim an immunity from state taxation only when the activity taxed is one of government. Thus, although the United States Supreme Court held that the Port of New York Authority and the Federal Home Owners' Loan Corporation were governmental instrumentalities, it refused to extend the instrumentalities' immunity from taxation to encompass the salaries of their employees.

Prior to 1938, the immunity granted to a governmental instrumentality included the salaries paid to its employees.[35] The Supreme Court, however, modified this doctrine in *Helvering v. Gerhardt,*[36] where an employee of the Port of New York Authority was held liable for federal income taxes, and finally abolished it in *Graves v. New York ex rel. O'Keefe,*[37] where an employee of the Federal Home Owners' Loan Corporation was held liable for New York State income taxes. The Court conceded that the removal of such an immunity would result in an increased cost upon the government which the employees served. The Supreme Court, however, did not regard such an increased cost as resulting in any "tangible or certain economic burden" on the employer-government.[38] Where the particular function of the agency which is taxed does not serve a governmental purpose, it will not be granted an immunity. The purpose of such immunities is not to protect the individual but rather "to prevent undue interference" with the activities of government.[39]

In addition to taxation which represents an undue interference with governmental activity, states are also barred from imposing such

[33] Id. at 151.
[34] E.g., Alabama v. King & Boozer, 314 U.S. 1, 8-9 (1941).
[35] New York ex rel. Rogers v. Graves, 299 U.S. 401, 408 (1937).
[36] 304 U.S. 405 (1938).
[37] 306 U.S. 466, 486 (1939).
[38] Id. at 486.
[39] Graves v. New York ex rel. O'Keefe, 306 U.S. 466, 483-484 (1939).

taxation where the legal obligation for payment is directly on the United States. In this area, it would appear that the Supreme Court frequently exalts form over substance to establish the taxability or non-taxability of the particular entity involved. In *United States v. Allegheny*[40] a state use tax was levied on machinery, which was located in and used by a privately owned manufacturing plant. The title to the machinery was vested in the United States. Declaring that its purpose in this area was "to withdraw private property and profits from the shelter of governmental immunity but without impairing the immunity of the State and Nation itself,"[41] the Supreme Court, however, held that the property of the United States, although contributing to private profit, was beyond the taxing power of the states. The tax involved was an ad valorem tax on all machinery in the manufacturing plant, and the assessment included the machinery owned by the United States. In *United States v. Detroit*,[42] the city of Detroit assessed a tax on the use, by private lessees for private profit, of tax-exempt real estate. The title to the property was vested in the United States. The assessment was computed on the basis of the freehold, and the holder of the term was obligated to pay. Under the rationale of *Allegheny*, such a tax, assessed in direct measurement of the property interest of the United States, could not be allowed. The form of the Detroit tax, however, was to tax the leasehold (measured by the freehold) and charge the lessee for his use. The Supreme Court allowed the city to tax the privately used, government-owned property.

The employment cases suggest that an instrumentality of government is immune from state taxation when it performs a governmental function; *Allegheny* and *Detroit* indicate that a similar immunity exists where the legal incidence of the tax is upon the United States. The crucial test is the direction of the tax: not how it is collected, or where the ultimate economic burden for its payment lies, but where the legal obligation for its payment rests.[43] A state tax on an instrumentality of government will be struck down only if the United States is the legal taxpayer, either itself, or acting through an instrumentality engaged in a distinctly governmental activity.

To determine whether the First Agricultural National Bank qualifies for the immunity sought in the instant case, two things must be shown: first, that national banks qualify as governmental instrumentalities under the Supreme Court test outlined above; and second, that the Massachusetts use tax was imposed upon a distinctly governmental activity of the bank.

National banks were created in 1864 by Congressional legislation which, as subsequently amended, became the National Bank Act.[44]

40 322 U.S. 174 (1944).
41 Id. at 186.
42 355 U.S. 466 (1958).
43 Powell, Remnants of Intergovernmental Tax Immunities, 58 Harv. L. Rev. 757, 758 (1945).
44 See 12 U.S.C. §38.

National banks operate in a dual role, pursuing a private profit-making purpose, as well as fulfilling certain public duties.[45] All of their activities are subject to the regulation of the United States government.[46] In the years following the establishment of national banks, the Supreme Court consistently declared national banks to be federal instrumentalities. Any attempt by a state to define the duties of the banks, or to control their activities, was declared void. According to *Davis v. Elmira Savings Bank*,[47] national banks were "created for a public purpose, and as such [are] necessarily subject to the paramount authority of the United States."[48] The Supreme Court affirmed this rule in 1899, in *Owensboro National Bank v. Owensboro*,[49] where the Court invalidated a state franchise tax on the operations of all banks, which tax included national banks.

