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The Proportionate Method of Imposing the Pennsylvania Capital Stock Tax

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Notes

THE PROPORTIONATE METHOD OF IMPOSING THE PENNSYLVANIA CAPITAL STOCK TAX—Probably most of the careful students of State taxation in Pennsylvania, certainly a vast majority of those who have had to do with the actual work of taxing, believe that the Pennsylvania system of imposing tax on the capital stock of corporations has few peers when tested by the concrete result of bringing a more or less steady and even flow of revenue into the State Treasury year after year. This dependable regularity in productivity results from the fact that the profit or loss of a corporation for a particular year is only one of the several statutory tests entering into a determination of the taxable value of the capital stock.

The possibility, however, of loss of revenue in vast amount, as a result of judicial interpretation of the statutes imposing the capital stock tax, when such decisions become involved in the intricate fact variations present, particularly in the case of large corporations, is well illustrated in the case of *Com. v. Pennsylvania Railroad Company.*[1]

For several years the Courts of Pennsylvania have sanctioned the practice of imposing capital stock taxes upon an apportionment basis.[2] Take, for instance, the case of a non-manufacturing Pennsylvania corporation which owns real estate in Maryland. This real estate is not taxable in Pennsylvania because beyond its jurisdiction. The question at once arises as to how, for capital stock tax purposes, the deduction shall be allowed on account of such non-taxable asset. Assume, for example, the following Balance Sheet:

ASSETS		LIABILITIES	
Buildings	$100,000	Capital Stock	$160,000
Land	50,000	Accounts payable	100,000
Equipment	50,000	Surplus	100,000
Merchandise	50,000		
Land in Maryland	50,000		
Accounts received	50,000		
Cash	10,000		
	$360,000		$360,000

In the absence of an unusual income record let us assume the capital stock has a valuation of $260,000. How

[1] 297 Pa. 308; 146 Atl. 903.

[2] Com. v. Union Shipbuilding Co., 271 Pa. 403; Com. v. Hazelwood Savings & Trust Co., 271 Pa. 375.

is the $50,000 asset in Maryland to be deducted in order to arrive at the taxable value of the capital stock? Two possible methods of deduction present themselves. You may deduct it from the $260,000 which is the value of the capital stock and a so-called taxable value of $210,000 results. This was the method employed by the taxing officers prior to 1921 for making the deduction on account of shares owned in other Pennsylvania corporations which corporations had paid a capital stock tax, and was known as the "flat" deduction, but a different method known as the "proportionate" deduction was resorted to in the case of United States securities and extra-territorial real estate.[3] The only reason for making a distinction between these classes of assets for deduction purposes was that, prior to 1921, it was the belief of the taxing officers that the case of *Com. v. Fall Brook Coal Company*[4] compelled such a procedure since it seemed at first blush to sanction a flat deduction for shares owned in other Pennsylvania corporations which corporations had paid a capital stock tax.

In 1921 the Supreme Court of Pennsylvania in a clear cut decision[5] approved of the "proportionate" deduction for United States securities and extra-territorial real estate. The taxing officers then began to study the *Fall Brook Coal Company* decision more carefully, because it was difficult to understand why one non-taxable asset should be deducted in one manner and another in a different manner, and they concluded that the *Fall Brook Coal Company case* merely involved the question of whether there should be a *deduction* for shares owned in other Pennsylvania corporations, which corporations had paid a capital stock tax, and that in no sense involved the question of *how the deduction should be made.*

It is of interest, then, to observe how the "proportionate" method of deduction operates and to consider whether the "proportionate" or the "flat" method is more nearly sound mathematically. To the taxing officers it looked as if the "flat" method was mathematically unsound, for it was as if apples, an asset, were being deducted from oranges, the capital stock valuation. To adopt the "flat" deduction method resulted in the allowance of a deduction disproportionately favorable to the corporation, since the land represented only $50,000 of a total asset valuation of $360,000 and it was being deducted "flat" from $260,000, the

[3]Com. v. Union Shipbuilding Co., supra.

[4]156 Pa. 488.

