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Taxing Interstate Commerce: A New Experience in Indiana

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THE FISCAL PROBLEM AND SOLUTION

The 93rd Indiana General Assembly, meeting for 101 days in 1963, completely revised the state's tax structure by the adoption of two new acts. The Legislature enacted a two per cent sales and use tax within the framework of the gross income tax; increased the gross income tax rates by one-third;[1] and enacted a new two per cent adjusted gross income tax, applicable to both individuals and corporations. The latter is essentially a flat-rate net income tax[2] and is hereinafter referred to as such.

Such sweeping tax legislation had not been passed since the Gross Income Tax was enacted in 1933.[3] But, as in 1933, the state in 1963 faced a financial crisis. The 1961 General Assembly had deliberately passed a deficit budget.[4] By mid-1962 state officials realized that the deficit would be even greater than had been anticipated by the legislators because gross income tax collections were considerably lower than the revenue forecasts on which the state's 1961-63 biennial budget had been based.[5] Before the 1963 General Assembly convened,

* Editor, Indiana State Bar Association Journal; former staff member, Indiana Commission on State Tax and Financing Policy; A.B., Cornell University, 1956; J.D., Indiana University School of Law, 1963.

1 Ind. Acts of 1963, Ch. 30, (Special Session). The sales tax is an amendment to the gross income tax and applies to all transactions which constitute "selling at retail" under the gross income tax. The amendment, for purposes of the sales tax only, also placed within the definition of "selling at retail" sales of utility services for domestic or commercial use and the rental of transient lodgings for periods of less than 30 days. Section 21 of the same act (IND. STAT. ANN. § 64-2603, Burns 1963 Special Supp.) increased the gross income tax rates from ⅜ of 1% to ½ of 1% on receipts derived from selling at retail, wholesale sales, laundry and dry cleaning, and display advertising, and increased the rate from 1½ to 2% on all other receipts. The constitutionality of this act was upheld in October of 1963 in Welsh v. Sells, 192 N.E.2d 753 (Ind. 1963).

2 Ind. Acts of 1963, Ch. 32, (Special Session). The adjusted gross income tax applies to all resident individuals, trusts and estates, and to all nonresidents and all corporations having income from sources within the state. Section 204 of the statute (IND. STAT. ANN. § 64-3219, Burns 1963 Special Supp.) provides an apportionment formula for those nonresidents and corporations who cannot separate their income from sources within and without the state. The entire net income of any such taxpayer is multiplied by the average of three fractions — taxpayer's property in Indiana divided by his property everywhere, his payroll in Indiana divided by his payroll everywhere, and his sales in Indiana divided by his sales everywhere. Section 701 of the act (IND. STAT. ANN. § 64-3249, Burns 1963 Special Supp.) relieves individuals subject to the adjusted gross income tax act from liability for the gross income tax. Corporations remain subject to the gross income tax, but section 302 (IND. STAT. ANN. § 64-3221, Burns 1963 Special Supp.) grants them a credit against adjusted gross income tax liability for gross income taxes paid. See text, *infra,* at notes 12 through 14.

3 Ind. Acts of 1933, ch. 50.

4 In the 1961-63 Biennial Budget (Ind. Acts of 1961, Ch. 298) general fund appropriations exceeded anticipated general fund revenues by approximately $24 million.

5 The Advisory Committee on General Fund Revenues had forecast gross income tax collections of $199,689,000 for fiscal year 1961, and $213,068,000 for fiscal year 1962. Actual collections were $192,027,000 in fiscal year 1961 and $202,376,000 in fiscal year 1962. Advisory Committee on General Fund Revenues, *The Outlook for Business Conditions and for General Fund Revenues in Indiana, Fiscal Years 1963, 1964 and 1965,* p. 15. This meant not only that revenues during the biennium were lower than had been anticipated, but also that the state commenced the 1961-63 biennium with a considerably smaller surplus than legislators had expected.

the State Budget Agency was predicting that by the close of fiscal 1963 the state's surplus would be reduced to a deficit figure.[6]

Augmenting the demand for increased state revenues was the hue and cry heard all over the state for relief from ever-increasing local property taxes. Sixty thousand new pupils were expected to enter the state's public school system during the 1963-65 biennium.[7] Educational costs are currently approximately $500 per child per year,[8] thus the 30,000 new children added to the school system in each of two years would cost about $45,000,000 to educate during that two-year period. Unless the state increased the amount it contributed to local schools, the entire $45 million would have to come from local property taxes. Further, other school costs were continuing to rise.[9]

These factors, combined with a host of others, created an urgent demand for an increase in state revenues[10] and sent legislators scurrying in search of previously untapped revenue sources. One such source was business whose receipts are derived partly or wholly from interstate commerce. Such receipts have always been exempt from the gross income tax. While legislators had been cautioned that the state could not look to this source for any substantial amount of revenue,[11] nevertheless many regarded this omission as a serious tax loophole.

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6 State Budget Committee, *State of Indiana Budget Report for the Biennium July 1, 1963, to June 30, 1965 (1962)*, p. 3. The estimate at that time was $5,897,093. That estimate was, in fact, too low. The actual unappropriated surplus in the state's general fund on June 30, 1963, was $4,632,023. State of Indiana, *Annual Report of the Auditor of State for the Fiscal Year ending June 30, 1963*, p. 9. In 1954, the state's unappropriated surplus was $74.5 million. It has dwindled more or less steadily since then, dropping an unprecedented $23.4 million in fiscal year 1963 – from $28.0 million on June 30, 1962, to $4.6 million on June 30, 1963. See Auditor's Annual Reports, *supra*, for the years 1954 through 1962.