The Supreme Judicial Court, considering the status of national banks in the instant case, found "little resemblance between the operation of today's national bank and that of national banks which existed at the time the *Owensboro* case was decided by the Supreme Court."[50] First Agricultural's claim for immunity must be judged "according to contemporary conditions under principles enunciated in the more recent Supreme Court decisions . . . ."[51] The establishment of the Federal Reserve System deprived national banks of many of their responsibilities as fiscal agents of the United States.[52] At the same time, activities of national banks in the private sphere of banking increased markedly. The Massachusetts Court thus reasoned that today there are few significant differences between national banks and state chartered banks.[53] The Court concluded that "we do not find these differences sufficient to exempt the plaintiff from the imposition of a nondiscriminatory tax of general application such as the use tax imposed by §2 of the Act."[54]

Since the *Owensboro* decision, not only has the governmental role of national banks narrowed, but their participation in the sphere of commercial banking has expanded to the point that national banks

45 See 12 U S.C. §§89, 90, 141-143, 162.

46 On receipt of their charter from the Comptroller of the Currency, national banks are authorized "to exercise, by [their] board of directors . . . subject to law, all such incidental powers as shall be necessary to carry on the business of banking." 12 U.S.C. §28(7). National banks also possess fiduciary powers, id. §92(a); may extend loans and accept savings deposits, id. §371; and must file regular reports on their condition to the United States Treasury, and be regularly examined by the Comptroller of the Currency, id. §161. The statute also prescribes such details as the requisite initial capitalization, id. §51(b); and places a limit on the indebtedness which banks may incur, id. §82.

47 161 U.S. 275 (1896).

48 Id. at 283.

49 173 U.S. 664 (1899).

50 1967 Mass. Adv. Sh. at 1312, 229 N.E.2d at 253.

51 Id.

52 Id. at 1314-1315, 229 N.E.2d at 254-255.

53 Id. at 1316, 229 N.E.2d at 255.

54 Id. at 1317, 229 N.E.2d at 256.

compete with state chartered banks in seeking investors and customers. As the role of national banks has become more diversified, the taxes which the states have attempted to levy upon them have become more varied. At the time when the broad declarations of immunity were made, the state taxes levied upon national banks were more likely to fall on the banks in their governmental capacity. In some cases, the tax was a franchise tax on the general privilege of banking.[55] In others, the resulting state taxation discriminated against money invested in national banks in favor of the money in state banks, discouraging investment in the former in favor of the latter.[56] These taxes had to be struck down if national banks were to survive.

Today, however, the private nature of national banks has overshadowed their governmental function. Dictum of the United States Supreme Court in *Emergency Fleet Corp. v. Western Union Telegraph Co.*[57] emphasized this dual nature of national banks: "Instrumentalities like the national banks . . . , in which there are private interests, are not departments of Government. They are private corporations in which the Government has an interest."[58] It is submitted that, when discussing national banks, a distinction should be drawn between their dual natures: that of agent of the United States, and that of commercial banking institution. When they act as agents of the government, national banks should be entitled to the immunity of a federal instrumentality; when acting as commercial banking institutions, they should be subject to the same restrictions and regulations as their state-chartered equivalents.

A reflection of this dual nature may be found in various cases where national banks, acting as commercial banking institutions, have been held subject to the same regulations — federal and state — as their state-chartered counterparts. A corporate consolidation involving a national bank, where the resulting institution would control an undue percentage of the banking market, has been held subject to the provisions of the Sherman Act[59] and of the Clayton Act.[60] The National Labor Relations Board has jurisdiction over labor disputes involving employees of a national bank.[61] State regulation of national banks has been upheld in some instances. In *Anderson National Bank v. Luckett*,[62] the United States Supreme Court upheld the right of a state to enforce escheat of presumptively abandoned deposits left untouched for a statutory period, against savings deposits in national banks. In allowing the state to exercise its power here, the Court

55 Owensboro National Bank v. Owensboro, 173 U.S. 664, 669 n.1 (1899).
56 Iowa-Des Moines Bank v. Bennett, 284 U.S. 239, 244 (1931).
57 275 U.S. 415 (1928).
58 Id. at 425-426.
59 United States v. First National Bank & Trust Co., 376 U.S. 665, 669-670 (1964).
60 United States v. Philadelphia National Bank, 374 U.S. 321, 371 (1963).
61 NLRB v. Bank of America National Trust & Savings Assn., 130 F.2d 624, 626-627 (9th Cir. 1942).
62 321 U.S. 233 (1944).

