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## TAXATION - JURISDICTION OF A STATE TO TAX PERSONAL INCOMES

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TAXATION — JURISDICTION OF A STATE TO TAX PERSONAL INCOMES — There have been comparatively few decisions of the United States Supreme Court involving questions of the jurisdiction of a state to impose income taxes, so that each case that has been reported has called for an adjustment of the earlier statements of the law in that field. Such a case was recently decided.<sup>1</sup> It is the purpose of this comment to consider the earlier cases in the light of that decision, and to determine what proportion of the income of a resident, and of a non-resident, a state may tax.

<sup>1</sup> *Cohn v. Graves*, (U. S. 1937) 57 S. Ct. 466.

The first of the United States Supreme Court cases of present importance was *Shaffer v. Carter*.<sup>2</sup> In it the Court held that Oklahoma could tax that part of the income of a non-resident which was derived from oil lands owned and operated within its boundaries. The argument of the taxpayer that an income tax is in its nature a personal tax, and therefore dependent on jurisdiction over the person, was rejected as an attempt to make the power depend on mere definitions. It is difficult to see what substantial basis there would have been for the other conclusion. As a matter of theory, it is not clear that an income tax is in its nature personal, and an analysis of the decisions has generally led to the conclusion that it is neither a personal, property, nor an excise tax, but is a unique kind or method of taxation.<sup>3</sup> Apparently realizing the difficulties of classifying the tax, the taxpayer argued that the money constituting the income was never in Oklahoma, but was realized as the result of his management and sales conducted outside that state. In this way, the possible argument that the tax was on the income as property was challenged, but the Court again avoided becoming involved in the theory of the tax and merely suggested that there might be a question whether the value of the taxpayer's services rendered outside the state should be allowed as an expense of producing the income.

On the same day the Court gave its decision in *Travis v. Yale & Towne Mfg. Co.*<sup>4</sup> There it considered settled by its other decision that a state could tax that part of the income of a non-resident derived from his employment in the taxing state and could enforce payment of the tax by requiring the employer to deduct it from the wages payable to the non-resident. However, it was held that provisions allowing certain exemptions to residents, while granting no equivalent exemption to non-residents, violated section 2 of Article IV of the Constitution by abridging the privileges and immunities of citizens of other states.

These cases were soon followed by the case of *Maguire v. Trefry*,<sup>5</sup> where it was held that a state may tax the income received by one of

<sup>2</sup> 252 U. S. 37, 40 S. Ct. 221 (1920), noted in 29 YALE L. J. 799 (1920); 20 COL. L. REV. 457 (1920).

<sup>3</sup> The common approach in classifying the income tax is to compare the law of personal property and excise taxes to the law of the income tax, so far as it is developed, and thus show that the latter is a different *kind* of tax from the others. Brown, "The Nature of the Income Tax," 17 MINN. L. REV. 127 (1933); 4 COOLEY, TAXATION, 4th ed., §§ 1743, 1745 (1924). But a new idea is suggested by Maguire, "Relief From Double Taxation of Personal Incomes," 32 YALE L. J. 757 at 760 (1923), where he suggests that the income tax is simply a new *method* of taxing the person, property, or right to engage in a particular activity.

<sup>4</sup> 252 U. S. 60, 40 S. Ct. 228 (1920).

<sup>5</sup> 253 U. S. 12, 40 S. Ct. 417. (1920).

its residents as the beneficiary of a trust of intangibles, created and administered in another state.<sup>6</sup>

It was a number of years before another case involving a state tax on personal incomes came before the Court, and in the meantime the tests of jurisdiction to tax had been undergoing substantial changes in the fields of property and inheritance taxation.