7 Indiana State Teachers Association, *Special Tabulation No. 7, Comparison of Total Expenditures for Current Expense, Capital Outlay, and Interest and State Distributions to Local School Corporations on the Basis of Total Amounts, Percentages, and Amounts per Pupil Based on Grand Total Enrollments*, 1949-50 – 1962-63 (September, 1962).

8 Calculated from the National Education Association, *Research Report 1963 – R12, Estimates of School Statistics, 1963-64*, Tables 3 and 11. The estimated total school enrollment in Indiana is 1,110,020 and the estimated total current expenditure, capital outlay and interest is $560 million, making a per pupil cost of $504.

9 Indiana State Teachers Association, *Research Report, Actual Expenditures for School Fiscal Years and Biennium for the Period from 1953-54 through 1960-61, and Estimated Expenditures for School Fiscal Years and Biennium for the Period from 1961-62 through 1964-65*, (January 7, 1963). The biennial cost increases since 1957-59 (including those occasioned by the increased number of students) have been in the neighborhood of 25 to 26% per biennium.

10 Indiana was not alone in its need for increased state revenues. 25 CCH, STATE TAX REV. No. 2, January 14, 1964, documents the tremendous volume of state tax legislation enacted in 1963. Seven states raised their sales tax rates, fifteen increased tobacco taxes, three raised gasoline taxes and five states altered their personal or corporate income tax rates.

Theodore H. White, in his Pulitzer Prize winning documentary book, *The Making of the President* 1960, recounts at the beginning of Chapter 8 a conversation with an aide to the Governor of Wisconsin in which the aide pointed out the revenue problems besetting Wisconsin because of the tremendous increases in population over the last decade. White indicates that these problems were not unique to Wisconsin and, in a footnote to the conversation, (p. 256, Cardinal Edition, Pocket Books, Inc.) observes:

> It is noteworthy that the chief casualties, in both parties in the fall elections later in 1960 were governors beset by such problems as these. There were twenty-seven governors of the union up for reelection in the Presidential year, and twelve governorships changed hands, largely because of grassroots tax revolts.

11 The Legislature was told that a 2% corporate net income tax with the gross income tax as a minimum alternative would produce only about $10 million over the biennium. Commission on State Tax and Financing Policy, *Key Points and Summary of Senate-House Conference Committee on H. B. 1226 and H. B. 1509* (Mimeo, April 17, 1963).

If new or higher taxes were to be levied on other taxpayers, interstate businesses should begin to pay something to the state for services provided.

The Legislature chose to close this loophole by levying a net income tax on all corporations in addition to the gross income tax to which they were already subject, while at the same time granting corporations a credit against net income tax liability (not to exceed that liability) for gross income taxes imposed for the same taxable year.[12] Corporations, therefore, now pay either a net or a gross income tax, whichever is greater. Obviously, except in rare instances,[13] a tax of 2% of apportioned *net* income will produce a tax liability in excess of a tax of ½ of 1% (or 2%, depending on the source of receipts) of *gross* income only if at least a substantial portion of the taxpayer's gross receipts are exempt from the gross income tax. Gross receipts derived from interstate commerce are so exempt.[14] Accordingly, the credit provision in the adjusted gross income tax act effectively limits its application, insofar as corporations are concerned, to those operating in interstate commerce. All other corporations will simply continue to pay the gross income tax (at increased rates).

At least two other methods for taxing these multistate corporations were available to the General Assembly. The state could have imposed a net income tax on all corporations, or it could have enacted an apportionment formula within the framework of the existing gross income tax. It is here proposed to examine these three alternatives: to speculate on the Legislature's reasons for selecting the method it did; and to discuss the constitutional questions raised by each method, in light of the most recent decisions of the Supreme Court of the United States.

The Corporate Net Income Tax

One constitutionally acceptable method for a state to reach receipts from interstate commerce is to impose a corporate net income tax on *all* corporations. Thirty-seven states aside from Indiana now do so. It seems to be well settled since the 1959 decision of the United States Supreme Court in *Northwestern States Portland Cement Co. v. Minnesota*[15] that such a tax, if properly apportioned to reflect an appropriate connection with business done in the taxing state, violates neither the commerce nor the due process clause of the federal Constitution, even though the income taxed is derived exclusively from interstate commerce.

There are, of course, certain hazards which a state must avoid in levying such a tax. For example, the statute must clearly state that the tax is imposed *on* net income and is not one levied for the privilege of engaging in business in the

12 Ind. Stat. Ann. § 64-3221 (Burns Special Supp. 1963). Unincorporated businesses are now subject to the net income tax act as individuals. If they are residents, it appears that Indiana has jurisdiction to tax them on their entire net income, whether earned in interstate or intrastate commerce. See Barrett, *"Substance" vs. "Form" in the Application of the Commerce Clause to State Taxation*, 101 U. Pa. L. Rev. 740, 755, nn. 45 & 45a (1953). If they are nonresidents with income from sources within and without the state, they may apportion their income as corporations do. Ind. Stat. Ann. § 64-3210 (Burns Special Supp. 1963).