[5]Com. v. Union Shipbuilding Co., supra.

capital stock valuation. Why should not the *asset* $50,000, which was non-taxable, be deducted from the total *assets*, $360,000, and the taxable valuation of the capital stock in Pennsylvania be determined by use of the following formula:

$$\frac{\text{taxable assets}}{\text{total assets}} \times \text{value of capital stock} = \text{taxable value of capital stock}$$

OR

$$\frac{\$310{,}000}{\$360{,}000} \times \$260{,}000 = \$223{,}888$$

This is the so-called "apportionment" or "proportionate" method of computing the taxable value of the capital stock and results in the illustrated balance sheet in a taxable valuation of $223,888, as against a taxable valuation of only $210,000 when the "flat" method of deduction is used.[6]

Resort to this formula appeared to be the mathematically sound method of making the deduction; a non-taxable *asset* was being deducted from *assets*, it was being taken out just where it had been put in, thus allowing a deduction in correct amount. To deduct the non-taxable *asset* from the *capital stock* was to take it out where it had not been put in, with the result that an improper and disproportionately large deduction was being allowed; the $50,000 non-taxable asset was not, under the "flat" deduction method, bearing its proportionate burden of the indebtedness of the corporation, which indebtedness as a whole had a direct bearing upon the value of the capital stock, and, in the absence of specific proof to the contrary, contributed in part to the purchase of the non-taxable assets.

The so-called "proportionate" method of allowing deductions and exemptions, on account of non-taxable assets, such as tangible property beyond the territorial limits of Pennsylvania, United States securities, patents, shares of stock of Pennsylvania corporations upon which a capital stock tax had been paid, etc., had accordingly been uni-

[6]To state the method as the Court does in the Pennsylvania Railroad Company case, supra, you determine the amount of the deduction by applying to the value of the capital stock the ratio of non-taxable assets to the total assets. For convenience the taxing officers arrive at the same result, and determine the taxable value of the capital stock in a single process by applying to the total value of the capital stock the ratio of taxable assets to the total assets.

formly adhered to at least since 1921, when the Supreme Court of Pennsylvania appears suddenly to have established a departure and to have set up a reversion to the old "flat" method of allowing deductions on account of shares owned, by its decision in *Com. v. Pennsylvania Railroad Company, supra.*

The Pennsylvania Railroad owned shares in other Pennsylvania corporations of a value of $146,291,873, upon which capital stock taxes aggregating $731,459.37 had been paid by the corporations whose shares they were. The Court said: "The effect of the 'proportionate method' is to apportion to the non-taxable assets to be deducted from the appraised value of the capital stock a proportionate share of the corporation's indebtedness. Without going into the arithmetical calculations which this formula in figures requires, it is sufficient for our present purpose to say that admittedly capital stock taxes have been paid on the $146,291,873 of stock of Pennsylvania corporations owned by appellant at the rate of five mills on the dollar or $731,459.37. Applying the 'proportionate method' and the formula resulting from it, appellant receives a credit for the taxes paid of only $173,421.77, or a difference of $558, 037.60. This is somewhat startling in view of what we have heretofore said about double taxation, and grows out of the attempt to apply the rule of the *Union Shipbuilding case*, correct as related to the situation existing in it, to an entirely different state of facts which the formula does not fit. In that case, we were not dealing with the allowance of a credit for a tax already paid, but with the deduction of assets beyond the reach of the taxing power, such as physical property in another state and United States bonds. The formula would fit that situation but not the one in hand."

Is this conclusion sound? Why are the stocks of other Pennsylvania corporations aggregating $146,291,873 exempt from taxation in the hands of the Pennsylvania Railroad? Because, as stated by Justice Williams in *Com. v. Fall Brook Coal Company, supra:* "It is clear that to tax the capital stock in the hands of the corporation, and then tax the owners of the parts or shares into which it is divided, upon their respective holdings in the same capital, is double taxation pure and simple. * * * An intent to impose double taxation will not be presumed. * * * The presumption is against the existence of such an intention, and this presumption will prevail unless it is overcome by express words showing an intent to impose double taxation. * * *". And continuing on page 499: "The shares of stock in the

Fall Brook Railway Company are not taxable in the hands of their holders because they have already paid the State tax through the corporation, and are excepted in express words from the liability to tax in the hands of the holder by the first section of the Act of 1889."

The shares of stocks of other corporations which the Pennsylvania Railroad Company owns are as to it, and in its balance sheet, an *asset*. Are we justified then in deducting an asset which is exempt from taxation by virtue of a statute or Court decision, by one method, known as a "flat" deduction, and deducting an asset which is clearly non-taxable because beyond the territorial limits of the State by another method known as the "proportionate" deduction. Certainly the non-taxable asset which has its situs beyond the taxing jurisdiction is entitled to as *full* an exemption as is the asset exempt by statute, and still the decision in the *Pennsylvania Railroad* case allots to it a smaller quantitative exemptions. No satisfactory reason why the two deductions should be taken by these different methods is given, although the Court says: "It is argued by the Commonwealth that unless the proportionate method be applied, the capital stocks in question will not bear their proportion of the indebtedness of the Pennsylvania Railroad, although part of its assets. If the taxing authorities properly levied the tax due by the *subsidiary* companies, as presumptively they did, then the stocks in question have been charged with *their* proportion of *the indebtedness*,[7] because in settling the entire taxes due, the Commonwealth's officials viewed the complete picture of the *Pennsylvania Railroad Company's* assets and *liabilities*,[8] all its property of every kind, taxable and not taxable, and made allowance for a proportion of chargeable indebtedness as it finally valued each of its subsidiaries and the valuation of $146,291,873 was reached by taking the indebtedness factor into account."[9]

