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The Meaning Behind Several Recent Decisions on Pennsylvania Corporate Taxes

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THE MEANING BEHIND SEVERAL RECENT DECISIONS ON PENNSYLVANIA CORPORATE TAXES

By

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Since the integration of the so-called emergency tax program of 1935 into the permanent Pennsylvania corporate tax structure, most of the issues which originally were controversial have been decided by the courts. This may explain the infrequency of court decisions on the subject within the last several years. In some instances, rules established by decisions have led to related questions, resulting in further litigation before the issues were finally settled. Cases of this nature are the subject of this article.

I

IMPORTS

The decision of *Commonwealth vs. Bayuk Cigars, Inc.*[1] should dispel any uncertainties that might remain concerning the proper treatment of imports in arriving at Bonus and Corporate Tax liabilities in Pennsylvania. Before discussing this case, it might be in order first to briefly review the whole issue.

The "Original Package Doctrine" was initiated by the United States Supreme Court in *Brown vs. Maryland*[2]. It stands for the principle that it would be in contravention of Article 1, Section 10, Clause 2[3] of the United States Constitution for a state to impose a tax on imported goods in the original package or container.

The issue in Pennsylvania can arise in respect to: (1) Capital Stock Tax, a tax upon the property and assets of a corporation[4]; (2) Franchise[5] and Cor-

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1Decided by Dauphin County Court February 10, 1947; Opinion on Exceptions April 17, 1947.
212 Wheat 419 (1827).
3Article 1, Section 10, Clause 2 states:

> "No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing it's Inspection Laws: and the net Produce of all Duties and Imposts, laid by any State on Imports or Exports, shall be for the Use of Treasury of the United States; and all such Laws shall be subject to the Revision and Control of the Congress."

4Commonwealth vs. Standard Oil Company, 101 Pa. 119 (1882).
5Commonwealth vs. Columbia Gas and Electric Corporation, 336 Pa. 209 (1939).

porate Net Income[6] Taxes, privilege or excise taxes; and (3) Foreign Bonus, a consideration for the privilege of doing business or employing capital in the state[7].

A — CAPITAL STOCK TAX

There appears to be no reported cases in which the Commonwealth attempted to include imports in the measure of the Capital Stock Tax. Since this is a property tax, there apparently was never any doubt that doing so would be offensive to the commerce clause and the above mentioned clause of the United States Constitution. However, the question indirectly came before the Dauphin County Court in *Commonwealth vs. J. N. Lambert*[8]. In this case, the Commonwealth conceded that the vanilla beans in their original container, which were stored in bond by the taxpayer, a Pennsylvania corporation, in a United States warehouse within the state, were exempt from the tax. The only problem before the court was whether the value of the beans was deductible on a "flat" basis from the value of the capital stock or on a "proportionate" basis. The court decided that the proper method for computing the exemption was on the latter basis, this being the proportion of the value of the capital stock that the vanilla beans bore to the value of the total assets.

B — FRANCHISE AND CORPORATE NET INCOME TAXES

Both of these taxes have been held by the courts to be excise or privilege taxes, the former measured by the value of the corporation's capital stock and the latter by the net income returned to and ascertained by the federal government. Under the applicable statutes[9], if the taxpayer transacts business both within and outside of Pennsylvania, the extent to which the tax can be imposed is ascertained by the application of identically the same three allocation fractions.

Section 2 of the Corporate Net Income Tax Act, provides that the net income, as defined therein, shall be divided into three equal parts against each of which shall be applied certain allocation fractions. By this means, an attempt is made to exclude from the tax measure the income that is unrelated to the value of the franchise exercised in Pennsylvania. Tangible property is the first fraction mentioned in the statute and is the only one affected by imports. With reference to this fraction, the statute provides:

> "Of one-third, such portion shall be attributed to business carried on within the Commonwealth, as shall be found by

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6Turco Paint and Varnish Company vs. Kalodner, 320 Pa. 421 (1936).
7Commonwealth vs. Merchant Shipbuilding Corporation, 26 Dauphin 89 (1923).
846 Dauphin 234 (1940).
9Act of May 16, 1935, P. L. 208,
As last amended by the Act of April 11, 1945, P. L. 190.
Act of May 16, 1935, P. L. 184,
As last amended by the Act of May 16, 1945, P. L. 606.

multiplying said one-third by a fraction, whose numerator is the value of the corporation's tangible property situated within this Commonwealth, and whose denominator is the value of all the corporation's property wherever situated."