13 If a wholly intrastate corporation whose entire receipts were taxable at ½ of 1% operated at any profit margin in excess of 25%, its net income tax liability would exceed its gross income tax liability.

14 Freeman v. Hewit, 329 U.S. 249 (1946); Adams Mfg. Co. v. Storen, 304 U.S. 307 (1938).

15 358 U.S. 450 (1959).

state *measured by* net income. Ironically, this is true even though the economic effect of either tax might be exactly the same. In *Spector Motor Service, Inc. v. O'Connor*[16] the United States Supreme Court invalidated a Connecticut franchise tax measured by apportioned net income but levied for the privilege of engaging in business in the state as it applied to a foreign corporation conducting an exclusively interstate transportation business in the state. Confronted with this decision, the court in *Northwestern* distinguished it, observing that the Connecticut tax was unconstitutional because no state may tax the privilege of engaging in interstate commerce. Minnesota's tax was also based on apportioned net income, but as applied to corporations doing interstate business it was not called a franchise or privilege tax.[17]

Some form of a corporate net income tax has been introduced in every session of the Indiana General Assembly since 1957, but it has met defeat each time.[18] There are numerous influential economic interests in Indiana unalterably opposed to the concept of a state corporate net income tax.[19] Furthermore, it

16 340 U.S. 602 (1951).

17 MINN. STAT. ANN. § 290.02 (1962) levies an excise tax on all domestic corporations for the privilege of doing business. Section 290.03 (1962) levies a direct tax on the net income of all domestic and foreign corporations whose business is exclusively interstate, but exempts all corporations subject to tax under § 290.02.

Three other states which levy a corporate net income tax employ this dual nomenclature. CALIF. REV. AND TAX CODE §§ 23151, 23501 (1963 Supp.); ORE. REV. STAT. §§ 317.055, 317.060, 317.070, 317.074, 318.020 (1961); PA. STAT. ANN. tit. 72 §§ 3420c, 3420n-3 (1963 Supp.). As applied to domestic corporations, the tax is called an excise, franchise or privilege tax, but as applied to all other corporations, it is termed simply a tax on net income. (In the case of Pennsylvania, it is called a property tax measured by net income.)

18 In 1957, it took the form of a net worth tax (H. B. 405). In 1959, it was a tax at graduated rates to be paid on either gross or adjusted gross income, with the gross income tax retained as a minimum alternative (H. B. 536). In 1961, a flat rate corporate net income tax was introduced as a Senate Finance Committee amendment to H. B. 53. The vote on passage of the amended bill in the Senate was 25 "ayes" and 25 "nays" with the President of the Senate casting the deciding negative vote. In 1963, essentially the same bill was introduced in the Senate as a second reading amendment to H. B. 1509. It was adopted in the Senate by a vote of 25 "ayes" to 23 "nays," but the amendment was rejected by the House.

19 The present gross income tax structure favors the type of business which operates with a low-turnover and high profit margin per unit sold. Compare, for example, two hypothetical business enterprises, each showing the same profit for a given year's operation — one a retailer, the other a manufacturer. The retailer, who depends for his profit upon a low markup and high-turnover of inventory will have higher gross receipts than the manufacturer and will, therefore, pay more in gross income taxes. According to the figures in the U.S. TREASURY DEPARTMENT, INTERNAL REVENUE SERVICE, STATISTICS OF INCOME . . . 1960-61, CORPORATION INCOME TAX RETURNS, Table 20, manufacturing corporations produced $1.00 of net income for each $16.46 in business receipts, while retail trade corporations required $56.53 in business receipts to produce $1.00 of net income.

In Indiana, in 1962, manufacturing industries were the source of 42.3% of the earnings of all employed (including self-employed) individuals in the state, while retail and wholesale trade supplied only 16.9% of those earnings. (Calculated from U.S. DEPARTMENT OF COMMERCE, SURVEY OF CURRENT BUSINESS, *August, 1963*, Table 70. The percentages for the year 1961 are approximately the same.) In spite of this disparity in size of contribution to the state's economy, and contrary to what might be expected, the retail trade segment of Indiana's economy paid almost twice as much as the manufacturing segment paid in gross income taxes in the years 1961 and 1962. The actual amounts are:

Year	Amount of Gross Income Tax Paid by Retail Trade	% of Total Gross Income Tax Paid by Retail Trade	Amount of Gross Income Tax Paid by Manufacturing	% of Total Gross Income Tax Paid by Manufacturing
1961	$25,370,000	14.7%	$12,946,000	7.5%
1962	$26,801,989	14.2%	$14,966,552	7.9%

Calculated from the Division of Data Processing, Indiana Department of Administration, *Annual Statistical Report of Department of Revenue*, Table 6, 1961 and 1962.

should be noted that the gross income tax is a prodigious producer of revenue, even at very low rates. In the calendar year 1962 corporations paid $69.8 million in gross income taxes — $34.8 million at the rate of 3/8 of 1% and $35 million at 1½%.[20] The State Budget Agency estimates that in the 1963-65 biennium corporations will pay more than $220 million in gross income taxes alone.[21] Although it is difficult to predict accurately revenues from a corporate net income tax, economists estimate that in Indiana it would take a flat rate tax of between 6% and 8% on corporate net income to equal the amount produced from the corporate gross income tax. Obviously, advocating a raise in tax *rates* by as much as 1,500%, albeit employing a wholly different base, would be a politically unpopular (if not suicidal) position for a state legislator to take.