Fundamentally, jurisdiction to tax is determined by an application of the conflict of laws test of jurisdiction; that is, the taxing power is limited by the territorial bounds of the state and depends on its power to enforce its laws by action in personam or in rem within those bounds.<sup>7</sup> For a number of years the Supreme Court has held that this test is included in the constitutional limitation of the due process clause of the Fourteenth Amendment.<sup>8</sup> But the due process clause, as applied to the power of a state to tax, has been held also to include certain other elements. The first of these to appear was the requirement that the imposition of the tax be reasonable, reasonableness depending on whether or not the state was in a position to benefit the subject taxed.<sup>9</sup> More recently the Court, in the field of inheritance taxation, restricted the simple benefit theory with a prohibition of multiple taxation.<sup>10</sup> The expressions of the Court were framed rather broadly,<sup>11</sup> and the application of the principle was extended.<sup>12</sup> Consequently, a number of writers looked for the application of the restricted theory of jurisdiction to tax in the field of property and income taxes also, although the new concept had been developed in a series of cases involving inheritance taxes.<sup>13</sup>

<sup>6</sup> But the taxpayers equitable interest may not be taxed by the state of his residence. *Safe Deposit & Trust Co. v. Virginia*, 280 U. S. 83, 50 S. Ct. 59 (1929).

<sup>7</sup> *St. Louis v. The Ferry Co.*, 11 Wall. (78 U. S.) 423 (1870).

<sup>8</sup> *Louisville & J. Ferry Co. v. Kentucky*, 188 U. S. 385, 23 S. Ct. 463 (1903).

<sup>9</sup> *Union Refrigerator Transit Co. v. Kentucky*, 199 U. S. 194, 26 S. Ct. 363 (1905).

<sup>10</sup> *Farmers' Loan & Trust Co. v. Minnesota*, 280 U. S. 204, 50 S. Ct. 98 (1930).

The term "multiple taxation" as used in this comment refers to taxation of the same legal interest by different states, and "double taxation" taken to be confined to the cases where the same state imposes the taxes. The latter terminology is often used to refer to both situations.

<sup>11</sup> See *First National Bank v. Maine*, 284 U. S. 312 at 326, 52 S. Ct. 174 (1932).

<sup>12</sup> The cases are discussed generally in the following articles, Merrill, "Jurisdiction To Tax—Another Word," 44 *YALE L. J.* 582 (1935), citing the leading articles published prior to that time in note 2; Brown, "Multiple Taxation By The States—What is Left of It?" 48 *HARV. L. REV.* 407 (1935).

<sup>13</sup> Rottschaefter, "State Jurisdiction of Income for Tax Purposes," 44 *HARV. L. REV.* 1075 (1931); HARDING, *DOUBLE TAXATION OF PROPERTY AND INCOME* 138 (1933), criticized on practical grounds by Leland, "Harding on Double Taxation," 24 *CAL. L. REV.* 379 (1936).

Then came another case involving a state income tax, *Lawrence v. State Tax Commission*.<sup>14</sup> The decision was evidently such a surprise to many of the writers on tax law that either they sought to discredit it, or they ignored it in their forecasts of the probable development of the law concerning jurisdiction to tax incomes. The Court held in that situation that a state might tax the income of a resident although earned in a business conducted outside the state. This was some indication that the Court was not ready to strike out the possibility of multiple taxation on incomes.

Early this year the imposition of an income tax by the state of New York on the profits derived from the sale of a fractional membership right arising from the ownership of a "seat" on the New York Stock Exchange was sustained against a non-resident in *Whitney v. Graves*.<sup>15</sup> The interesting feature of the opinion is that it is based wholly on decisions applicable to the taxation of intangible property. The Court found that the primary characteristic of the taxpayer's membership, that is, that it could be enjoyed only at the Exchange, so localized the membership in New York that it was within the taxing power of that state, which as a result could tax the profits derived from the sale. It seems, then, that the Court is using the rules as to "business situs"<sup>16</sup> of intangible interests to determine the right of a state to tax the income derived from such intangibles.

The most recent case, and the one which calls for a reconsideration of the whole problem, is that of *Cohn v. Graves*.<sup>17</sup> The taxpayer, a resident of New York, was the owner of an interest in real estate located in New Jersey from which she received rents as part of her income. Having paid a tax on her entire income to the state of New York, she sought a refund for that portion attributable to these rents. The denial of her application was finally sustained by the Supreme Court. The only reference in the majority opinion to the problem of multiple taxation was in this passage:<sup>18</sup>

"The imposition of these different taxes [referring to a tax on land and a tax on the income from that land] by the same or different states, upon these distinct and separable taxable interests, is not subject to the objection of double taxation, which has been successfully urged in those cases where two or more states have laid the same tax upon the same property interest in intangibles or upon its transfer at death."