pointed out that national banks are subject to state regulation "unless those [state] laws infringe the performance of the banks' functions."[63]

Since the Massachusetts sales and use tax is not directed specifically against national banks in their governmental function, it is clear that the tax is not unconstitutional on its face. The tax, however, is patently non-discriminatory, making no distinction, in its application to national banks, between their public and private functions. In upholding the constitutionality of the tax, the Supreme Judicial Court also failed to distinguish between these two functions of the banks. It is submitted that insofar as the Court's decision in *First Agricultural* may be read to uphold state taxation of a national bank, exercising a governmental function, the decision is in error.

Although state taxation of national banks functioning in their private capacities may not be violative of the Constitution, it remains to be seen whether the imposition of such tax would conflict with specific congressional legislation. Specific permission to the states to tax national banks appears in 12 U.S.C. §548.[64] National banks are thereby protected from unfriendly discrimination by the states in the exercise of their taxing powers.[65] In stating that the states are "wholly without power to levy any tax, either direct or indirect, upon the national banks, their property, assets or franchises,"[66] the Supreme Court in *Owensboro* held that this section of the statute is

> the measure of the power of a State to tax national banks, their property or their franchises. By its unambiguous provisions the power is confined to a taxation of the shares of stock in the names of the shareholders and to an assessment of the real estate of the bank. *Any state tax therefore which is in excess of and not in conformity to those requirements is void.*[67] [Emphasis added.]

Under the provisions of Section 548, therefore, certain methods of taxation of national banks are specifically allowed to the states, and it is declared that those methods will not be regarded as an interference with the purpose of Congress in creating national banks. This, in turn, would seem to imply that all other methods and degrees of taxation will be considered an interference with the Congressional purpose.[68]

The holding in *Owensboro*, that Section 548 sets an outer limit to the states' power to tax national banks, has served as the basis for decisions in cases, similar to *First Agricultural*, which have recently been argued before state courts in New York and South Dakota. In *Liberty National Bank v. Buscaglia*,[69] the Appellate Division of the

[63] Id. at 248.
[64] See note 14 *supra*.
[65] First National Bank v. Anderson, 269 U.S. 341, 347-348 (1926).
[66] Owensboro National Bank v. Owensboro, 173 U.S. 664, 668 (1899).
[67] Id. at 669.
[68] Traynor, note 22 *supra*, at 91-93.
[69] 26 App. Div. 2d 97, 270 N.Y.S.2d 871 (1966). As the Survey was going to press,

Supreme Court of the State of New York rejected the argument that the nature of national banks has changed since the days of *M'Culloch* and *Owensboro*, and that precedent holdings that national banks are always governmental instrumentalities are no longer necessarily valid.[70] Their rejection of the argument was based on the United States Supreme Court's statement in *Colorado National Bank v. Bedford*,[71] that although the usefulness of a national bank as "an agency to provide for currency has diminished markedly," its operations are still subject to state taxation only as permitted by Congress.[72] Stating that "possessions, institutions and activities of the Federal Government itself" may not be taxed in the absence of Congressional permission, the New York court barred the imposition of a state and county sales and use tax on a national bank.

The Supreme Court of South Dakota, in *Northwestern National Bank of Sioux Falls v. Gillis*,[73] discussed the application of a state use tax to purchases of materials for use by a national bank. The South Dakota court held that the use tax was directed against the bank when it was assessed upon materials for use by the bank in its banking business. The court felt that Section 548 set the outer limit of state taxing power over national banks. Therefore, since the state statute required the bank to pay the assessment directly to the State Commissioner of Revenue, the South Dakota court held the tax to be prohibited by Section 548.[74]

The Massachusetts decision is clearly inconsistent with holdings of the United States Supreme Court. The Supreme Judicial Court, recognizing this conflict, suggested, however, that, in light of the changed status of national banks, the United States Supreme Court should reconsider its holding in *Owensboro*, especially insofar as it interprets 12 U.S.C. §548 as setting the outer limit of state power to tax national banks.[75]

Two conclusions clearly follow from the above analysis. First, when a national bank acts in its public capacity, exercising wholly governmental functions, it is within the Supreme Court's definition of a governmental instrumentality. As such, it should be immune from state taxation. Secondly, where a national bank engages in an exclusively private, commercial activity, in competition with state chartered banks, the bank is without the Supreme Court's definition of federal instrumentality. Consequently, the means used by a national bank to

---

the New York Court of Appeals, with approving citation to First Agricultural, reversed the Appellate Division and held national banks subject to the sales and use taxes. Liberty National Bank v. Buscaglia, 21 N.Y.2d —, — N.E.2d —, — N.Y.S.2d — (1968).