The first *Bayuk Cigars* case[10] on the subject of imports involved Corporate Net Income Tax. Since, as previously stated, the two taxes are both excise or privilege taxes and have adopted the same system of allocation, it would seem that any ruling concerning allocations applicable to one would apply with equal weight to the other. In computing the tax, the Commonwealth included in the numerator and denominator of the tangible property allocation fraction the value of tobacco imported from foreign countries which was located in a United States bonded warehouse in Pennsylvania. It was contended by the taxpayer that the imports continued in foreign commerce until removed from the warehouse, that tobacco so stored does not constitute use in Pennsylvania, and the inclusion of such imports in the measure of the tax would be in violation of the commerce clause of the United States Constitution.

At the outset, the court clearly stated that the imports in question were still in foreign commerce and the state had no right to impose a tax on the tobacco. But the state, the court pointed out, had not attempted to do so. The court went on to explain that the tax at issue is not a property tax, but an excise or privilege tax; it is levied for the privilege of doing business and is no direct burden on foreign commerce. The court also found that the merchandise is clearly "tangible property situated within the Commonwealth" within the meaning of the statute.

It should be noted that the court distinguished the case before it from *Anglo-Chilean Nitrate Company vs. Alabama*[11]. It was pointed out that in the latter case, the Supreme Court of United States imposed a tax on the actual doing of business and not on the privilege of doing business, and further, that the taxpayer was engaged exclusively in foreign commerce, transacting no intrastate business. Bayuk Cigars, on the other hand, was also engaged in business of an intrastate nature. The Dauphin County Court added on Page 249 of the opinion that if the taxpayer in the *Anglo-Chilean Nitrate* case, in addition to its business of selling imported nitrate in the original package, had also engaged in business of an intrastate character, or if the Alabama statute provided for a tax on the privilege of doing business instead of on the actual doing of business, "the decision would likely have been otherwise."

It should also be noted that the court on page 250 cited for authority the decision of the Supreme Court of the United States, *Parke Davis & Company vs. Roberts*[12], in which "it was held that a franchise tax could be measured by a base which included income produced in part from the sale of imports in the original

[10]Commonwealth vs. Bayuk Cigars, Inc., 50 Dauphin 243 (1941).
[11]288 U. S. 218 (1933).
[12]171 U. S. 658 (1898).

packages," and also cases in which it was held permissible to impose franchise taxes measured by net income upon income which included interest on United States and other tax exempt bonds[13].

Seemingly, the right of the Commonwealth to tax depends upon the proximity of the incidence of the tax to the imports. In the instant case, the tax was not levied upon the imports as such. They were considered only in determining how far Pennsylvania could go in measuring the value of the taxpayer's franchise exercised within the state.

The case was appealed to the Pennsylvania Supreme Court on other issues, but presumably the Dauphin County Court's ruling on the question of imports was accepted as final since this point was not raised.

C — FOREIGN BONUS

Bonus is imposed under the act of 1901[14] on all corporations, except insurance companies, organized under the laws of other states of the United States or foreign countries, provided that such companies "have any part of their capital employed wholly within the state of Pennsylvania." It has been held Foreign Bonus is imposed upon the actual amount of capital employed in the state, and that "capital" as used in the Act means property and not capital stock, and that "property" refers to tangible assets[15].

Technically, Bonus is not a tax, but is a consideration for the grant of the privilege or franchise to carry on corporate business under the laws of the state[16]. In *Commonwealth vs. Merchants Shipbuilding Corporation*[17], the court held that the payment of Bonus is a consideration exacted by the state for the privilege of doing business and using property in the jurisdiction.

The second case of *Commonwealth vs. Bayuk Cigars, Inc.,*[18] questions the right of the Commonwealth to include imports in computing Foreign Bonus. The appellant, a Maryland corporation, admittedly was doing business and employing capital in Pennsylvania during the year in question. Imported tobacco in the original and unbroken packages was stored in the company's plant and also in a United States bonded warehouse located in Pennsylvania.

The first question before the court was whether the value of the imports was capital employed or to be employed wholly within the state as intended by the Act. The appellant, of course, contended that the inclusion of the imports in the measure of the Bonus would violate Section 10 (2) of Article I of the

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[13]Pacific Company vs. Johnson, 285 U. S. 480 (1932), Tradesman National Bank vs. Oklahoma Tax Commission, 309 U. S. 560 (1940).
[14]Act of May 8, 1901, P. L. 150.
[15]Commonwealth vs. Schwarzschild, 259 Pa. 130 (1917).
[16]United Gas Improvement Company vs. Burnet, 64 Fed. (2d) 957, (C.C.A. 3rd 1933).
[17]Note 7 supra.
[18]Note 1 supra.

United States Constitution denying any state the right, without congressional consent, to levy "imposts or duties on imports or exports, except what might be absolutely necessary for executing its inspection laws."