<sup>14</sup> 286 U. S. 276, 52 S. Ct. 556 (1932), noted in 42 YALE L. J. 283 (1932).

<sup>15</sup> (U. S. 1937) 57 S. Ct. 237, noted in 50 HARV. L. REV. 704 (1937).

<sup>16</sup> See *Wheeling Steel Corp. v. Fox*, 298 U. S. 193, 56 S. Ct. 773 (1936), and Powell, "The Business Situs of Credits," 28 W. VA. L. Q. 89 (1922).

<sup>17</sup> (U. S. 1937) 57 S. Ct. 466.

<sup>18</sup> *Ibid.* at 468.

It is obvious that the "double taxation" which the Court has in mind here is a tax on the land by one state and on the income from the same land by the same, or another, state. But the other possibility, that of a tax on the same income by two states, was presented in the briefs.

It has been suggested that the reason the Supreme Court has never expressed itself on the problem of multiple taxation in regard to income taxes is that the problem has never been presented.<sup>19</sup> As in all the earlier cases, it was true in this case that there was in fact no income tax imposed in more than one state, whereas in the inheritance tax cases two states had actually sought to tax the same transfer. At least, the Court has never said either that multiple taxation of income is objectionable, or that it is not. While the law would not be made to depend on the facts of the particular case, it might be that the increase in the use of an income tax by the states which will finally present the question for an express "yes or no" answer, will also give a reasonably adequate picture of how the multiple taxation of income will operate in fact; and if the Court is not pleased with that picture, it may attempt to point out any lack of reasonableness by the use of the Fourteenth Amendment.

An even more plausible contention of those who still feel that the prohibition against multiple taxation will be extended to income tax cases is that *Shaffer v. Carter*,<sup>20</sup> which was decided before that doctrine developed, will be overruled if the question is again presented to the Court.<sup>21</sup> But the decision in *Whitney v. Graves*<sup>22</sup> would indicate otherwise. In the present state of the law it would seem that the prohibition of multiple taxation will not be extended to income taxes, and of course it is possible that the ground is prepared for a retreat from the advance already made in the field of inheritance taxation.

The principal line of discussion in *Cohn v. Graves*<sup>23</sup> was drawn by the argument based on the propositions, first, that a state cannot tax real property beyond its bounds, and, second, that a tax of income derived from real property is a tax on the property itself. Therefore, it was argued, a state cannot tax the income derived from real property that lies beyond its bounds.

It is certainly settled that although a state has jurisdiction over a person it cannot tax his real estate that is located in another state.<sup>24</sup>

<sup>19</sup> Rodell, "A Primer of Interstate Taxation," 44 YALE L. J. 1166 at 1176 (1935).

<sup>20</sup> 252 U. S. 37, 40 S. Ct. 221 (1920).

<sup>21</sup> See the note to *Cohn v. Graves* in 85 UNIV. PA. L. REV. 645 (1937).

<sup>22</sup> 299 U. S. 366, 57 S. Ct. 237 (1937).

<sup>23</sup> (U. S. 1937) 57 S. Ct. 466.

<sup>24</sup> In fact, such taxation has apparently never been attempted, so that there is no direct authority for the proposition, which has always been assumed to be correct. 2 COOLEY, TAXATION, 4th ed., § 447 (1924).

This is a simple rule, since the tax is ruled out both by our conflict of laws concept of jurisdiction and the benefit theory of taxation.

Then we want to know whether a tax on the income from land is a tax on the land. *Pollock v. Farmers' Loan & Trust Co.*<sup>25</sup> is advanced as the fundamental authority for the proposition that it is. Though that case decided only that a federal income tax as applied to the rents from real estate was a "direct tax" and therefore invalid, since not apportioned as required by the Constitution,<sup>26</sup> there was language in the opinion which indicated that a tax on the income from land was a tax on the land, and several state court decisions so construed the opinion.<sup>27</sup> Later expressions of the Court threw doubt on that proposition.<sup>28</sup> In *Cohn v. Graves*<sup>29</sup> it is definitely recognized that all that was decided in the earlier case was that "for purposes of apportionment there were similarities in the operation of the two kinds of tax which made it appropriate to classify both as direct, and within the constitutional command." So the decision in the recent case is also notable because it finally denies these implications of the opinion in the *Pollock* case as to the nature of the income tax on income derived from property.