70 Id. at 99-100, 270 N.Y.S.2d at 874.

71 310 U.S. 41 (1940).

72 26 App. Div. 2d at 100, 270 N.Y.S.2d at 874, citing Colorado National Bank v. Bedford, 310 U.S. 41, 48 (1940).

73 148 N.W.2d 293 (S.D. 1967).

74 Id. at 297.

75 1967 Mass. Adv. Sh. at 1312, 229 N.E.2d at 253.

engage in competition with private banks should be subject to the same taxation as are the activities of private banks.

The Supreme Judicial Court, however, has not discussed what would result if a state tax were levied on materials purchased for use in both the private and the public business of the bank. The Court tacitly assumed that the materials taxed in the instant case were purchased for use in the plaintiff's commercial activities. A fuller discussion of this situation would appear crucial, however, because of the likelihood that the national bank uses such items as office machinery and supplies, for example, in furtherance of both its governmental and commercial functions. It is submitted that where the use of materials is allocable between the bank's federal and commercial functions, the tax might be pro-rated as to the percentage of use for the particular functions, and the private activities be taxed. Thereby, those elements engaged in competition with other banks would not escape taxation.

Where, on the other hand, the public and private functions are so integrated that no allocation would be practicable, a more difficult problem is presented. If the activity were taxed because of its private or "commercial" nature, then such taxation would necessarily be upon the federal activity. It is submitted that the best solution would be to place the entire transaction beyond the reach of state taxation. Otherwise there would be direct interference with a governmental activity. Only when the result reached by the Supreme Judicial Court is modified, as described above, will it comport with the United States Supreme Court's endeavor "to withdraw private property and profits from the shelter of governmental immunity but without impairing the immunity of the State and Nation itself."[76]

JACEK A. WYSOCKI

§18.2. Property tax exemption: Charitable organization: Children's Hospital Medical Center v. Board of Assessors of Boston.[1] In 1959, Children's Hospital Medical Center and six other Boston hospitals, all charitable corporations, formed a committee to investigate the establishment of a central laundry facility which would serve them on a cooperative basis. The committee concluded from their investigation that the projected volume of laundry could not be handled commercially and that a central laundry would satisfy the hospitals' needs more effectively and less expensively than separate laundry facilities operated by each hospital. The hospitals then embarked upon a plan to establish the Hospital Laundry Association. In March 1961, the association was incorporated as a nonprofit corporation, by representatives of Children's and six other hospitals. The association's corporate purposes were to operate facilities to do laundry work for nonprofit

[76] United States v. Allegheny, 322 U.S. 174, 186 (1944).

§18.2. [1] 1967 Mass. Adv. Sh. 1151, 227 N.E.2d 908.

Massachusetts hospitals and medical schools. Each organizing hospital made a substantial financial contribution to the association and following its incorporation entered into a contract under which the association would do its laundry work for ten years.

Prior to the association's incorporation, Children's Hospital had purchased real estate on Ipswich Street in Boston for itself or as trustee for the association for the purposes of converting what was then a garage into a central laundry. Children's conveyed this real estate to the association upon its incorporation. In October 1961, the association's laundry began actual operation.

Children's Hospital claimed a tax exemption on the Ipswich Street property for 1961, and the association claimed an exemption on the same property and on its personal property for 1962 and 1963. The statute under which both organizations claimed exemption was General Laws, Chapter 59, Section 5, the pertinent portions of which exempts from taxation "personal property . . . and real estate owned by or held in trust for a charitable organization and occupied by it . . . for the purposes for which it is organized. . . ." In order for an organization to be granted an exemption under the statute it must show: (1) that it is a charitable organization; and (2) that its real estate is owned and occupied for the purposes for which it is organized. Since Children's Hospital concededly was a charitable organization, the issue here was whether it owned and occupied the property for the purposes for which it was organized. Unlike the hospital, the association had clearly owned and occupied the property for the purposes for which it was organized. The issue as to the association, therefore, was whether it had met the statute's first requirement of being a charitable organization.