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[7]Here again the Court refers to the "indebtedness" of the Pennsylvania Railroad Company, the holding Company, but manifestly when the capital stock taxes were levied against the so-called subsidiaries, only the indebtedness of such subsidiaries could have been considered. The indebtedness of the Pennsylvania Railroad Company was in no sense pertinent to a determination of the value of the capital stock of such so-called subsidiaries.

[8]Here the "liabilities" of the holding company are referred to but it is clear that the stocks of the subsidiaries are not bearing their proportionate share of these liabilities of the holding company under the "flat" deduction method here sanctioned by the Court.

[9]Italics ours.

This reasoning is confused. It is true that in arriving at the value of the capital stock of each subsidiary *its* indebtedness was considered, but it is equally clear that the indebtedness of the Pennsylvania Railroad Company could not under any circumstances have been considered in fixing the capital stock valuations of the subsidiaries. The Court's reasoning does not, therefore, eliminate from the picture the "indebtedness" or "liabilities" of the Pennsylvania Railroad Company, the holding company, a proper proportion of which the shares of the subsidiaries fail to reflect under the decision.

It should be too clear for argument that if the exempt asset is to be deducted "flat" from the total value of the capital stock in order to arrive at the taxable value of the capital stock, the *taxable* assets will have to bear the entire burden of the indebtedness of the holding company and in the case of many large holding companies it will be possible to buy shares of other Pennsylvania companies and pay for them with borrowed capital in such amount as will *exclude the holding company entirely from the capital stock tax.* A simple illustration will suffice. A Pennsylvania corporation's capital stock has a valuation of only $100,000, largely because it has borrowed most of the money with which it purchased shares in another Pennsylvania corporation worth $100,000, which other corporation has paid a capital stock tax. The company owning such shares has assets of the value of $200,000, consisting of miscellaneous tangibles of a value of $100,000 and the shares of the other Pennsylvania corporation of a value of $100,000. If the "flat" method of deduction is followed the company owning the shares will not be required to pay any capital stock tax to the Commonwealth, whereas under the "proportionate" method the taxable valuation of the capital stock would be $50,000. Did the Legislature intend that such a corporation should be entirely free from the capital stock tax?

The Court cites *Com. v. Fall Brook Coal Company, supra,* to support its conclusion, but when the record in that case is studied it is seen that the decision has no application. The question of double taxation was there involved, and none other. It was *determined* there, as it is *admitted* by all parties to the Pennsylvania Railroad case, that the shares of the subsidiary[10] should be deducted. The proper

[10]Throughout the opinion the Court appears to use the word "subsidiary" inadvisedly. From all that appears in the record, the Pennsylvania Railroad Company may have had only nominal hold-

method of allowing the deduction, however, was not there before the Court. It so happened in that case, which involved the tax for the year 1892, that the taxing officers added to the *tax* imposed against the Fall Brook Coal Company, the holding company, the exact amount of *tax* paid by the Fall Brook Railway Company, whose shares the Fall Brook Coal Company owned. This was a most unusual as well as erroneous settlement. The proper method, if the deduction was to be denied, would have been to estimate the total value of the capital stock of the holding company with the shares of the subsidiary included among its assets in its balance sheet and tax the full amount. Under such erroneous method of stating the settlement the Court was not called upon to consider *how* the deduction should be made, and it actually did only decide that there should be a deduction. Once it had decided there should be a deduction, there was only one thing to do and that was to take the *tax* against the Railway Company out *at the exact place where it had been improperly added* to the settlement against the Coal Company.

It is of interest to note that while the opinion of the Court clearly states that to apply the "proportionate" method of deduction on account of shares of subsidiaries owned by the Pennsylvania Railroad Company would be improper, it does not, except by inference, say how the deductions should be taken. Apparently the method sanctioned is to first ascertain the value of the capital stock, then deduct therefrom the value of the shares of stock of Pennsylvania corporations upon which a capital stock has been paid, the resulting amount being the capital stock valuation to which you apply the taxing formula approved in *Com. v. Union Shipbuilding Co., supra,* in order to work out a proper deduction for extra-territorial tangibles and U. S. securities. To the valuation which results you of course apply the further fractional formula, in the case of a railroad company, of mileage in Pennsylvania over total mileage in order to arrive at the taxable value of the capital stock in Pennsylvania.