There is greater difficulty in distinguishing *Cohn v. Graves*<sup>30</sup> from *Senior v. Braden*.<sup>31</sup> The facts resulting in the latter case were these. An Ohio statute provided that equitable interests in land, and rents and royalties from land, divided into shares evidenced by transferable certificates, should be taxed and that the tax should be measured by their income yield. The plaintiff was the owner of such interest, the subject matter of the trusts including lands located outside the state of Ohio. Counsel admitted that if the tax was one on land, or an interest in land, outside the state it was invalid. The Court, confining itself to the determination of that question, found that the interest taxed was an interest in land.<sup>32</sup> So the distinction is simply

<sup>25</sup> 157 U. S. 429, 15 S. Ct. 673; 158 U. S. 601, 15 S. Ct. 912 (1895).

<sup>26</sup> Art. I, § 9, cl. 4 and Art. I, § 2.

<sup>27</sup> Opinion of the Justices, 84 N. H. 559 at 573, 149 A. 321 (1930); *Pierson v. Lynch*, 237 App. Div. 763, 263 N. Y. S. 259 (1933), *affd.* in 263 N. Y. 533, 189 N. E. 684 (1933), certiorari dismissed because no federal question presented, 293 U. S. 52, 55 S. Ct. 16 (1934).

<sup>28</sup> *Union Refrigerator Transit Co. v. Kentucky*, 199 U. S. 194 at 204, 26 S. Ct. 36 (1905); *Brushaber v. Union Pac. R. R.*, 240 U. S. 1 at 16, 36 S. Ct. 236 (1916).

<sup>29</sup> (U. S. 1937) 57 S. Ct. 466 at 468.

<sup>30</sup> *Ibid.*

<sup>31</sup> 295 U. S. 422, 55 S. Ct. 800 (1935).

<sup>32</sup> In distinguishing *Maguire v. Trefry*, 253 U. S. 12, 40 S. Ct. 417 (1920), the opinion of the Court seemed to discredit that decision, and so strengthened the belief that the prohibition of multiple taxation was to be extended to this field. That case is cited with approval, however, in *Cohn v. Graves*, (U. S. 1937) 57 S. Ct. 466.

between a tax on land, but measured by the income it produces, which is invalid, and a tax on the income derived from land, which will be sustained. This seems to be only a verbal distinction, and the fault probably lies in *Senior v. Braden*,<sup>33</sup> which has been severely criticized.<sup>34</sup>

While, as indicated, it cannot be ascertained that the assumptions here made are correct, the jurisdiction to tax income apparently depends on control over the person receiving it, or the property or act producing it. No limitation on the possibility of multiple taxation has yet arisen, and although the Court has reconciled taxation of incomes with the benefit theory, it has not yet used that test as a restriction on the right to tax incomes. The state of residence is thus able to reach all the income of its resident wherever it is derived, while the state where the property is located or which permits certain acts to be done within its bounds may tax the income produced from that property or those acts.

Thus, both the state of residence<sup>35</sup> and the state where the realty is located<sup>36</sup> may tax the income derived from it. Probably this is true also of tangible personal property, although the question has not been presented. The jurisdiction to tax the income of intangibles is apparently settled so far as the state of residence is concerned,<sup>37</sup> but questions are bound to arise as to what other states, if any, may tax such income. If the intangibles have a "business situs" in another state it can reach the income.<sup>38</sup> But there have been no decisions as to the taxability of income from simple debts at the domicile of the debtor, or of speciality debts at the place where the instrument is located, or of shares of stock at the state of incorporation. The approach of the Court in *Whitney v. Graves*,<sup>39</sup> however, indicates that the power of a state other than that of residence to tax the income from property will depend on the taxable "situs" of that property; that is, it will only extend to income derived from property which is within the taxing jurisdiction of that state.<sup>40</sup> The income derived from services per-

<sup>33</sup> 295 U. S. 422, 55 S. Ct. 800 (1935).