In answering this question the court stated: "While in a United States bonded warehouse, or while in the hands of the importer, in the original and unbroken packages, they remain imports which cannot be said to have become part of the general mass of property in the state; and that consequently the state may not impose any charge upon them by way of tax, bonus, license, or other means, until they have lost their character as imports. When the original packages are broken and the goods are sold, manufactured or put to the use for which they were imported, the immunity ceases to exist. Applying these principles in the present case, we have no hesitation in reaching the conclusion that the imported tobacco in the United States Government bonded warehouses is still in foreign commerce, has not entered into the common mass of property in this state, and hence is not capital employed or to be employed wholly within this state. It is not therefore to be included in the measure of the bonus and should be excluded from the bonus settlement."

The court pointed out that the goods in the original and unbroken packages stored at the company's plant presented a slightly different problem. In this connection, reference was made to *Hoover and Allison Company vs. Evatt*[19], in which the Supreme Court of United States held that a state may not impose tax on imported goods as long as they remain in the hands of the importer in the original and unbroken package. The immunity is lost only when the package is broken or the goods are entered into the manufacturing process. Likewise, the Court held that this merchandise may not be considered as capital employed in Pennsylvania for the purpose of computing Bonus.

In ruling on the exceptions the court clearly distinguished this case from the first *Bayuk* decision which dealt with imports in the tangible property allocation fraction of the Corporate Net Income Tax by stating:

"However, in that case the incidence of the tax was remote and indirect so far as the imported tobacco was concerned. In the present case, the incidence of the bonus is, in our opinion, directly on the imported tobacco, while it is still in foreign commerce."

It is of interest to note that the court also, in its opinion on the exceptions, observed that the difference between the cases in which immunity was granted to imports and those in which it was not, are so finely drawn as to become almost indistinguishable.

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[19] 324 U. S. 652 (1945).

II

ALLOCATION OF GROSS RECEIPTS

Of the three allocation fractions in the Franchise and Corporate Net Income Tax Acts[20], the third, consisting of gross receipts, has presented the most complexity. The allocation of gross receipts has resulted in frequent litigation and has been the subject of more legislative changes than either of the other two.

The first decision of major importance on the subject was *Commonwealth vs. Continental Rubber Works*[21]. This case involved Corporate Net Income Tax for 1935 imposed under the original Act[22]. In Section 2 of this statute, in respect to the allocation of gross receipts it was provided, in part, that:

"The amount of the corporation's gross receipts from business assignable to this Commonwealth shall be the amount of its gross receipts for the taxable year from (1) sales, except those negotiated or effected in behalf of the corporation by agents or agencies chiefly situated at, connected with, or sent out from, premises for the transaction of business owned or rented by the taxpayer outside the Commonwealth, and sales otherwise determined to be attributable to the business conducted on such premises."

It should be noted that the Act[23] was amended in 1939 and the word "maintained" was substituted for the words "owned or rented." A similar change was made in the Franchise Tax Act in 1945[24]. Also, it should be noted again that due to the similarity of the statutory allocation provisions in the Corporate Net Income and Franchise Tax Acts, rulings pertaining to one would apply with equal force to the other.

The taxpayer was a corporation organized under the laws of Pennsylvania with its manufacturing plant in this state, but transacting business in the state of New York. During the year in question, a branch sales office was operated in Buffalo under the supervision of a manager named Prince and covered a territory arranged and controlled by the sales manager located at the home office. Orders were solicited by salesmen working out of the Buffalo office and were transmitted to the home office for acknowledgement, confirmation, and credit approval. Although an inventory was maintained at the branch office, most of the goods were shipped and billed from the home office. The goods shipped to the branch office were not consigned or billed to Prince. Title remained in the taxpayer until the merchandise was sold to the trade. The branch office was rented in the name of the branch manager, but the name of the taxpayer appeared on the office window and in the telephone directories. The salesmen as

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[20]Note 9 supra.
[21]347 Pa. 514 (1943).
[22]Act of May 16, 1935, P. L. 208.
[23]Act of May 5, 1939, P. L. 64.
[24]Act of May 16, 1945, P. L. 606.

well as Prince held themselves out as representatives of the company and generally conducted themselves in a manner that led to that conclusion. Prince received a monthly commission on all sales of the branch out of which he paid the operating expenses including rent, commissions to salesmen and social security taxes. The balance remaining represented his compensation for services. Prince was, however, permitted to make sales for other companies and keep for himself whatever commissions he so earned.

The taxpayer claimed that the gross receipts arising from the sales of the Buffalo branch office should have been excluded from the numerator of the gross receipts allocation fraction because they were "negotiated or effected in behalf of the corporation by agents or agencies chiefly situated at, connected with, or sent out from, premises for the transaction of business owned or rented by the taxpayer outside the Commonwealth." The Pennsylvania Supreme Court sustained the Dauphin County Court in finding that the degree of control exercised by the taxpayer over Prince and the relationship between them were of such nature as to make him an agent of the company and not an independent contractor.