Apportioned Gross Income Tax

Another possible method whereby Indiana could tax receipts from interstate commerce would be to apportion gross receipts so that the state's present gross income tax would, theoretically, apply only to those receipts attributable to business done in the state. Whether or not such a scheme would survive a commerce clause challenge can be only a matter of speculation at this point, since the precise issue has never been before the courts. But there have been several recent cases dealing with state taxation on an apportioned basis of gross receipts derived from interstate transportation. Perhaps a trend is evident from these decisions, indicating how the United States Supreme Court would treat a state gross income tax levied on all intrastate and interstate receipts if that gross income tax were apportioned to reflect business done in the taxing state.

In the 1918 decision in *United States Glue v. Town of Oak Creek,*[22] the United States Supreme Court, in upholding a state net income tax, stated what it considered to be the difference between taxing net income and gross receipts:

> The difference, in effect, between a tax measured by gross receipts and one measured by net income, recognized by our decisions, is manifest and substantial, and it affords a convenient and workable basis of distinction between a direct and immediate burden upon the business affected and a charge that is only indirect and incidental. A tax upon gross receipts affects each transaction in proportion to its magnitude and irrespective of whether it is profitable or otherwise. Conceivably it may be sufficient to make the difference between profit and loss, or to so diminish the profit as to impede or discourage the conduct of the commerce. A tax upon the net profits has not the same deterrent effect, since it does not arise at all unless

20 Statistical Report of Department of Revenue, *supra,* note 19, 1962, Table 12. In calendar year 1961, corporations paid $33.4 million at 1½% and $32.2 million at 3/8 of 1%. Statistical Report, *supra,* 1961, Table 12.

21 Indiana State Budget Agency *1963-65 Biennial Budget As Passed by the 1963 General Assembly,* pp. 6 & 7. Part of the anticipated increase over the amount paid in the 1961-63 biennium in corporate gross income taxes is due to the increase in rates and part is due to an expected increase in general economic activity. The shift in the tax base from a gross to a net income concept for some corporations will not result in any decrease in state revenue because the corporations which will now be subject to the net income tax have paid little or no gross income taxes in the past.

22 247 U.S. 321 (1918).

> a gain is shown over and above expenses and losses, and the tax cannot be heavy unless the profits are large.[23]

In general, state gross receipts taxes as applied to receipts from interstate commerce have fared badly in the hands of the Supreme Court. Such taxes usually have been struck down because they imposed a "direct burden" on interstate commerce,[24] or because more than one state could tax the same income, thereby subjecting commerce to a "cumulative" or "multiple" burden.[25] Indiana's gross income tax, in its thirty years of judicial history, has been called both a direct and a multiple burden on interstate commerce.[26]

How would Indiana's gross income tax fare if subjected to a test on the issue of constitutionality, after being amended to tax interstate commerce by means of an apportionment formula? Would an apportioned comprehensive gross receipts tax survive commerce clause objections? If the Supreme Court chooses to regard a possible cumulative tax burden as the relevant criterion, an apportionment formula would appear to overcome this objection. Such a formula, at least in theory, allows a state to tax only that portion of a business' receipts attributable to activities carried on within that state.[27] On the other hand, if the court chooses to object to a gross receipts tax, not because of possible multistate taxation, but because it imposes a *direct* burden on interstate commerce, an apportionment formula will not cure this defect. Even an apportioned gross receipts levy will tax each transaction in proportion to its magnitude without regard to profitability. An apportionment formula can only prevent multistate taxation of the same receipts.

The states in the past have not been prevented entirely from taxing gross receipts from interstate commerce. The court has consistently upheld two forms of such taxes — those levied only on some local activity, and those levied in lieu of all other property taxes the state could impose.

A. Taxes on a Local Activity

Indiana's gross income tax, as applied to specific transactions, has been sustained several times by the United States Supreme Court on the theory that

23 *Id.* at 328.

24 Joseph v. Carter & Weekes Stevedoring Co., 330 U.S. 422 (1947) (New York City); Fisher's Blend Station v. State Tax Commission, 297 U.S. 650 (1936) (Washington); Crew Levick Co. v. Pennsylvania, 245 U.S. 292 (1917) (Pennsylvania); Fargo v. Michigan, 121 U.S. 230 (1887) (Michigan); Philadelphia & Southern Steamship Co. v. Pennsylvania, 122 U.S. 326 (1887) (Pennsylvania).

25 Joseph v. Carter & Weekes Stevedoring Co., *supra,* note 24; Gwin, White & Prince Inc. v. Henneford, 305 U.S. 434 (1939) (Washington).

26 In Adams Manufacturing Co. v. Storen, 304 U.S. 307 (1938), the court objected to Indiana's tax because of a possible multistate taxation of the same receipts. In Freeman v. Hewit 329 U.S. 249 (1946), the court was content to call the tax, among other things, a direct, forbidden imposition on the very processes of interstate commerce.