From the refusal of the assessors to make abatements on the Ipswich Street property, Children's Hospital and the association appealed to the Appellate Tax Board. The Board upheld the assessors' decision as to Children's Hospital on the ground in preparing the property as a central laundry which was to be separately incorporated the hospital had owned and occupied the property for purposes other than those for which it was organized.[2] The Board held that the association's corporate purpose of laundering linens and clothing for medical institutions was no more a charitable purpose than laundering linens and clothing for any other class of institutions, and, therefore, the association was not a charitable organization within the meaning of the exemption statute.[3]

Reversing on appeal, the Supreme Judicial Court HELD: (1) Children's Hospital owned and occupied the property in accordance with powers granted charitable hospitals under Acts of 1959, Chapter 283, in furtherance of its function of caring for the ill. Therefore, Children's had owned and occupied the property "for purposes for which

2 Record at 14-15.

3 Id. at 15-18.

it was organized." (2) The association's purpose — to conduct an incidental hospital function for charitable organizations — was a charitable purpose. The association was, therefore, a charitable organization. Consequently, both the hospital and the association were entitled to the tax exemption.

The conflict between the Appellate Tax Board and the Supreme Judicial Court as to the hospital centered around whether it had owned and occupied the Ipswich Street property for the purposes for which it was organized. The focal point of the conflict was the interpretation of the word "purposes." To the Tax Board, "purposes" meant the reasons for which the charitable organization was organized. From this interpretation the Board reasoned that since Children's was holding the property as a laundry, but had been organized as a hospital, it had not complied with the proviso of the exemption statute.[4] The Supreme Judicial Court held that such an interpretation was too restrictive. The Court expanded the Board's interpretation of "purposes" to include within its meaning that use of property which is a valid exercise of powers specifically conferred by the legislature. The Court's underlying rationale was that where an organization is simply exercising such a conferred power, it would be anomalous to deprive the organization of its legislatively granted tax exemption. The Court found that Children's Hospital was exercising such a specially conferred power, granted by Acts of 1959, Chapter 283. By virtue of Section 5 of this statute, the hospital had the power:

> to form . . . with such other charitable corporations . . . an alliance for, and otherwise to cooperate in, establishing, maintaining and operating a medical center and to render mutual services and operate one or more plants in common in connection with such medical center.

On its face, the statute would seem to require that Children's Hospital, in concert with the other six charitable hospitals, utilize the Ipswich Street property as a laundry "in connection with a medical center" either formed or shortly to be formed by them. The record gives no indication that Children's or the other six hospitals had any intention of establishing such a medical center. To the contrary, the record discloses that the property owned and occupied by Children's was being prepared as a central laundry for separate medical centers already established. Consequently, the Supreme Judicial Court gave a strained construction to Acts of 1959, Chapter 283, not justified by any precedent or by any manifestations of legislative intent.[5]

The Court, however, looked not only to the word "purposes," but also the phrase "for the purposes," and construed this phrase to include within its meaning such use of property as is reasonably related to the charitable purposes of the organization. The Court

[4] Id. at 14.

[5] See Brief for Appellee at 7-8.

reasoned that since Children's owned and occupied the property as a laundry, and the cleansing of linens and clothing for hospital patients is directly related to one of Children's aims, that of providing the public with sanitary hospital services, it is within the statutory exemption. The Court's interpretation was not a novel one. As early as 1868, in the case of *Trustees of Wesleyan Academy v. Inhabitants of Wilbraham*,[6] the Court interpreted "purpose" to include the use of property which is directly related to primary charitable activity.[7] Such an interpretation appears to be justified. To hold otherwise, the Court in *Children's* noted, would be to "unsoundly fragmentize"[8] the various component activities of these organizations.

In addition to the arguments the Court used to justify its decision, there was another argument which it might have used to buttress its holding that Children's Hospital had owned the Ipswich Street property for the purposes for which it was organized. In the past, the Court has stated that managing officers of a charitable corporation are vested with considerable discretion as to what use of corporate property will best promote the charitable purposes of the organization. In *Assessors of Dover v. Dominican Fathers Province of St. Joseph*,[9] the Court stated:

> The rule deducible from our decisions is that what lands are reasonably required, and what uses of the land will promote the purposes for which the institution was incorporated, must be determined by its own officers. So long as they act in good faith and not unreasonably in determining how to occupy and use the real estate of the corporation their determination will not be interfered with by the courts.[10]

Applying this standard to the facts of the present case, the officers of Children's were, in effect, entitled to a presumption that the acquisition of the Ipswich Street property, and the occupation of it for preliminary steps towards its conversion to use for a cooperative central laundry facility, would be in the best interests of Children's. Therefore, their ownership would be in furtherance of the purposes for which the hospital was organized.[11] The Court's failure to use this approach could possibly be interpreted as an indication of a desire to limit the application of the *Dover* rule.