Which method of allowing deductions is proper? No statute prescribes the method, and the answer depends entirely upon the determination of the question as to which method mathematically eliminates from the total capital

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ings in certain Pennsylvania corporations, and this, as is well known, is in fact the case. The writer will continue to use the word "subsidiary" merely for convenience in referring to the Pennsylvania corporations whose stocks the Pennsylvania Railroad Company owned.

stock valuation the amount of *capital stock* invested in non-taxable *assets*, because it is in terms of *capital stock* so invested that the exemption must necessarily be taken since the Commonwealth is taxing *capital stock* and not *assets* as such. It must be appreciated that the Pennsylvania Railroad Company may buy stocks of other Pennsylvania corporations from assets which represent indebtedness or liabilities as well as from assets which represent capital stock. Theoretically, therefore, stocks so purchased have a relationship both to the purchasing company's capital stock and its indebtedness, and presumably the relationship to each depends upon the proportionate relationship of capital stock, surplus and undivided profits combined to total indebtedness, unless, as would be most rare, a company can prove that it increased its capital stock and invested the proceeds of such increase in shares of other companies, in which latter case the "flat" deduction might be justified mathematically.

That the exemption should be taken in terms of *capital stock* rather than in terms of *assets* was definitely determined in the relatively early case of *Com. v. Lehigh Coal and Navigation Company*,[11] where the Court said: "It is well settled by the decisions of the Supreme Court of the United States, as well as of this Court, that when the total appraised value of the property of a corporation and the consequent value of its *capital stock* has been made, *so much of this sum as represents investments* in United States bonds or in patent rights must be deducted before the taxes are assessed. In addition to these deductions, *so much of the capital stock as may be invested* in manufacturing corporations should be deducted, for the shares in such corporations are not subject to State tax; and finally, *so much as may be invested* in shares of stock in corporations that have been assessed with and paid, the tax on capital stock should be taken out, and the sum so arrived at will represent the total value of the whole capital stock for the purposes of State taxation."[12]

The reference throughout is to "*so much* of the *capital stock*" as represents an investment in non-taxable assets as exempt. The confusion in the Pennsylvania Railroad decision may result from the fact that while a non-taxable asset *as such* is wholly exempt from taxation it reflects a capital stock exemption only to the extent that the capital stock purchased or produced such asset. However, the

[11]162 Pa. 603, 613.

[12]Italics ours.

Court experienced no similar difficulty in the cases of *Com. v. Union Shipbuilding Company, supra,* and *Com. v. Hazelwood Savings and Trust Company, supra,* where it was clearly recognized that the exemption extends to only *so much* of the *capital stock* as represents an investment in the wholly exempt asset.

The conclusion would seem to be irrestible that a uniform method of deduction should be employed for eliminating from the capital stock valuation all non-taxable and exempt assets.

A motion for reargument is now pending in the case of *Commonwealth v. Pennsylvania Railroad Company, supra,* and it is to be hoped that it will result either in a modification of the decision in such manner as will render it consistent with the principles established in *Com. v. Union Shipbuilding Company, supra,* or else that the Court will more clearly state why in its opinion a different rule should apply to the instant case.[13]

Leon D. Metzger

GARAGES AS NUISANCES—Several recent cases disclose a startling change in the policy of the Pennsylvania Supreme Court as to when public garages shall be deemed to be nuisances *per se.*[1] That our law can no longer be regarded as senseless to the demands of the commercial world for advances in its favor is evident. A remarkable growth in the law as enunciated by the Supreme Court can be noticed in the span of a few months.[2]

The doctrine declared by the cases discussed in a previous note and reiterated by the most recent ones mentioned above is that a public garage becomes a nuisance

[13]On September 30, 1929, the Court handed down a modified opinion as a result of the Commonwealth's motion for re-argument. Slight changes were made in the original opinion in order to delete certain erroneous conclusions of fact or misunderstandings on the part of the Court but the main conclusion was in no way modified nor was it further supported. The case of Com. v. Fall Brook Coal Co., supra, was still considered to be controlling.

[1]Burke v. Hollinger, 296 Pa. 510 (1929); Burke v. Bassett, 296 Pa. 524 (1929); Ladner v. Siegel, 296 Pa. 579 (1929).

[2]See note in 33 Dickinson Law Review 158 (March, 1929).