27 In fact, because all states do not use the same formula, and because the same terms are defined differently by different states, an interstate business may actually be taxed on more or less than exactly 100% of its income. For a discussion of this problem and of the need for Congressional action in this area, see Hartman, *State Taxation of Corporate Income from a Multistate Business,* 13 VAND. L. REV. 21, 64-81 and 117-126 (1959). The whole problem of state taxation of interstate commerce has been under intensive study by a special subcommittee of the House Judiciary and Senate Finance Committees of the United States Congress. In June, 1964, this subcommittee issued a lengthy report describing its findings on the complexities and conflicts in state corporate income taxes and calling for legislative action by the Congress on these problems.

Indiana was taxing only a local event even though the receipts taxed seemed to be from an interstate transaction. For example, in *Department of Treasury v. Wood Preserving Corp.*,[28] the delivery of railroad ties in Indiana to an out-of-state buyer was held to be a local, taxable activity even though the buyer immediately shipped the ties out of the state. In *International Harvester v. Department of Treasury*,[29] where goods were shipped from outside the state to a buyer in Indiana or shipped from Indiana to an out-of-state buyer who took delivery in Indiana, the transactions were taxable as local events. In *Department of Treasury v. Ingram-Richardson Mfg. Co.*,[30] where stove parts were shipped into Indiana to be enameled and then shipped out again, taxation of the transactions was held permissible as a local event.

In the very recent case of *General Motors v. Washington*,[31] the United States Supreme Court upheld the State of Washington's gross receipts tax levied for the privilege of doing business as applied to sales by General Motors to Washington dealers, many of which were handled through an Oregon zone office or an Oregon warehouse. The court begins with the proposition that:

> It is well established that taxation measured by gross receipts is constitutionally proper if it is fairly apportioned.[32]

Although no apportionment formula was applied to the proceeds here being taxed and the tax was therefore "suspect" in the words of the court, nevertheless, the court felt there was sufficient local activity to make the tax constitutional. As to General Motors' claim of multiple taxation, the opinion, quoting from the *Northwestern* case, states, vaguely:

> "The taxpayers must show that the formula places a burden on interstate commerce in a constitutional sense." This it has not done.[33]

According to the dissenters:

> It is difficult to conceive of a state gross receipts tax on interstate commerce which could not be sustained under the rationale adopted today.[34]

The "local activity" rationale has also been used to sustain a tax on a privilege or franchise, the value of which is measured by gross receipts including receipts from interstate sales, on the theory that the privilege of engaging in business in a state, which the court views as the local activity, is made more valuable because the company is also engaged in interstate commerce. The gross receipts may be the sole measure of the value of the local activity[35] or they may be part of an apportionment formula designed to measure taxable income, as long as what is being taxed is only a local event. For example, in *International Harvester v. Evatt*,[36] the United States Supreme Court sustained an Ohio franchise tax on all foreign corporations levied for the privilege of doing business in the state, and measured by a two-factor formula: property and business done

said: "Words in early times, like form in a document or pleading were all important." Com-

28 313 U.S. 62 (1941).
29 322 U.S. 340 (1944).
30 313 U.S. 252 (1941).
31 377 U.S. 436 (1964).
32 *Id.* at 440.
33 *Id.* at 449.
34 *Id.* at 456.
35 American Manufacturing Co. v. St. Louis, 250 U.S. 459 (1919).
36 329 U.S. 416 (1947).

(gross receipts). Included in "business done in Ohio" were the sales price of all goods manufactured in Ohio regardless of where they were shipped and the total of all sales made to Ohio customers through Ohio sales agencies, even though the goods were shipped to the Ohio customers from out of state. The court said that the inclusion of the sales price of all goods manufactured in Ohio was justified because it was simply a measure of the value of the manufacturing business, and the inclusion of all sales made to Ohio customers was justified because it was intrastate business. However, the court qualified the inclusion of Ohio sales thusly:

> What effect inclusion of this element in the "business done" numerator would have were those transactions not intrastate is a question we need not now decide.[37]

The Court concluded that the formula was valid because it was used only to arrive at a fair determination of the value of the intrastate business for which the franchise was granted.

In *Ford Motor Co. v. Beauchamp,*[38] Texas levied a franchise tax on the outstanding capital of all corporations based on the proportion that gross receipts in the state bore to total gross receipts of the company. By the formula, Ford, which sent parts into Texas for assembly and intrastate sale to dealers, paid a state tax on $23,000,000 when the book value of all of its assets in Texas was only $3,000,000. The court sustained the tax, recognizing that a local privilege or franchise is made more valuable because the company is engaged in interstate as well as intrastate business. But the tax was considered only a tax on the value of the privilege of engaging in business in the state, which was a local activity.

Would this "local activity" rationale sustain an apportioned Indiana gross income tax as a tax on a privilege, the value of which is measured by gross receipts? In the case of *Miles v. Department of Treasury,*[39] the Indiana Supreme Court characterized the Indiana gross income tax as:

> . . . *an excise,* levied upon those domiciled within the state or who derive income from sources within the state, *upon the basis of the privilege of domicile or the privilege of transacting business within the state* and that the burden may reasonably be measured by the amount of income. (Emphasis supplied.)[40]

If the Indiana gross income tax is a tax on the privilege of engaging in business in the state, the value of which is measured by gross receipts, perhaps inclusion in the tax base of apportioned gross receipts of a multistate business, reflecting accurately the amount of business activity carried on within the state, would not be objectionable.