In addition to the requirement that Children's Hospital own the property for the purposes for which it was organized, it was also necessary that it "occupy" the Ipswich Street property for those purposes in order to claim the tax exemption. In its most recent interpretation

6 99 Mass. 599 (1868).
7 Id. at 604.
8 1967 Mass. Adv. Sh. at 1157, 227 N.E.2d at 912.
9 334 Mass. 530, 137 N.E.2d 225 (1956).
10 Id. at 540-541, 137 N.E.2d at 231.
11 See Brief for Appellants at 13-14; Reply Brief for Appellants at 2, 3.

of the statute's occupancy requirement, the Supreme Judicial Court stated:

> Such occupancy means something more than that which results from simple ownership and possession. It signifies as *active* appropriation to the *immediate* uses of the charitable cause for which the owner was organized. . . . [T]he nature of the occupation must be such as to contribute *immediately* to the promotion of the charity and physically to participate in the forwarding of its beneficent objects.[12] [Emphasis added.]

The hospital had purchased the property and had renovated it so that the association could use it as a laundry. However, it had not "occupied" the property while laundry work was performed there. Thus, it would appear that under the active, immediate use test, the hospital failed to meet the "occupancy" requirements. The Court stated that this approach was "entitled to very slight weight. . . ."[13] It would appear, thus, that the Court was accepting preparation towards active use as sufficient to qualify for "occupancy."[14] The apparent purpose of the occupancy requirement is to prevent charities from allowing land to lie dormant, and at the same time to insure that only that property which contributes to the charitable function be tax exempt.[15] These purposes are satisfied when the organization is taking positive steps toward utilizing the real estate. Thus, the Court's implicit qualification of the active use test is justified.

The issue raised by the association's appeal — whether the association was a charitable organization — presented a more difficult question. It is generally recognized that the typical charitable organization provides benefits directly to the members of the public by bringing their "hearts and minds" under the influence of education or religion, by relieving their bodies from suffering or disease, or by assisting them to establish themselves in society.[16] The association, on the other hand, did not directly benefit the general public, but merely assisted charitable organizations which rendered benefits directly to the public. Consequently, the underlying issue which faced the Supreme Judicial Court was whether an organization whose dominant purpose is to aid charities to perform their charitable functions is itself charitable in nature.

In answering in the affirmative the Court emphasized three con-

[12] Board of Assessors of Boston v. Vincent Club, 351 Mass. 10, 14, 217 N.E.2d 757, 760 (1966), quoting Babcock v. Leopold Morse Home for Infirm Hebrews & Orphanage, 225 Mass. 418, 421-422, 114 N.E. 712, 712-713 (1917). But see Trinity Church v. Boston, 118 Mass. 164 (1875); New England Hospital v. Boston, 113 Mass. 518 (1873).

[13] 1967 Mass. Adv. Sh. at 1156, 227 N.E.2d at 912.

[14] See Brief for Appellants at 12-13.

[15] See G.L., c. 59, §5, which exempts: "real estate purchased by a charitable organization with the purpose of removal thereto, until such removal, but not for more than two years after such purchase. . . ."

[16] Jackson v. Phillips, 96 Mass. 539, 556 (1867).

trolling factors in deciding the issue: (1) the character of those participating in the benefits provided by the organization, (2) the ultimate class of beneficiaries of the organization's activities, and (3) the relationship of the function it performs for the other charities to their overall operations.

The Appellate Tax Board, upholding the tax assessment, had held that "the character of those participating in the benefits of the laundry facility . . . is not of great materiality in resolving the question of exemption."[17] The Supreme Judicial Court's disagreement was founded on the implication of the significant case law in this area. In *Assessors of Boston v. Boston Pilots' Relief Society*,[18] the organization was denied tax exemption, in part because the members were entitled to its benefits as a matter of legal right rather than on the basis of need. In contrast to this case is *M.I.T. Student House, Inc. v. Board of Assessors of Boston*.[19] In *M.I.T. Student House*, the corporation was organized to assist needy students of M.I.T. by maintaining a house which provided them with room and board at a cost lower than would be otherwise available to them. It was held that the corporation was a charity, because membership in the student house was limited to needy students.[20] Basically the same principle was applied in *New England Trust Co. v. Commissioner of Corporations and Taxation*,[21] where the issue was whether a gift to the Alumnae Association of Smith College was exempt from the legacy tax under provisions of General Laws, Chapter 65, Section 1. The Court reasoned that since the alumnae association's purpose was the advancement of learning through the medium of Smith College, the character of the major participant in the gift was charitable, and therefore the gift was exempt from the legacy tax. Thus, analogous precedent would support the Court's conclusion that the character of those participating in the benefits of the organization is a significant factor in determining whether the organization is a charity.