<sup>34</sup> 35 COL. L. REV. 1151 (1935); 46 YALE L. J. 148 (1936); and see 49 HARV. L. REV. 159 (1935).

<sup>35</sup> *Cohn v. Graves*, (U. S. 1937) 57 S. Ct. 466.

<sup>36</sup> *Shaffer v. Carter*, 252 U. S. 37, 40 S. Ct. 221 (1920).

<sup>37</sup> *Maguire v. Trefry*, 253 U. S. 12, 40 S. Ct. 417 (1920).

<sup>38</sup> *Whitney v. Graves*, 299 U. S. 366, 57 S. Ct. 237 (1937).

<sup>39</sup> *Ibid.*

<sup>40</sup> We might hope to find some indication of the answer to these particular questions in the decisions concerning the federal jurisdiction to tax incomes, although it is recognized that the federal government is not subject to some of the limitations that restrict the taxing power of the states, so that the cases upholding a federal tax have not been considered precedents in the field of state taxation. *Burnett v. Brooks*, 288 U. S. 378, 53 S. Ct. 457 (1933). On the basis of his residence in this country, the



formed in another state is taxable by the state of residence<sup>41</sup> and probably in the state where such services are performed.<sup>42</sup>

In many of these cases it becomes apparent that states other than that of residence will have some difficulty in showing what portion of the income of a non-resident may be attributed to property or activity in those states.<sup>43</sup> The Court would have similar problems if it ever began to limit the right of a state to tax in order to prevent multiple taxation and was called upon to choose the state that was entitled to impose the tax on a particular item of income, since income is the result in many cases of a combination of activity and property extending over a broad territory.

The doctrines that have arisen in other fields of taxation seem to arise from the necessity of protecting the taxpayer from the results of competitive taxation and the failure of legislative efforts to do so. Certainly they are not firmly founded on consistent legal or economic theories. Suggestions for reciprocal legislative control of state income taxation in order to prevent multiple taxation have been made, and it is to be hoped that some constructive developments will result in that direction.<sup>44</sup>

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federal tax may reach the income of any individual without regard to its source. *Bowring v. Bowers*, (C. C. A. 2d, 1928) 24 F. (2d) 918. The jurisdiction of the federal government to tax the income of a non-resident citizen, without regard to its source, has been sustained. *Cook v. Tait*, 265 U. S. 47, 44 S. Ct. 144 (1924). This basis of jurisdiction would not seem to be applicable to the individual states, since our conception of state citizenship is synonymous with residence. It is said that the federal tax will reach all income derived from local sources. For example, a tax on the income to a non-resident alien from stocks, bonds and mortgages, held in this country by an agent, and deriving their value from local sources, has been upheld. *De Ganay v. Lederer*, 250 U. S. 376, 39 S. Ct. 524 (1919); a tax on the dividends from a foreign corporation, more than 50% of whose gross income was derived from sources within the United States, was sustained against non-resident aliens. *Lord Forbes v. Commr.*, 25 B. T. A. 154 (1932); a tax on the interest from bonds of domestic corporations held abroad by non-resident aliens was sustained in *Railroad Co. v. Collector*, 100 U. S. 595 (1879), but see *Domenech v. United Porto Rican Sugar Co.*, (C. C. A. 1st, 1932) 62 F. (2d) 552, denying the authority of Porto Rico to levy a similar tax.

<sup>41</sup> *Lawrence v. State Tax Commission*, 286 U. S. 276, 52 S. Ct. 556 (1932).

<sup>42</sup> *Travis v. Yale & Towne Mfg. Co.*, 252 U. S. 60, 40 S. Ct. 228 (1920).

<sup>43</sup> Cases determining the validity of formulas for the allocation of corporation incomes among the several states in which they are doing business are *Underwood Typewriter Co. v. Chamberlain*, 254 U. S. 113, 41 S. Ct. 45 (1920); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U. S. 271, 45 S. Ct. 82 (1924); *Hans Rees' Sons, Inc. v. North Carolina*, 283 U. S. 123, 51 S. Ct. 385 (1931).

<sup>44</sup> Maguire, "Relief From Double Taxation of Personal Incomes," 32 *YALE L. J.* 757 (1923).