But even assuming that the "local activity" theory would sustain an apportioned gross receipts tax insofar as the apportionment formula measures only the value of the in-state business, reliance on such a theory leaves unanswered the question of whether apportioned gross receipts would be taxable if those receipts were exclusively from interstate commerce — the kind of income in question

37 *Id.* at 421.
38 308 U.S. 331 (1939).
39 209 Ind. 172, 199 N.E. 372 (1935).
40 *Id.* at 188, 199 N.E. at 379.

in the *Northwestern* case. An apportionment formula cannot measure the value of the local activities of the corporation in such a case, because none have occurred. The United States Supreme Court skirted the issue in *International Harvester v. Evatt*,[41] by avoiding a decision on the validity of including receipts from interstate transactions in the gross receipts factor of the apportionment formula.

B. In Lieu of Taxation

States may also levy a gross receipts tax if it is in lieu of, and a fair substitute for, all other property taxes which the state could levy[42] on the theory that if the business would be subject to a property tax, then an equal burden in the form of a franchise tax should not constitute a difference of constitutional significance.[43]

A recent, and, from the point of view of this discussion, the most important case upholding such a tax is *Railway Express Agency, Inc. v. Virginia*.[44] In that case, a Virginia statute levied a franchise tax of 2.15% on express companies' gross receipts earned in the state, including receipts from business passing through, into or out of the state. The tax was *in lieu of* the property tax which the state could have levied on the company's rolling stock and intangible property. On its tax return, REA stated it had no way of determining what part of its receipts were earned in Virginia from business passing through, into or out of the state. So the State Tax Commission devised an apportionment formula by computing the proportion of national mileage travelled in Virginia by six railroads and five airlines used by REA to transport express. This same proportion of REA's entire national gross receipts was ascribed to Virginia and the tax computed accordingly. The action was sustained by the United States Supreme Court on the ground that the tax was in lieu of any property taxes which the state could have levied. But the fact that the tax REA paid on its apportioned gross receipts was more than nineteen times its possible property tax liability[45] would seem to indicate that the "in lieu" feature of the tax was not the only reason for sustaining it. These facts were before the court, but it put them aside saying:

> While the tax is in lieu of other property taxes which Virginia can legally assess and should be their just equivalent in amount . . . we will not inquire into the exactitudes of the formula where appellant has not shown it to be so baseless as to violate due process.[46]

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41 See text following note 36 *supra*.

42 Railway Express Agency, Inc. v. Virginia, 358 U.S. 434 (1959); Illinois Central R. R. v. Minnesota, 309 U.S. 157 (1940); Cudahy Packing Co. v. Minnesota, 246 U.S. 450 (1918); U.S. Express Co. v. Minnesota, 223 U.S. 335 (1912).

43 *The Supreme Court 1958 Term*, 73 HARV. L. REV. 84, 174 (1959).

44 358 U.S. 434 (1959).

45 The property tax which the state could have levied (based on the rate applied to the rolling stock of other railway and freight car companies) amounted to $7,235.76 while the franchise tax levied in lieu therof was $139,739. 66. The majority on the court viewed the difference as reflecting only the amount the state could have levied as a property tax on the company's *intangible* property — in this case, its going-concern value. But as pointed out by Mr. Justice Brennan in his concurring opinion, Virginia did not, in fact, levy any such tax on the going-concern value of other businesses, nor had she ever previously levied such a tax on express companies. In other words, the court was willing to assume a great deal in construing this apportioned gross receipts tax as equivalent to a state property tax.

46 *Id.* at 436.

Justice Brennan concurred in the result stating that he thought the tax should be called what it really was, *viz.*, a tax on apportioned gross receipts:

> To me, the more realistic way of reviewing the tax and evaluating its constitutional validity is to take it as what it is in substance, a levy on gross receipts fairly apportionable to the taxing State.[47]

Nonetheless, this "in lieu of" feature cannot be lightly put aside. The *same* Virginia tax had been before the court in 1954[48] and at that time was held unconstitutional. The only differences between the tax in 1954 and in 1959, when it was held to be valid, were that in 1954 it was called a license tax for the privilege of engaging in business in the state and was *in addition to* the state property tax; in 1959 it was called a franchise tax and was *in lieu of* the property tax. The measure of the tax, *i.e.*, 2.15% of apportioned gross receipts, was exactly the same.

Taken at face value, the constitutionality of the 1959 Virginia tax turned on the fact that it was in lieu of the state property tax; therefore, it would not be precedent for sustaining an apportioned gross income tax in Indiana. But if the "in lieu of" feature was the expedient which the court needed to sustain this tax without overruling the previous REA decision and if, in fact, the court was actually sustaining an apportioned tax on gross receipts including receipts from interstate sales, perhaps a similar apportioned gross income tax in Indiana would be constitutional.

Two other cases bear mention in this discussion. In *Central Greyhound Lines, Inc. v. Mealey,*[49] while holding unconstitutional an unapportioned tax on gross receipts from transportation beginning and ending in one state but passing through two others, the United States Supreme Court said that such a tax, even though imposed directly on gross receipts from interstate commerce, would be constitutional if properly apportioned to prevent the commerce from being subject to a multiple tax burden.