A problem arose, however, in the application of this test to the association. The assessors had argued that the association more closely resembled a mutual benefit society, as was the situation in the *Boston Pilots' Relief Society* case, than it did a charitable organization. Similar to the members of such a society, the member hospitals in the association were charged for the services which the association performed. As the Court pointed out, however, that fact alone did not necessarily destroy the association's charitable character. In the *M.I.T. Student House* case, the Court held that although the needy students

17 Record at 18.

18 311 Mass. 232, 40 N.E.2d 889 (1942). Each member of the society was required to pay a substantial admission fee, annual dues, and a large initial assessment in return for payments to him or his estate upon his death. Id. at 237, 40 N.E.2d at 892.

19 350 Mass. 539, 215 N.E.2d 788 (1966), noted in 1966 Ann. Surv. Mass. Law §21.12.

20 Id. at 541, 215 N.E.2d at 790.

21 327 Mass. 113, 97 N.E.2d 164 (1951).

made certain payments to the corporation, their cooperative living arrangement did result in a reduced cost to each student, and therefore was in furtherance of the corporation's general charitable purpose.[22] The underlying rationale for this principle is that so long as the organization is organized as a nonprofit venture and so long as the organization renders services at a lower fee than would otherwise be charged, it may still be charitable regardless of the fact that it receives some payment for its services.[23] Applying the same rationale to the association, it can be said that although the association had charged for its services, it was a nonprofit venture. Also, it may be reasonably inferred from the facts that the association, being a cooperative laundry arrangement, similar to the cooperative living arrangement in the *M.I.T. Student House* case, reduced the member hospitals' costs. The findings of fact on this point were vague, but it is reasonable to assume one central laundry facility was more economical than six laundries operated separately by each hospital.

There is an additional distinction. In a mutual benefit society the benefits are apportioned to the members, regardless of whether they are needy individuals. The association's benefits, however, are available only to hospitals which are charitable in character, and this, the Court held, was sufficient to meet the test. The character-of-the-participant requirement seems intended to assure that those benefited are worthy of aid. The Court's holding that the character-of-the-participants test is met when the participants are charitable, as well as when the participants are needy, would appear to be justified.

The second point emphasized by the Court was the importance of ascertaining who the ultimate class of beneficiaries are. It has long been the rule in the Commonwealth that:

> an institution will be classed as charitable if the dominant purpose of its work is for the public good and the work done by its members is but a means adopted for this purpose. But if the dominant purpose of its work is to benefit its members or a limited class, it will not be so classed, even though the public will derive an incidental benefit from such work.[24]

The assessors argued that the association was of the latter type since the patients in the hospitals served received only an incidental benefit, while the dominant purpose of the association was to benefit its limited group of member hospitals. In essence, the assessors were arguing that the association did not fall within the classic definition of a charity because its activities were not "for the benefit of an indefinite number of persons."[25] The Court was unwilling to apply this

[22] 350 Mass. 539, 541-542, 215 N.E.2d 788, 790-791 (1966).

[23] See Thornton v. Franklin Square House, 200 Mass. 465, 466-467, 86 N.E. 909, 910 (1909).

[24] Massachusetts Medical Society v. Assessors of Boston, 340 Mass. 327, 332, 164 N.E.2d 325, 328 (1960).

[25] See Jackson v. Phillips, 96 Mass. 539, 556 (1867).

test in terms solely of the immediate recipients of the benefit. The Court stated that "the hospitals in the alliance and Association are charitable corporations and the ultimate class of beneficiaries is the general public."[26] In effect, the Court was willing to treat the member hospitals as conduits, and to allocate to the association "the indefinite class" served by the member hospitals. Treating the hospitals as conduits is valid because, in situations where charitable organizations are benefited, they cannot absorb this benefit for themselves, but must necessarily pass on this benefit to the general public whom they serve.

Perhaps to balance its extension of the previously mentioned tests, the Court stressed the relationship of the function performed by the association to operations of the charities involved. The Appellate Tax Board had found, as a matter of fact, that the processing of laundry was "only an incidental part of an overall hospital operation, although an important one."[27] On appeal, the Supreme Judicial Court drew what it termed necessary inferences from the facts: namely, a laundry is an integral[28] and indispensable[29] part in a hospital's operation. The question arises whether the function performed by an organization for a charity must be incidental, important, integral, or indispensable to that charity's operation.