Despite the fact that the lease for the branch office was in the name of Prince, the court also sustained the lower court in holding that the office was rented by the taxpayer. In reaching this conclusion, it was pointed out that from the commissions received from the home office, the branch manager was first required to pay rent. In renting this space, Prince acted as agent of the company and not on behalf of himself as an independent contractor.

Under the circumstances, it was held that the gross receipts in question were not assignable to Pennsylvania and should be eliminated from the numerator of the fraction.

In *Commonwealth vs. Minds Coal Mining Corporation*[25], the taxpayer seems to have relied to a great extent on the *Continental Rubber* case in claiming an out-of-state allocation for gross receipts. The facts as presented are however distinguishable. As in the previously discussed case, the appeal involved Corporate Net Income Tax, but concerned the year 1941 instead of 1935.

The taxpayer was a corporation organized under the laws of the state of West Virginia. It had qualified to do business in Pennsylvania although it owned and operated a coal mine in the former state. It maintained its mine office and had a mailing address in West Virginia. No coal was mined in Pennsylvania. The executive and administrative office was located in Pennsylvania and the company's two principal officers were likewise located there during the year in question. There existed a contract between the taxpayer and the Bulah Coal Mining Corporation, a sales company, under the terms of which the sales company undertook to act as sales agent for the taxpayer. The sales company main-

[25]Decided by Dauphin County Court, December 23, 1946.

tained its own offices in New York, employed its own sales representatives, and during the year in question, sold practically the entire output of the mine. The agreement also provided that the sales company should make contracts with customers, issue invoices for all shipments, make collections and assume all credit risks.

Upon receipt of orders, the sales company forwarded them to the mine office of the taxpayer in West Virginia, whereupon the coal was shipped pursuant to instructions and invoiced to Bulah Coal Mining Cororation. The commissions as provided in the contract were paid by the taxpayer to the sales company.

In its Corporate Net Income Tax Report for the year in question, the taxpayer excluded from the numerator of the gross receipts allocation fraction the value of all sales billed to Bulah Coal Mining Corporation. The Commonwealth, in making the settlement, disallowed this out-of-state allocation and included the sales in the numerator of the fraction.

There was no controversy over whether the taxpayer was not transacting all of its business in Pennsylvania; this was admitted. The question was whether there was a location outside the state to which the sales could be allocated. Under the Act, the gross receipts would be assignable to Pennsylvania in their entirety unless the sales came within the exception noted in the Act. The exception in this case would be the same as in the *Continental Rubber* case. It would include those sales which were negotiated or effected by representatives of the taxpayer "chiefly situated at, connected with, or sent out from, premises for the transaction of business maintained by the taxpayer outside the Commonwealth." The only difference in this respect was that the *Continental Rubber* case came under the Act of 1935 in which the Act provided that the out-of-state office be "owned or rented" while this case came under the 1941 Act in which it was required that the office be "maintained." The taxpayer took the position that the selling company was an independent contractor and its activities must be disregarded. It did not contend, as was claimed by the Continental Rubber Works, that the New York office of the selling company was its own office maintained in a manner contemplated by the Act. On the contrary, it contended that the sales were negotiated or effected by the taxpayer's superintendent at the mine in West Virginia, this event taking place when he was instrumental in causing the coal to be loaded on cars pursuant to the orders received from the selling company. In the *Continental Rubber* case, the taxpayer's viewpoint was different. It was contended that Prince, the manager of the branch office, was not an independent contractor, but an employee who was responsible for "negotiating or effecting" the sales; it was not claimed that an employee who filled the orders or became responsible for delivering the merchandise "effected or negotiated" the sales.

The court in considering the taxpayer's contention observed that although title to the coal might have passed at the point where the superintendent caused the coal to be loaded on cars, this however was not the only meaning of the term "sale" as used in the Act, adding that "a sale must be negotiated or effected." In the latter connection, the court found that the selling company performed this function and expressed the belief that the words "negotiated or effected" in the Act related to the activities which brought about or resulted in a sale. Obviously the filling of the order at the mine had nothing to do with determining the allocation.

It should be observed that although the coal was invoiced to the Bulah Coal Mining Company, neither the Commonwealth nor the taxpayer contended that the coal in question was sold to the selling company. The court found that the agreement contemplated only that the sale should be made by the selling company on behalf of the taxpayer for stipulated commissions. In this respect, according to the court, the two cases were similar; in the Continental Rubber Works case the sale was negotiated or effected by Prince or his salesmen, and in the Minds Coal Mining case, by Bulah Coal Mining Corporation. The important distinction was that in the former case it was held that Prince's office was an office maintained by the taxpayer as contemplated in the Act while in the latter case the New York office of Bulah Coal Mining Corporation was not.

Since it was not established that the sales in question were negotiated or effected on behalf of the taxpayer by representatives working from an office maintained outside of the state, the court had no alternative but to rule that the gross receipts were assignable to Pennsylvania.