And in *Interstate Oil Pipeline v. Stone,*[50] the court upheld a Mississippi tax on gross receipts derived from the transportation of oil within the state but intended for shipment in interstate commerce. All the members of the court conceded that receipts from interstate commerce were being taxed, but, said the four who joined in the majority opinion, "The statute is not invalidated by the commerce clause . . . merely because . . . it imposes a 'direct' tax on the 'privilege' of engaging in interstate commerce."[51] They were satisfied that the tax was constitutional since no other state could tax the same income, even though the tax was laid directly on interstate commerce. A fifth justice concurred on the ground that only a local activity was being taxed.[52]

To date, the cases which have or would have sustained apportioned gross receipts taxes have been in the area of transportation. But the same reasoning

47 *Id.* at 447.
48 Railway Express Agency, Inc. v. Virginia, 347 U.S. 359 (1954).
49 334 U.S. 653 (1948).
50 337 U.S. 662 (1949).
51 *Id.* at 666.
52 Unfortunately, this case will not serve as precedent in future gross receipts tax cases because a majority of the court did not agree on the principles of law involved. For the effect of decisions by an equally divided court, see, United States v. Pink, 315 U.S. 203, 216 (1942) and Hertz v. Woodman, 218 U.S. 205, 213-14 (1910).

should apply to the receipts of a multistate manufacturing or merchandising enterprise. In line with the court's frequent statements that interstate commerce should pay its way, the trend of the decisions seems to be toward allowing states to use gross receipts as well as net income as a measure of value.[53]

Combination Net and Gross Income Tax

What might be the judicial fate of the dual net and gross income structure as adopted by the 93rd General Assembly if its constitutionality is challenged? As previously described,[54] Indiana now has two entirely different corporate taxes — a gross income tax applying to intrastate businesses and a net income tax applying chiefly to interstate businesses.[55] The Legislature's reasons for adopting this hybrid tax structure were discussed earlier. Briefly, shifting entirely to a corporate net income tax is extremely unpopular politically, and an apportioned gross income tax is still subject to much constitutional uncertainty.

Leaving aside the problem of the economic "unneutrality" to which corporations and other businesses are now subject in Indiana,[56] the question to be answered is whether a state may single out interstate commerce and impose on it a tax different from that to which local business is subject. The answer is probably "yes" as long as the tax does not discriminate against the interstate commerce. A concise definition of what constitutes "discrimination" against interstate commerce is not easy to find. Certain taxes have been struck down as being discriminatory on their face.[57] Others have failed because they imposed a heavier burden on out-of-state than on local business.[58] The court has looked with particular disfavor on fixed license fees on solicitors, since the out-of-state traveling

53 For example, in the 1954 Railway Express case, *supra* note 48, the court had this to say about gross receipts as a measure of value:

> But we have declined to regard mere gross receipts as a sound measure of going-concern value in a practical world of commerce, where values depend on profitableness of a business, not merely its volume (at 367).

By 1959, when it reconsidered Virginia's tax, *supra* note 44, the court had changed its mind to this extent:

> While it may be true that gross receipts are not the best measure (of going-concern value), it is too late now to question its constitutionality (at 441).

The change in attitude becomes even more graphic when the statement in the later Railway Express case is compared with the court's earlier dissatisfaction with gross receipts taxes expressed in the U.S. Glue case, *supra* note 22:

> . . . (a tax on gross receipts) may be sufficient to make the difference between profit and loss, or to so diminish the profit as to impede or discourage the conduct of the commerce (at 329).

54 See text at notes 12, 13 and 14, *supra*.

55 No other state has this kind of twofold income tax structure. As pointed out in note 17, *supra*, four of the states imposing a corporate net income tax call it by a different name as it applies to interstate business, but local and interstate corporations are taxed alike.

56 Indiana now taxes local unincorporated businesses on net income, interstate corporations on apportioned net income and intrastate corporations on gross income. This unneutral economic treatment is almost certain to generate intense pressures for further changes in the state's tax structure at the next session of the General Assembly.

57 *E.g.*, Webber v. Virginia, 103 U.S. 344 (1880) — a county license tax on agents selling goods manufactured in other states, from which resident manufacturers selling goods produced in the state were exempt; Guy v. Baltimore, 100 U.S. 434 (1879) — a city wharfage fee levied only on products from states other than Maryland; and Welton v. Missouri, 91 U.S. 275 (1875) — a state tax on peddlers selling wares not manufactured in that state.

58 Memphis Steam Laundry Cleaner, Inc. v. Stone, 342 U.S. 389 (1952).

seller might be subject to a new fee each time he moved, while the local merchant need pay only once.[59]

But a tax on interstate commerce *different* from that imposed on local business is not, in itself, enough to constitute discrimination. In *Interstate Busses Corp. v. Blodgett,*[60] Connecticut levied a tax of one cent per mile traveled by each motor vehicle used in interstate commerce. Intrastate motor bus transportation companies paid no mileage tax but instead a tax of 3% of gross receipts. Both intrastate and interstate companies paid property, license and gasoline taxes. The court said:

> To gain the relief for which it prays appellant (Interstate Busses Corporation) is under the necessity of showing that in actual practice the tax of which it complains falls with disproportionate economic weight on it.[61]

And in *West Publishing Co. v. McColgan,*[62] a challenge of California's net income tax on interstate corporations, the California Supreme Court said:

> It is settled that a tax does not discriminate against interstate commerce if other related taxes impose equal burdens on local commerce.[63]

Under the Indiana income tax statutes, all corporations[64] which derive income from sources in the state must, in effect, compute both their gross and their net income tax liability and pay whichever is higher. This means that although some interstate corporations will now be paying taxes to the state of Indiana which they may never have done before, nevertheless, all local corporations will be subject to an equal, or greater tax burden. Discrimination would not seem to exist in such a situation. Local commerce will pay a different tax, but one equally or more burdensome than that paid by interstate commerce.