The Appellate Tax Board stated that if Children's and the other hospitals were allowed to form an organization, such as the association, whose real estate would be tax exempt, nothing would prevent these allied hospitals from establishing organizations similar to the association to handle any number of hospital-related activities.[30] To this contention, the Supreme Judicial Court stated: "There has been no finding that [any one of these hospital related activities] . . . is 'an *incidental* part of the overall hospital operation.' "[31] From the language of the Court, it would appear that, although the particular function performed by the association was an integral and indispensable part of the hospitals' operations, the third test would be satisfied if the function performed was merely incidental[32] to a charity's overall operation.

In summary, it may be said that an organization will be "chari-

26 1967 Mass. Adv. Sh. at 1159, 227 N.E.2d at 914.

27 Record at 14.

28 1967 Mass. Adv. Sh. at 1159, 227 N.E.2d at 914.

29 Id. at 1156, 227 N.E.2d at 912.

30 Record at 17. "What would prevent this same group of allied hospitals from taking title to a large chemical plant and manufacturing drugs for their use; or a bakery, or a machine tool company to produce surgical instruments, or a plant for manufacturing surgical dressings or x-ray machines, et cetera." Id.

31 1967 Mass. Adv. Sh. at 1158, 227 N.E.2d at 913.

32 Although "incidental," as it is commonly used, may be defined as "occurring merely by chance or without intention or calculation," Webster's Third New International Dictionary 1142 (1963), the more reasonable definition of "incidental," as used in the context of the opinion, would be "something necessary, appertaining to, or depending upon another which is termed the principal." Black's Law Dictionary 904-905 (4th ed. 1951). If the latter definition is not assumed, then the third criterion enunciated by the Court would be meaningless in practical application.

table" under the tax exemption statute if each of the following three tests is satisfied: (1) the organization's members are needy or charitable, (2) the general public is benefited either immediately, or ultimately through conduit member organizations, and (3) the function performed for the organization's members is an incidental part of their overall operation. The Supreme Judicial Court's decision is undoubtedly an expansion of existing law. For the first time, the Court has recognized that an organization whose purpose is to assist charitable organizations in the performance of their charitable works is itself charitable in nature. Although the Court did expand the law in this area, it was able to do so consistently with the rationale underlying prior case law. Also, the test used by the Court in reaching its decision appears to be a judicially manageable standard for application in future decisions.

The shortcoming of the Court's decision arises not from the holding or the rationale, but rather from reasonable inferences which may be drawn from the Court's dicta. The inference is that the Court, in the future, will consider as irrelevant the question of whether an organization claiming a tax-exempt charitable status competes with commercial industry, and that the Court, moreover, will construe tax exemption statutes liberally in favor of organizations claiming tax-exempt status as charitable organizations.

The Appellate Tax Board was of the opinion that the association and organizations similar to it would have an unfair advantage over commercial industry if they were allowed to compete with it and still retain their tax-exempt status.[33] In response, the Court held that since the hospitals had traditionally provided their own laundry, there was no basis for finding competition with commercial industry.[34] The Court, however, stated:

> We are sure that the legislature never intended to impose restrictive limitations upon the efforts of these charitable organizations to perform their service to the public in as efficient a manner as possible or to force up the already high costs to hospital patients.[35]

This, it is submitted, is a precarious position. If an organization can claim exemption as a charitable organization despite the fact that it competes with commercial industry, one can imagine situations in which an enterprising officer of a charitable corporation, through an alliance with similar charitable corporations, could detrimentally affect numerous commercial industries in his zealousness to reduce corporate expenditures.[36] Moreover, an additional consequence would be to reduce the community's tax basis inordinately, since there would be no tax revenue on the properties utilized by such corporations. The Commonwealth's tax revenue from those businesses which had

[33] See Record at 17.
[34] 1967 Mass. Adv. Sh. at 1157, 228 N.E.2d at 913.
[35] Id. at 1158, 227 N.E.2d at 913.
[36] See id. at 1157-1158, 227 N.E.2d at 913.

formerly dealt with the charitable corporations would be substantially less because of the businesses' reduced income. Furthermore, such a holding would amount to a liberal construction of the tax exemption statute contrary to the traditional strict construction rule.[37] It is submitted, therefore, that in some situations the question of whether the organization claiming tax exemption competes with private industry may be relevant, and should be considered by the courts.

BRIAN J. QUINN

[37] Boston Chamber of Commerce v. Assessors of Boston, 315 Mass. 712, 716, 54 N.E.2d 199, 201 (1944); Animal Rescue League of Boston v. Assessors of Bourne, 310 Mass. 330, 332, 37 N.E.2d 1019, 1021 (1941).