But even assuming a tax on interstate commerce is nondiscriminatory it may still be unconstitutional if levied on the privilege of engaging in interstate commerce.[65] Indiana's new corporate adjusted gross income tax is not denominated a franchise or privilege tax and appears to be simply a tax on adjusted gross income.[66] Might it be argued, however, that since it will apply only to corporations operating in interstate commerce it amounts, in effect, to a tax upon the privilege of engaging in such commerce? Perhaps some support for such an argument can be found in the methods available to the state for collecting the tax.

Numerous cases have said that if payment of a tax is made a condition precedent to engaging in interstate business in the state, the tax becomes a forbidden privilege tax.[67] Even as late as the *Northwestern* case, the court, in de-

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59 Nippert v. City of Richmond, 327 U.S. 416 (1946); Best & Company, Inc. v. Maxwell, 311 U.S. 454 (1940).

60 276 U.S. 245 (1928).

61 *Id.* at 251.

62 27 Cal.2d 705, 166 P.2d 861 (1949), *aff'd.* 328 U.S. 823 (1946).

63 *Id.* at 710, 166 P.2d at 864. See also Gregg Dyeing Co. v. Query, 286 U.S. 472 (1932).

64 Except those corporations with ten or fewer stockholders all of whom are residents of Indiana and who have elected to be taxed as partnerships for federal income tax purposes. IND. STAT. ANN. § 64-3249 (Burns 1963 Special Supp.) exempts such corporations from liability for either gross or adjusted gross income taxes.

65 See text at notes 16 and 17, *supra.*

66 IND. STAT. ANN. § 64-3218 (Burns 1963 Special Supp.).

67 St. Louis Southwestern Ry. Co. v. Arkansas, 235 U.S. 350 (1914); Western Union Telegraph Co. v. Kansas, 216 U.S. 1 (1910).

ciding whether the tax on interstate business was a privilege tax, gave weight to the fact that Minnesota was left to collect the tax only through an ordinary debt action.[68] The collection provisions in the Indiana adjusted gross income tax statute are somewhat different from Minnesota's. In the main, they are the same as those found in the gross income tax act. In addition to giving the state the right to collect the tax in a debt action, the statute provides that:

> Any taxpayer against whom a tax shall be assessed as herein provided *shall be restrained and enjoined* upon the order of the department (of Revenue) . . . from engaging or continuing in business until the taxes shall have been paid.[69] (Emphasis supplied.)

Provision is also made for the appointment of a receiver.[70] Thus the state is given the right to prevent business from being done until the tax is paid. This collection provision would, at the very least, aid an argument that this is a tax on the privilege of engaging in interstate commerce. On the other hand, the adjusted gross income tax act contains a severability clause.[71] Perhaps a court, even if unsympathetic to the tax, would hold that only the injunction and receivership provisions of the statute are invalid, leaving the state to an ordinary debt action in order to collect the tax.[72]

On balance, the combination of net and gross income taxes as adopted by the last General Assembly would not appear to present serious constitutional problems, if challenged under the commerce clause.

CONCLUSION

Although the 93rd General Assembly considered and dealt with the problem of taxing interstate business, the 94th General Assembly may well have to face the problem again in 1965. It is certainly possible that the adjusted gross income tax act may be held unconstitutional in its entirety before next January. If it is, the state will revert to the gross income tax[73] at the increased rates mentioned earlier,[74] leaving interstate commerce again exempt from the state income tax. Even if the adjusted gross income tax act is upheld, or is not challenged, there will undoubtedly be pressures in the next General Assembly to modify the tax if not actually to repeal it. At such time the alternative taxes treated in this article would almost certainly come under careful study. But whatever the specific means whereby interstate commerce is taxed, it appears certain that from now on such commerce will pay its way in Indiana.

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68 Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 462 (1959). The collection provisions of Minnesota's income tax law are found in MINN. STAT. ANN. § 290.48 (1962).

69 IND. STAT. ANN. § 64-3237 (c) (Burns 1963 Special Supp.).

70 *Id.* § 64-3237 (d).

71 Ind. Acts of 1963, Ch. 32, § 705 (Special Session).

72 See St. Louis Southwestern Ry. Co. v. Arkansas, 235 U.S. 350 (1914) where the statute provided that the certificate to engage in business could be cancelled for failure to pay a license tax. The court observed that this forfeiture of the right to do business for failure to pay the tax could be construed as an unconstitutional effort by a state to regulate interstate commerce. But in this case, the tax was upheld, since the state was attempting to collect the tax only by means of an ordinary debt action.

73 The 1963 Legislature did *not* repeal the gross income tax. Corporations remain subject to it, and individuals will be subject to it should the adjusted gross income tax act be held invalid. IND. STAT. ANN. § 64-3249 (Burns 1963 Special Supp.).

74 *Supra* note 1.